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INSIDE

1 What's the outlook for the residential property market for the rest of the year?

4 7 Different ways of thinking about Volatility

6 Why would you use an Advance Care Directive?

7 Top 11 Family Trust Mistakes NOT to Make (Part 2 of 3)

What's the outlook for the residential property market for the rest of the year?

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by **CHRIS ANDREWS**

1. What's the outlook for the residential property market for the rest of the year?

We are thinking about the residential property market in two phases for the remainder of 2020.

The first phase is the hibernation phase. This is where we are today. Enforced social distancing and lockdown measures are the rule and the property market remains effectively closed. Transactions are limited and reports on property prices are based on sparse and unrepresentative data. Most people would be well-advised to ignore commentary on property prices through this period.

As the year progresses and continued progress is made in containing the coronavirus, social distancing measures will be eased and the economy will enter the rebound phase. At that point, the fundamentals of demand and supply will begin to re-assert themselves.

We see these two phases playing out as follows:

(a) First, the damage to the economy, incomes and investor sentiment will reduce demand for property. There have been multiple economic shocks in Australia's history and a typical house price response has been in the order of negative 10-15% on average;

(b) Longer-term outcomes depend on how extensive the damage is to the Australian economy and how quickly we return to more normal settings. Recent IMF projections see a 2020 GDP decline of 6.7% followed by a 6.1% increase in GDP in 2021. In our view that represents the "bull case". Our base case is that the first stages of the recovery will indeed be rapid as tens of thousands of businesses return to work, but that the recovery of pre-cornavirus peaks is likely to be the work of some years. It remains our view that economies cannot simply be switched 'on' and 'off', but will take some time to return to a new normal.

(c) Two key variables affecting house prices outcomes are migration and housing construction. Net overseas migration has been responsible for 57.5% of Australia's population growth this century and is accordingly a material demand-side component. In the short-term, migration is temporarily ceased during the hibernation phase of the coronavirus response and that is a substantial short to medium term headwind for house prices. However, a strong migration program will be critical to budgetary repair post coronavirus and goes hand in hand with our key educational export sector. Further, Australia's success (so far) in containing the coronavirus will certainly not damage our international reputation with potential migrants. So, in the medium term, migration is likely to again become a key house price tailwind.

Conversely, building approvals have plunged dramatically since mid-2017 and remain at very low levels. They will almost certainly remain at near-record-low levels during the hibernation phase and will take some time to build momentum in the rebound phase. When this is coupled with the normal lag time between approval, construction, and completion, the supply side is likely to be sticky in the recovery and further support house prices.

(d) It should always be remembered that there is no single property market. Each local area has its own drivers and economies and will react to the coronavirus episode differently. Amongst our cities, Sydney and Melbourne have the most diversified economies, attract most population growth and therefore tend to recover the fastest from economic shocks. Despite the fact that their household balance sheets are more stretched than other cities, we remain of the view that they are better equipped than most other cities to navigate the hibernation and rebound phases. Similarly, historical observations are that economic shocks tend to disproportionately affect the most expensive housing deciles, and sometimes the least expensive deciles as well. Typically, the middle deciles – the family homes of "middle Australia" tend to be more resilient.

" Overall, we remain of the view that **housing will be among the most resilient of asset classes** to the economic shock that Australia has and will experience as a result of the coronavirus.

Overall, we remain of the view that housing will be among the most resilient of asset classes to the economic shock that Australia has and will experience as a result of the coronavirus. That is, of course, because of housing's role as an essential consumption good, as well as an investment. No matter how bad the economic data, people do still need somewhere to live. We have positioned our portfolios with weighted average loan to value ratios around 63% and have high conviction that this presents a strong margin for safety against likely house price outcomes.

2. Is the risk moving forward higher unemployment and mortgages in arrears?

In the short term, Australia will undoubtedly see higher unemployment and borrowers who are unable to pay their mortgages as a result of the economic hibernation phase of the coronavirus. Most lenders, including La Trobe Financial, have already activated their pre-existing borrower hardship frameworks to assist borrowers through this phase. These frameworks typically allow borrowers to defer repayments for a few months until incomes normalise.

There are a number of reasons to believe that the impact of the hibernation phase on arrears will not be as dramatic as some are projecting.

As well as the flexibility of hardship arrangements, we note the following three factors:

(a) Nearly 40% of households have mortgage prepayments in the form of redraws and offsets of at least 12 months and the RBA's April Financial Stability Review assesses most households as being in good financial health. That is, many households are entering this period with substantial buffers;

(b) The unprecedented $130 billion JobKeeper package will provide 70% of the median income (and close to 100% of the median income in the industries most affected) and for many borrowers will support both living expenses and all or part of debt obligations through the hibernation phase; and

(c) Further flexibility is provided for borrowers in the form of their ability to access up to $20,000 from their superannuation funds to support their living expenses, including debt obligations, in this period.

Longer-term trends will, of course, depend on how quickly the economy rebounds and re- employs the labour force.

3. How will all of this affect small businesses and their loans?

Small business employs 44% of Australia's workforce and is in many cases a key driver of the dynamism and entrepreneurial spirit that, over times, transforms economies. It has long been a point of pride for La Trobe Financial that our approach makes capital available to this sector in a way that the mainstream banks have been unable to replicate.

In aggregate, small businesses tend to have lower buffers than larger businesses and for that reason are exposed to periods of income interruption. For that reason, it is appropriate that much of the Federal and State government stimulus packages are targeted chiefly at the SME sector. However, small businesses tend to be nimbler than their larger counterparts and are likely to experience the upswing of the rebound phase more rapidly.

In terms of asset performance, portfolios of business loans without real asset backing are likely to experience heightened stress through this period, although there is no doubt that the coordinated government responses will provide a material lifeline for many.

Where there is real asset collateral backing the loan, the SME borrowers will benefit from increased flexibility and, critically, time to rebuild and restructure their businesses as the Australian economy enters the road to recovery.

4. How will this impact La Trobe Financial?

La Trobe Financial remains open for business and 'on station' to assist our borrower and investor customers. Our commitment to the delivery of the highest standards of friendly, professional service remains unchanged.

At an investment level, our fundamental investment objective has always been to build portfolios that are resilient in times of economic difficulty. Our careful borrower selection and low loan to value ratios across all of our portfolios will be substantial buffers against heightened levels of borrower hardship. We also note that our pooled portfolios all benefit from Investor Reserves that smooth monthly income and permit our portfolios to weather substantially higher levels of non- payment amongst our borrowers for extended periods. Current internal modelling of our 12 Month Term Account, for example, indicates that our portfolios could withstand 25% non-payment rates (arrears and hardships) across the portfolio for an extended period without need to adjust the distribution rate. For these reasons, we have high conviction that our portfolios are well positioned to maintain performance throughout the coronavirus episode.

7 Different ways of thinking about Volatility

by **JACK STANDING**

As one of the top three retirement killers, it consistently surprises me how widely misunderstood and underestimated the impact of volatility is. The lack of understanding probably stems in some way from the issue that the people managing the money talk about volatility in terms like; standard deviations and return dispersion, and the people who are genuinely impacted by it have no real understanding of what these terms mean.

In the below, I will be focusing on the impact of volatility on the everyday investor. Said another way, the impact of someone's financial worth fluctuating up and down on a daily basis.

Here are my 7 insights on volatility:

1. Average Returns

First things first, in capital volatile markets, average returns do not exist.

When determining whether to make an investment we will need to make some assumptions on returns. In most forecasting models we must pick linear return assumptions that are chosen based on what we might think is a suitable long-term rate of return expectation (not guarantee!). The reason being that we simply cannot predict volatility with any level of accuracy.

> **Investors will commonly sell an asset that was made with a long-term investment timeframe** simply because it has underperformed in the short term.

The lower the volatility, the closer the average return will be to the actual (annualised) return.

2. Liquidity

We are told from an early age in investing that liquidity is good. Well I am here to tell you that it can be very bad. It is no coincidence that the places that people often make the most money are generally the least liquid, the family home and superannuation.

The flip side of the coin of liquidity is volatility, think about it as the evil twin. You don't get one without the other. Investments with no formal secondary market (e.g. annuities, term deposits) experience far less volatility than those with popular secondary markets (e.g. listed shares). If you increase liquidity, you increase volatility.

3. Bad Behaviour

Humans are inherently bad at making their own investment decisions. The reason that investment professionals exist is not necessarily because they know all about the investments, it's because it is easier to remove emotion from an investment decision when it is not your money.

Investors will commonly sell an asset that was made with a long-term investment timeframe simply because it has underperformed in the short term. Just think about anyone who sold CBA shares at some point during the GFC. Short term market shocks are not necessarily a softening of economic fundamentals.

When volatility is increased, bad investor behaviour becomes rife.

4. Bad Language

Volatility causes investors to use bad language, examples are:

- My super is doing 10% right now
- I made 15% last year

Firstly, unrealised gains are just that, unrealised. Until you take the money off the table, you have "made" nothing. The rises and falls in the apparent value of the investment are meaningless as they can reverse themselves at the drop of a hat.

Income (rent, dividends etc.) is real as it turns to cash in your bank account. Volatility comes in the form of capital growth/loss and is not real until it is realised.

5. Psychological Damage

Humans are emotional. We make emotional decisions. We feel loss and we feel grief. The impact on a 70-year-old opening up their share trading account to see a 10% drop in their share portfolio can be enormous. The anxiety and stress it can cause to someone who may rely on those investments to live cannot be marginalised. The more volatility in a portfolio, the more stress and the greater chance for psychological damage.

6. Money Flow

This is about the speed at which money can flow in and out of an investment. Something with low frictional costs of entry will experience (all else equal) greater volatility than those that don't.

Property for example, has stamp duty, legal fees, agency fees and so on, often slowing down the rate at which people trade it. Stocks on the other hand have evolved into a world where buy/sell spreads are often zero and low-cost online share trading platforms continue to speed up trading.

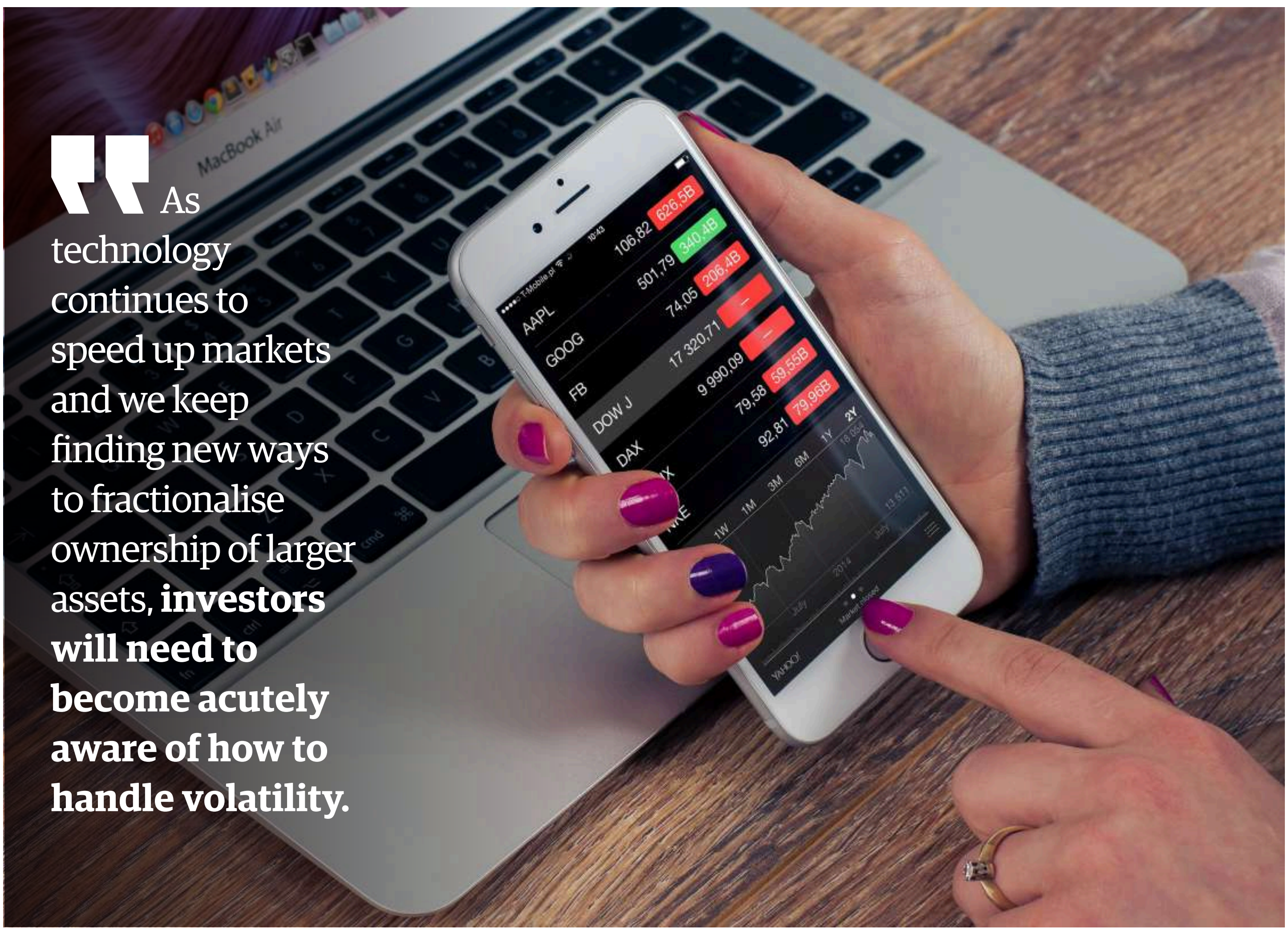
7. Capital Consumption

Often referred to as 'sequencing risk', the order of return sequence can be the deciding factor as to how long someone's money lasts. It is essentially the difference between the average return and the annualised (actual) return.

With the length of retirement time frames due to the increase in life expectancy, we are only getting more and more exposed to this phenomenon. Sequence does not matter to a portfolio receiving no contributions or no withdrawals. Unfortunately for us, most people are always either contributing, or drawing from, their super. Making sequencing vitally important.

Generally speaking, the greater the volatility, the faster your capital is consumed. Consider the retiree with $1m in super who spends $70k pa. In a year where his portfolio has dropped by 20%, he/she would have "consumed" $270k worth of capital in one year. To recover that the next year, after accounting for the $70k annual spend, that investor would need a 50% annual return to get back to square one.

As technology continues to speed up markets and we keep finding new ways to fractionalise ownership of larger assets, investors will need to become acutely aware of how to handle volatility. From what I can see, it doesn't look like the money managers of the world are going to do it for them.



Why would you use an Advance Care Directive?

Republished from Informedinvestor.com.au

by **JOHN GODFREY**

Enduring Guardianship is the legal form of appointment of a substitute decision-maker in areas concerning general health and lifestyle. An Advance Care Directive (ACD) which is sometimes referred to as a 'Living Will' is a different document. It should provide a clear statement on the wishes and values that need to be considered before medical treatment decisions are made on your behalf. Discussions around these issues are best done with people who are important to you and your doctor.

An ACD can be attached to an Enduring Guardianship appointment. Alternatively, An Enduring Guardian can be instructed by a separately written ACD. Having Advance Care Directive and Enduring Guardianship as separate forms provides greater flexibility to adjust your ACD as health conditions change without the need to execute a new Enduring Guardianship document.

There is no prescribed format or form for an ACD. It can be simply written down. Many are concerned that they should not be forced to linger on in old age or in states of physical suffering. There is the fear that they will lose control over prescribed medical treatment. Both an enduring guardianship and/or an advance care directive go some way in providing control.

In legal terms you own and control what happens to your body. If you are not in the position to decide at the time, then having a valid document that sets out what treatment you want to refuse to receive can be useful. You cannot instruct a clinician to perform a medical procedure, but you can refuse to have one that they want to carry out. If you are competent at the time, then you can personally issue those instructions. If not, then an advance care directive could have addressed the matter. A doctor must be aware that the directive exists for it to be effective.

Enduring guardianships and advance care directives are legal mechanisms that may join wills and powers of attorney as a routine subject in completing a financial plan. Legal advice is important as an invalid authority has no capacity to achieve the desired outcomes. It is advisable to ask your doctor to sign the directive to verify that you have capacity when you made it, and then you should sign it in front of an independent witness. This witness should also be 18 years of age or older.

It is advisable to discuss your ACD with your family, your health care providers and your friends so that they know your wishes and reasons for making those decisions. Give copies to everyone who may be involved in making healthcare decisions for you if you lose the capacity to do so yourself.

ACDs are legally binding under the Common Law and if there is evidence of a competent person's wishes, and if those wishes would apply to the current situation, then they must be honoured (provided they are not against the current law). No-one can overturn those wishes.

> **Enduring guardianships and advance care directives are legal mechanisms** that may join wills and powers of attorney as a routine subject in completing a financial plan.

Top 11 Family Trust Mistakes NOT to Make

WEALTH ADVISER SERIES:
Part 2 of 3

Mistakes #4 – Not factoring in land tax

A cost associated with owning property that is often missed by inexperienced investors is the fact that some properties may attract a land tax. This tax exists in all states and territories (except currently in the Northern Territory) and it has to be factored into decisions on family trusts as will be made clear below.

The rates and thresholds associated with land tax differ from state to state. For example, you can own up to $734,000 of land in NSW before the tax kicks in. In Queensland and Victoria, the threshold is $600,000 and $250,000 respectively. These thresholds are impacted very significantly when properties are placed inside a trust. In NSW you will be required to pay Land Tax at 1.6% on total value straight of the bat with no threshold applied (this will translate into $11,844 per year on $734,000 land value). This could obviously represent a significant dent in your bottom line. There are, once again, differences between the states.

In Victoria and Queensland, the threshold does not drop to zero, but it will still be significantly reduced once a property is placed in a trust (to $25,000 in Victoria and $350,000 in Queensland).

It could, in light of the above, be that the protection that you think you are gaining by placing assets in a trust could come at a significant cost (i.e. almost $12,000 dollar p.a. in the case of $734,000 land value in NSW). It is, therefore, once again important that you assess the numbers and weigh the pros and cons before fully committing yourself.

Mistake #5 – Not understanding the impact of losses on the trust

Losses, both in terms of revenue and capital, are 'caught' inside a trust and cannot be distributed. This means that they will be reflected in the statements of the trust. Such losses cannot be parcelled out and reflected in the tax statements of individuals associated with the trust.

Losses 'caught' in trusts can therefore not be offset against personal income and gains. This will pose a particular problem for those who rely on the tax benefits associated with negative gearing as they will not be able to claim the tax relief associated with losses on negatively geared properties inside trusts.

Placing negatively geared properties inside a family trust could therefore represent an extremely costly mistake.

Mistake #6 – Not fully familiarising yourself with the contents of the trust deed

None of us like nasty surprises and there can be few surprises quite as unpleasant as realising that what you thought were carefully worked out financial plans are not quite as watertight as you thought they were.

In the case of family trusts you can avoid this by making absolutely sure that you know exactly what is in the trust deed as this is ultimately the document that governs every aspect of your trust. We strongly recommend that you read the deeds of trusts that you are involved with (or are planning to become involved with) as carefully as possible. While doing so take careful note of things that are perhaps a bit too vague or that you do not fully understand.

This is one area where hoping for the best simply will not cut it. If your

> **We strongly recommend that you read the deeds of trusts** that you are involved with (or are planning to become involved with) as carefully as possible.

reading of the deed leaves you with questions or if you simply do not understand parts of the deed, seek out the help of your advisors.

Mistake #7 – Being unaware of penalty tax rates for underage children

Please do not set up a family trust if you think that you can use your children to give you some tax relief. This is because distributions to minors are taxed at an eye watering rate. Any income above $416 up to $1,307 distributed to a minor will be taxed at 68% (66% plus Medicare), with any amount above $1,307 tax at 45% (45% plus Medicare).

So, while it is certainly true that adult children will often benefit greatly from being named as a beneficiary of a family trust the same does not automatically hold true for minors. There are certainly many more tax efficient ways to help secure their financial futures than giving 47% - 68% to the taxman!