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From the Editor

Melbourne Cup looms, but interest rates are on hold this year

Another volatile month in the markets has seen the RBA opt to keep interest rates on hold this month at 4.75%. Many economists have tipped the Reserve Bank to now stay on the interest rate sidelines for at least a year, and if there is any movement at all it will be down (and then only if there is a sudden major shock to the economic outlook). Rates have been on hold since the Reserve Bank surprised borrowers with an increase on Melbourne Cup day last November.

This latest decision will certainly be welcomed by those with a mortgage as an increase in rates would have added unwelcome pressure. Households are becoming increasingly penny-conscious, as can be seen by the recent spike in savings. Each 0.25 per cent interest rate rise adds another \$60 to the monthly cost of an average Australian mortgage.

The global economy still struggles with the European debt crisis, but an injection of confidence this week saw the Australian market rise around 8%. I expect further volatility to remain for some time until there are definite long term plans to address the European situation.

This month we look at buying shares cheaply, and why somehow we manage to buy at the wrong time. We revisit dollar cost averaging and why contributing to your super fund now will pay big dividends in the future. We also have a very informative article on why Trauma Insurance is so important in any investor's portfolio. Why are we so underinsured in Australia? Find out in this article.

This time next month we will have another Melbourne cup winner join the hall of fame and bring some joy and even a few pennies to its owners. Let's hope we can say the same thing about the markets

Michael Phillips

Authorised Representative No: 242227

If you would like further information or would like to discuss your situation, please contact our office on Ph: 02 4332 8853 or Email michael@catsfp.com.au



Tips, Traps and Quotes

Shares will always be volatile. It's just when we buy them that matters.

Shares will always be volatile; sometimes it's because of supply, sometimes it's because of demand and sometimes it's just market sentiment.

While company share prices are not driven simply by supply, we seem to like them more when they are expensive rather than when they are cheap. The average investor has this weird habit of buying shares after a few years of rising prices – when they are expensive. These same investors then tend to become fearful of their shares losing value, and sell

them after their price has fallen – when they are cheap.

Whether the share market is in an 'expensive' or 'cheap' period, the companies making up the bulk of the value of the Australian share market index (the ASX 200) are essentially always the same. In the four months to 11 August 2011, the price of BHP Billiton shares reached a high of \$50 and a low of \$35, but the company itself was largely unchanged. You can't argue that at one point during those four months BHP was actually worth nearly 40% more than it is now. Part of the problem is that we sometimes equate 'price' to 'value.'

Share prices move as a result of many things other than intrinsic value, but if you are buying shares to hold long term, these short term elements are less relevant.

Shares are real (even if you can't eat them, see them or touch them) in that they represent a piece of a real business doing real things. Once you start to ignore all the hype, then the idea of buying them when they are cheap starts to make more sense.

Of course, individual companies can and do go broke. When that happens, the shareholders (owners of the company) lose all the value that they had invested in that company's shares.

Most superannuation funds reduce this risk by investing in a wide range of different companies. Even if one company does go broke, the overall impact to a well diversified share portfolio should not be too dramatic.

When we see market volatility like we have seen over the last few weeks, we are seeing the effect of events that drive changes in the short term value of the entire market. In that same four months to 11 August, the ASX 200 went from 4,976 to 3,765 – a movement of over 30%.

The downgrading of the USA's credit rating from AAA to AA+ should not on the face of it impact the value of companies in the Australian share market. But market sentiment – call it confidence or lack thereof – does change the price. The price changes because poor market confidence leads to people selling, and when there are more sellers than buyers, the price goes down. It doesn't necessarily change the fundamental value of those companies.

So when we see volatility in share prices the question we should be asking is: does this new price level reflect a fundamental shift in the value of these companies? Does it change the companies' ability to continue operating, provide services and products, employ people, and generate profits? If the answer is "No" then we have an opportunity to make a decision on buying, holding or selling based on the reality of the value of those shares rather than market sentiment.

Want to know more

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Words into Profits

Universal Principal – Dollar cost averaging

**Your big opportunity may be right where
you are now. – Napoleon Hill**

In this chaotic topsy-turvy world the idea of a big opportunity being right where we are may seem laughable for some. But in times of struggle there are always winners and losers. I'd like to introduce a favourite universal principal that can assist investors during this difficult time.

Dollar cost averaging is one of the most exciting concepts of investing. Professional investors and fund managers take advantage of this method and now you can too. So take

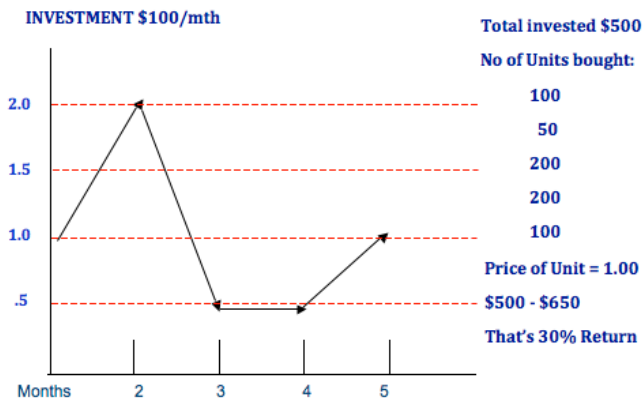
your time to read and understand this important concept.

Dollar cost averaging involves investing an amount of money in shares or units at regular intervals, eg monthly. The idea is that by making purchases during both falling and rising markets you will hopefully achieve a lower total average cost. Because the amount remains constant (eg, \$100 per month) you buy more shares or units when the price is low and fewer when the price is high.

Let's look at an example. Over the course of the next five months the unit price rises and falls, but you continue investing \$100 each month. When you begin, the units are \$1 each, so your \$100 buys 100 units in the first month. Let's say the price rises to \$2 per unit in the second month; your \$100 buys 50 units. In the third and fourth months the price falls to 50

cents per unit (this is a really volatile fund! Similar to the markets at the moment!) so your \$100 buys 200 units during those months. When the unit price is low you accumulate more units for your \$100. And when the units rise, all of your unit holdings bought at the lower price will benefit from the uplift. In the fifth month the unit price returns to its starting point of \$1 per unit, so once again your \$100 buys 100 units. The graph below shows us what this looks like.

Graph 5.2: Dollar Cost Averaging. Extremely volatile fund



So \$100 invested each month for five months:
 Month 1: \$100 invested @ 1.00 = 100 units
 Month 2: \$100 invested @ 2.00 = 50 units
 Month 3: \$100 invested @ 0.50 = 200 units
 Month 4: \$100 invested @ 0.50 = 200 units
 Month 5: \$100 invested @ 1.00 = 100 units
 Total investment was \$500
 Total units purchased = 650 units

Interesting points to consider at the end of five months:
 We have invested \$500 and now we have 650 \$1 units worth \$650. The performance of the fund itself from month 1 to month 5 is zero, because if you invested \$500 in month 1 and decided to cash in at month 5, you would have made zero capital gain.

Yet you have made \$150 (or 30%) on a fund that has recorded a zero return over five months. How is this possible?

The answer is the value in months three and four; the unit price was 50 cents. Your monthly investment of \$100 purchased 200 units during these months, which are now worth double the value, enough to make up for the units bought in Month 2 at \$2.

Many fund managers use this technique to invest in a stock. They 'drip' money into the market to average their cost, thus 'dollar cost averaging.' So, in falling markets you buy more shares or units for the same lump sums, and wait for them to rise again.

What is a recent example of this? Let's look at your superannuation.

Over the years that you hold your superannuation account you will experience some positive and some negative years. If you can see that your superannuation fund has had a negative return you may want to talk to your employer or superannuation fund provider about increasing your contributions during this time. This may seem counter-intuitive but can

make good financial sense: you may never get to buy units in your superannuation fund as cheaply as when the market is down.

Use these weak markets to add to your investments, not hide. We wish you every success.

Want to know more

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Wealth Protection

You, capital gains tax and estates

Relatively simple investment situations can often result in unexpectedly complex capital gains tax implications. The following scenario demonstrates not only the complexity which can arise (apologies if your eyes glaze over trying to make sense of this – you are not alone!) but also the importance of keeping accurate and up to date records.

This scenario also highlights a potential two year “grace period,” during which the sale of a property from a deceased estate may be exempt from Capital Gains Tax. This is always worth considering and investigating before

taking action, and may prompt you to sell sooner than you had thought.

Joseph and Maria

- Joseph and Maria were married in 1950 and had three adult children.
- They jointly owned their own home, which they bought in 1957. They lived in it continually until their deaths.
- They also jointly owned a residential unit, bought in 1982 as an investment property, providing them with income.
- They built up a portfolio of shares over the years, which had grown to a reasonable value by the time they died.
- Joseph died in December 2007.
- Maria died in July 2010.
- Joseph left everything he owned to Maria when he died.

- Maria's will left:
 - Their home to their adult son George, who had been living in it with his parents for some years;
 - The investment property to their adult daughter Danni;
 - The share portfolio to their adult daughter Christina.

The Capital Gains Tax (CGT) status of the assets, in the hands of the beneficiaries, is as follows:

The home:

When Joseph died in December 2007 his half share in their home passed to Maria, who continued to occupy the property until she died in July 2010. Their son George has continued to occupy it as his main residence since Maria's death. The home has always enjoyed, and continues to enjoy, the "main residence" exemption from capital gains tax.

When the property is transferred to George, he will take it with a cost base made up of:

- Half of its value in December 2007;
- Half of its value in July 2010.

If George continues to use the property as his main residence, it will remain CGT exempt.

The Investment property:

The investment property was acquired by Joseph and Maria prior to the introduction of the CGT legislation in September 1985, and was accordingly a CGT exempt asset while it remained in their hands.

When George died, his half share passed by virtue of the joint ownership to Maria. It lost its pre-CGT status and Maria acquired that half share at its value at that date. The other half share remained a pre-CGT asset in Maria's hands until her death.

When the property is transferred to Danni, she will take it with a cost base made up:

- Half of its value in December 2007;
- Half of its value in July 2010.

If Danni sells the unit within 2 years of Maria's death, any capital gain on the half share which Maria owned in her own right since 1982 will be disregarded. This applies even though it was not her main residence – where a “dwelling” was acquired pre-CGT, the two year exemption applies regardless. If Danni sells after this two year period, the exemption does not apply – this half share would then be subject to tax on any gain in value since July 2010.

The other half share will be subject to capital gains tax in the usual way, on any gain in value between December 2007 and the date of sale.

It is important to get a valuation of the property soon after Maria's death, as well as

determining the value in December 2007. If a valuation was not sought at that time, you may be able to obtain a valuer's opinion of the value as at December 2007.

The Shares:

The portfolio of shares were acquired by Joseph, mainly in Maria's name (for tax purposes), over many years.

Some shares were acquired prior to the introduction of the CGT legislation. Gains made in respect of those shares are exempt from CGT up until Maria's death (ie they are acquired by the estate, and pass to Christina at their July 2010 values). If Christina sells the shares, any gains from July 2010 to the date of sale will attract CGT.

Some shares were acquired since the introduction of the CGT legislation. Gains made in respect of those shares will attract CGT from the date of purchase to the date of

sale of the shares (but not on the transfer to Christina; only when she sells them).

Some shares, which were bought in Joseph's name, were inherited by Maria from Joseph. To the extent that any of those shares were acquired by Joseph prior to the introduction of the CGT legislation, any gains become liable to CGT only from the date of Joseph's death. Shares bought by Joseph after the CGT legislation will attract CGT from the date of his purchase until the date of Christina's disposal (but again not on the transfer to Christina).

Note that Christina can offset capital gains realised by the sale of her shares against realised capital losses, however Maria and Joseph's capital losses which have not been used up prior to their deaths cannot be used).

The moral to the CGT story

Confused? You are not alone! Capital gains tax is complex and difficult to grasp. What is

important to grasp is the need to maintain complete and up to date records of all investments and their capital gains tax status and costs.

It can be a long and painstaking task to identify the shares that fit into each of the above categories and to establish a record of all cost bases, but it is one that has to be done. In a case like Joseph and Maria's, if left until after both parents have died, the task can be a mammoth exercise, as each shareholding and multiple transactions need to be traced back, often for decades. Often records are missing and need to be reconstructed, and the cost of doing so can run into the thousands of dollars, while also substantially delaying winding up an estate. It is far better to undertake this work while the investor is still alive.

Ideally of course, anybody holding shares should keep proper Capital Gains Tax cost base records on an ongoing basis. Many wrap accounts and broker sponsored holdings provide a facility for creating and maintaining

these records. Your investment adviser and accountant can assist to set up and maintain these records.

Similarly, keeping proper records of outlays on an investment property assists to establish the full cost base. Without that, the cost base may be calculated as lower than it needs to be, so that when it is eventually sold more tax is paid than necessary.

In a case like Joseph and Maria's, it is advisable to get a proper valuation of the investment property when the first of the couple dies, so that when it is needed the family have a reliable opinion from the appropriate time instead of the extra cost of a valuer's opinion years later.

Want to know more

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Wealth Protection

Trauma Cover – The jewel in the personal protection crown

The miracle insurance product - but only 3% of us have it

I often describe trauma cover (aka critical illness, crisis cover & recovery money) as the miracle product from cradle to grave, and yet its market penetration in Australia today is negligible – less than 3% of the population own trauma cover.

My mission is to motivate clients and advisers to want two things:-

- 1) To want as much trauma cover as they can reasonably afford
- 2) To want to own it for as long as possible.

Let's have a look at how these two objectives can be achieved:-

Q: "How many people buy personal protection products because they expect to claim?"

A: "None." People buy them "just in case."

Let's look at this in a new way. With the advent of trauma cover, people should be buying *because they expect to claim*.

A General Reinsurance Life Australia Ltd study (2007) showed that a 30 year old male in Australia had a 68% likelihood of suffering a "trauma" by the age of 70. By taking out trauma cover, he would be insuring against a *probability* not a *possibility*.

However, the likelihood of a claim is only half the story – what about the likelihood of recovery?

In 1990, (and how many medical advances have there been since then?), a large medical study carried out in the USA showed a 70% survival rate from cancer, heart attack and stroke. What would that have increased to by now?

Trauma cover is different from other forms of cover – you are more likely to claim the longer you have it, and you are also more likely to be around to benefit from it. In the world of insurance, this becomes an irresistible combination.

But the key is owning it for as long as possible. The tragedy of trauma cover in this country is that probably close to 90% of it is owned by people aged between 35 and 50. Very little trauma cover is owned prior to age 35 (therefore excluding the majority of car

accident victims) or over age 50 (excluding the majority of people who suffer cancer, heart attacks and strokes).

It is typically at the very time that the insured person is reaching the age where they are more at risk of cancer, heart attack or stroke that he or she has to give it away because it has become unaffordable.

A few years ago, I discovered that 25% of the working population in the UK owned trauma cover - this compared with 2.5% here in Australia! I also discovered that there is no such thing as a “stepped” premium in the UK, i.e. one that is guaranteed to increase every year because of your age. There is only a “level” premium in the UK - one that is guaranteed to stay the same all the way to age 65.

This was my “light bulb moment” – I suddenly realised: “Of course 25% of the working population in the UK own trauma cover, because all of the people who bought trauma

cover in their 30s and 40s have still got it in their 50s and 60s because they are still paying the same amount of money for it!”

The moral of this story is to always try and buy as much trauma cover as you can on a level premium, and if affordability is an issue, split your cover between stepped and level premiums (always remembering that the appropriate **level** of cover is the most important thing.

Also remember that stepped premiums can be converted in to level premiums at any time with no underwriting required.

Finally, a note on the “cradle to grave” aspect of Trauma Cover. It is a unique type of cover in that it legitimately targets any individual of any age, as the wide range of medical conditions covered tend to apply to varying degrees at different age points, as follows:-

AGE BAND	TARGETED TRAUMAS
0 - 18	Child related illnesses/injuries
18 - 25	Accident related injuries (paralysis, coma, major head trauma, Severe burns, loss of limbs – i.e car accidents
25 - 35	Accident related injuries (see above), cancer (females – breast cancer), Multiple Sclerosis (average age of diagnosis in Australia is 31), Motor Neurone Disease & Muscular Dystrophy
35 - 50	All traumas
50+	Lifestyle Diseases – cancer, heart attack & stroke

Want to know more

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Let's Talk Tax

Negative gearing – a great strategy, if you don't lose sight of the real objective

Negative gearing is one of the most common forms of tax planning in Australia. Yet, it is often poorly understood. Two very simple facts are often forgotten leaving people chasing red herrings.

Fact 1

Negative gearing does not only relate to property investment. Although it is probably the most common asset negatively geared, the strategy can also be applied to many asset classes. Remembering this should help keep the overall goal in perspective.

Fact 2

The purpose of negative gearing is to absorb annual revenue losses to realise a capital gain. Over the period of ownership, the total cash inflows from the asset (i.e. income plus capital proceeds on sale) must be greater than the outflows (i.e. initial purchase price plus expenses) for negative gearing to be effective. Admittedly, there are some specific elements of the tax law which affect the cash flows and should be considered.

I am strongly against any laws which distort the investment decision matrix, but we have plenty in Australia. Few are going to be removed in the near future so we need to work with them. Some, such as the capital gains tax exemption on a person's principal place of residence, are so ingrained in our culture that it may be politically impossible to ever remove them.

The two specific distortions which influence negative gearing strategies are;

- Capital gains are taxed concessional (generally they are 50% exempt from tax if the asset has been held for over 12 months), and
- Capital gains are added to all other assessable income in the year of assessment, then taxed at the marginal rate.

These rules encourage investors to incur revenue losses in years of high income, and capital gains in a year without significant other income.

Equity would be best served by quarantining revenue losses to be offset against future gains – revenue or capital – from the same asset. Yes, you read that right, I said ban negative gearing!

As an immediate effect it would reduce the speculative investment in residential property. A flat rate of capital gains tax would help too;

meaning that tax planning doesn't influence *when* investors sell property.

However, as I said, I don't think this will happen in the near future. So, negative gearing can be an excellent tax planning strategy as long as you always remember that an investment which loses money is always a bad investment; regardless of the tax laws.

Want to know more

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Your Feedback

YES, We Want To Hear from You!

We need your feedback in order for us to continue to improve our publication for you.

- We want to know how you liked it.
- We want to know what you want to know about.
- We want to know the topics you want.

Send us an email with your suggestion, testimonial or enhancement

Send all emails to:
michael@catsfp.com.au



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