



**JUNE 2016**

## Investor Update June 2016

Welcome to the June Edition of Investors Update. In recent issues, we have highlighted proposed changes to superannuation and how they would affect investors. However changes to the age pension announced in the 2015 budget, largely escaped under the radar because they do not come into effect until 1 January 2017.

Whereas the proposed superannuation changes announced in the 2016 Budget still require passage through Parliament before they become law, the changes to the age pension are already legislated.

In this issue of Investors Update, we provide a summary of the changes to the aged pension and aged care fees.

We also look at realising capital losses for EOFY by Marcus Padley and Angel Clark and Russell Markham pose the question are stop losses for you?

### LETTER TO GOVERNMENT ON SUPERANNUATION CHANGES

Recent issues of Investors Update have provided updates on proposed changes to the superannuation system. Detailed analysis by Dr Ron Bewley, former Head of the School of Economics at the University of NSW, has analysed the assumptions underpinning the proposed changes, raising a number of questions.

The AIA has joined the SMSF Owners' Alliance, the Australian Shareholders' Association and the Small Independent Superannuation Funds Association in preparing a letter to the Prime Minister, Treasurer and Assistant Treasurer. The letter questions aspects of the proposed superannuation policy and requests further consideration of the consequences of the policy before they are passed into law. [Read letter](#)

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**Changes to Centrelink aged pension to take effect 1 January 2017****Jon Kalkman & Brian Spies**

In May 2015 the Government announced a number of changes to the age pension to take effect on 1 January 2017. The major changes are a higher threshold for the assets test and a steeper “taper rate”, which will see many part-pensioners will lose their pension entirely. Unlike the superannuation changes in the 2016 Budget which are proposals that still require passage through Parliament before they become law, the changes to the age pension have already become law, and the ALP has announced that they will not rescind these changes if they form Government despite previous promises to do so.

These changes to the assets test will affect more people over time as they retire with larger superannuation balances. Also, changes in the taper rate will likely to affect many people entering retirement over the next 10 to 15 years.

As you know, people are eligible for the Age pension if they meet the residence requirement, the assets and income test, and attain the pension age. The pension age is slowly increasing. If you are born before 1 July 1952 the pension age is 65. If you are born after 1 January 1957, the pension age is 67.

The age pension is also dependent on both your marital status (including de facto couples) and whether or not you are a home owner.

The full age pension is paid fortnightly and is adjusted twice yearly in March and September in line with the highest of the Consumer Price Index (CPI), Male Average Weekly Total Earnings (MWATE) and Pensioner and Beneficiary Living Cost Index. Because the pension is targeted at the neediest recipients, it is means tested against your assets and income so that you receive the full pension with income and assets up to a certain threshold, and the fortnightly pension is reduced as either income and/or assets exceed that threshold. If your income or assets are high enough the fortnightly pension is reduced to zero. This is sometimes called the taper rate – the rate at which the pension is withdrawn.

It is important to note that your income and assets are assessed under both the income test and the assets test. Whichever test gives you the lower pension result, is the one that is applied.

Using the latest pension figures from March 2016, the single pension is \$873.00 per fortnight or \$22,698.00 per year. For a couple the pension is \$1,317.40 per fortnight or \$34,252.40 per year.

**Canberra Discussion Group****Charnwood 13 June 7.30pm****Brisbane Equities Discussion Group****Carindale 15 June 7.00pm****Sunshine Coast Discussion Group****Buderim 15 June 6.30pm****Adelaide Information Meeting****Fullarton 20 June 7.00pm****Sydney One-Day Workshop****SMC Centre 17 June 8.30am**[All Meetings](#)**Income Test**

A single person can earn up to \$160.00 per fortnight (\$4,160 pa) in extra income and still be paid the full pension. Every dollar above that level means the pension is reduced by 50 cents per fortnight. A single person earning \$500 per fortnight (\$13,000 pa) from any source such as work, investments or superannuation would have their pension reduced by \$170, (50% of the excess above \$160) per fortnight. A couple can earn \$284 per fortnight (\$7,384 pa) before their pension is reduced by 50 cents for each dollar in excess of that threshold. In this example of a couple earning \$500 per fortnight, their fortnightly pension would be reduced by \$108 (50% of the excess above \$284). Please note that with investments and superannuation it is not the actual income that is used in the calculation but the “deemed” income. The deeming rate is set by the government and adjusted periodically. The deemed rate of income may be higher or lower than the actual income but the actual income is irrelevant to the calculation. See here for more on deeming:

<https://www.humanservices.gov.au/customer/enablers/deeming>

**Assets Test**

At present, a single person, who owns their own home, can have \$205,500 in assets before their pension is affected. Please note the family home is not counted as an asset under this test. A single person who is not a homeowner can have \$354,500 in additional assets before their pension is affected. Similarly, a home-owning couple can have \$291,500 in addition to the family home and a non-home-owning couple can have \$440,500 in additional assets before the pension is affected. These thresholds are adjusted every July.

**Comment:**

**The family home is not assessed under the pension assets test.** This may encourage some pensioners to invest heavily in their family home thereby becoming asset rich and income poor.

The taper rate at present is \$1.50 of pension for every \$1000 of assessable assets over these thresholds.

If a single person who owns their home had \$400,000 of additional assets, their pension would be reduced by \$291.75 per fortnight  $[(400,000 - 205,500) / 1000 * 1.5 = 291.75]$ . As a result the fortnightly pension would be \$581.25 per fortnight. A non-home-owning single pensioner has a higher asset threshold, so they lose less pension  $[(400,000 - 345,500) / 1000 * 1.5 = 68.2]$  which results in a fortnightly pension of \$804.25

The taper rate at present for couples is also \$1.50 of fortnightly pension for every \$1000 of assessable assets over the threshold, which is correspondingly higher for a couple.

If a couple who own their own home had \$750,000 in assets in addition to their home, their fortnightly pension would be reduced by \$687.75  $[(750,000 - 291,500) / 1000 * 1.5 = 687.75]$  which leaves a fortnightly pension of \$629.65. Similarly the couple without their own home with the same level of assets would have their pension reduced by \$464.25  $[(750,000 - 440,500) / 1000 * 1.5 = 464.25]$  leaving a fortnightly pension of \$853.15.

**Comment:**

For the same level of assets, the higher threshold for the couple without a family home, results in a higher pension but, in many areas of Australia, that higher pension is unlikely to compensate them for the rent they need to pay for their accommodation. **This suggests that, where possible, retirees should aim to be home owners before the reach pension age.**

With these taper rates it has been possible for pensioners to have a large pool of assets and still be eligible for a small part pension. Note that a pension of only \$1 qualifies the pensioner for the pension card and all the medical and pharmaceutical benefits that flow from that.

A single person who owns their own home can have an additional \$750,000 in assets and still get a part pension of \$56.25 per fortnight.

A single person without their own home can have \$900,000 in assets and still get a part pension of \$54.75 per fortnight.

A couple who own the own home can have \$1.15 million and still a part fortnightly pension of \$29.65 and couple who do not own their own home can have \$1.3 million and still get a part pension of \$28.15.

**Changes from 1 January 2017**

The big change from 1 January 2017 is to the taper rate. Instead of losing fortnightly pension at the rate of \$1.50 for every \$1000 over the threshold, the new rate of withdrawal will then be \$3 per \$1000 over the threshold. This is a return to the rate that applied before 2007 but the effect for some people will be a dramatic reduction in their fortnightly pension.

In recognition of this dramatic effect the government has also raised the assets test thresholds. The income test remains unchanged. The result will be that some people who previously received a part pension because their assets exceeded the threshold for a full pension by a small amount will now find they receive the full pension because of the higher threshold. Many people will find they receive a lower part pension than at present because of the harsher taper rate and quite a number of people will lose their entitlement to the pension altogether for the same reason.

The new thresholds are set out in this table:

Assets allowed to qualify for the full age pension	Single Pensioner	Couple
Home owner	\$250,000	\$375,000
Non Home -owner	\$450,000	\$575,000

From 1 January 2017, additional assets will reduce the pension by \$3 per fortnight for every \$1000 over these thresholds. If we use the same assets levels as in the example above, the effect of the higher taper rate is clear.

A single person who owns their home and has \$400,000 in assets will have their pension reduced by \$450.00 per fortnight  $[(400,000 - 250,000) / 1000 * 3 = 450.00]$ . As a result the fortnightly pension would be \$423.00 per fortnight. This is \$206.65 lower than the \$629.65 received fortnightly at present. For the non-home-owning single pensioner with the same assets they will find that their assets are now under the new higher threshold of \$450,000 and so they receive the full pension, up from \$804.25 received fortnightly at present.

For a couple who own their own home and have \$750,000 in assets in addition to their home, their fortnightly pension will be reduced by \$1,125.00 per fortnight  $[(750,000 - 375,000) / 1000 * 3 = 1,125.00]$ . This leaves a fortnightly pension of just \$192.40. Even though their financial circumstances have not changed, **this couple will lose \$437.25 of their fortnightly pension from 1 January 2017 due to these rule changes.**

Similarly the couple without their own home with the same level of assets as before will have their pension reduced by \$525.00  $[(750,000 - 575,000) / 1000 * 3 = 525]$ , leaving them with a fortnightly pension of \$792.40. This is a reduction of \$60.75 in fortnightly pension from 1 January 2017

Indeed, single home owners with assets of more than \$545,000 or couple home owners with more than about \$820,000 will lose their age pension entitlement altogether. Single non home owners with more than \$741,000 or couple non home owners with more than \$1.15 million will **also lose their entitlement to the age pension altogether.**

All of these people may be receiving part pension at present and may be unaware of the impact of these changes. The only consolation for these people is that they will automatically qualify for the Commonwealth Seniors Health Card which provides many of the health and pharmaceutical benefits as the pension card.

#### Comment:

At this taper rate, pensioner will find that by reducing their assets by \$100,000 they improve their pension payment by \$300 per fortnight or \$7,800 per year. This is equivalent to earning 7.8% on that \$100,000. As it is unlikely that this \$100,000 would earn 7.8% if invested, there may be an incentive for people to maximize their pension by reducing their assets by spending some of their accumulated capital on travel or to invest more into the family home because the family home is not an assessable asset. Before members are tempted to spend their capital in pursuit of a short-term higher age pension, the AIA would caution pensioners to take the long view in considering their needs for capital associated with aging, unanticipated expenses and the increasing cost of aged care.

#### Conclusion

These changes to the age pension assets test have already been legislated and are scheduled to begin on 1 January 2017. For some people it will mean a dramatic reduction

in their fortnightly pension and it may take considerable reorganisation of their affairs to compensate for this loss of income.

Age pensioners have 6 months to take advice and to start planning.

#### Tips for maximizing the age pension

Australians have had a long history of trying to maximize their age pension by artificially lowering their income or their assets or both. All of those loopholes have been closed but there are now some traps for the unwary.

#### Income

For many years some pensioners placed their money in low interest bank accounts as a way of reducing their income. In response, the government introduced deeming. This essentially means that what you actually earn as interest on your bank account is irrelevant because the government will “deem” that you earn a standard rate on your investments that is set by the government. The rates are as follows:

- For singles the deeming rate is 1.75% for assets up to \$48,600 and 3.25% on everything above that.
- For couples the deeming rate is 1.75% for assets up to \$80,600 and 3.25% for everything above that level.

Clearly a high deeming rate means that pensioners are deemed to be earning more income, even if they are not actually earning that rate and that will reduce the amount of pension they receive. In the present low-interest rate environment, the present deeming rate is causing some angst. Some major banks offer savings accounts that actually match the deeming rate.

It is worth noting that if pensioners can earn a rate of return on their investments that is higher than the deeming rate, they can enjoy that higher income without it affecting their pension.

#### Gifting

In the past pensioners would gift money to children and relatives as a way of reducing their assets. In response the government introduced the gifting rules. Gifts in excess of \$10,000 per year or \$30,000 over 5 years will still be counted as assets under the pensioner's assets test for a period of 5 years. These gifts will continue to reduce the age pension long after the pensioner has deprived



themselves of the income the gifted asset could have produced.

### Superannuation

Before 1 January 2015, superannuation was considered an accumulation of your own assets and a superannuation pension was seen as a return of your own assets of your remaining lifetime. The amount of your own assets returned to you each year in your retirement was calculated by your life expectancy. If you had a life expectancy of 20 years at age 65, it was assumed that one twentieth or 5% of the super pension was considered as a return of your own capital and therefore was not counted as income under the income test.

This was called the deductible amount. This meant that in many cases the age pension was hardly affected by the income flowing from a superannuation pension.

Since 1 January 2015, superannuation is considered as just another investment. The superannuation balance is counted as an asset and the income it produces is deemed like any other investment.

Just to complicate matters, those pensioners who have an existing superannuation income stream that was started before 1 January 2015 will not be affected as they have been “grandfathered”. This new treatment of superannuation pensions only applies to superannuation pensions started after that date. It is important to note that if you stop and restart your superannuation pension, it too will be assessed under this new arrangement as it is a new pension. That means care must be taken to ensure that the minimum pension payment is taken every year from the superannuation pension fund as failure to do so will mean restarting the pension. It also means that care should be taken not to roll a new superannuation contribution into and existing pension as that too will start a new pension.

### Please note:

The assets in a superannuation fund are only counted for age pension purposes when the pensioner reaches pension age or when they begin a superannuation pension. This can open a small window of opportunity. If one spouse is above pension age and therefore subject to the income and assets tests and they have a younger spouse below pension age with superannuation in an accumulation fund, those assets and income are not counted in assessing the age pension of the older spouse. This opportunity is only available until the younger spouse reaches pension age, at which point all assets and income for the couple are assessable, even if they

maintain the accumulation fund. If this involves a transfer of superannuation assets to the younger spouse, it must be done due regard for the prevailing superannuation contribution caps.

### Family Trusts

A trust is a structure that separates control and legal ownership from beneficial ownership; so that at least one person and/or company agrees to hold and manage assets or property in a way that will benefit someone else (beneficiary). Essentially a trust allows an individual to control an asset without necessarily owning it. Before 2002, if you didn't own the asset because it was held inside your family trust, it could not be counted as an asset for Centrelink purposes.

In 2002 that all changed. Now, if you are the beneficiary or trustee of a trust or a relative or an associate of the trustee in such a way that you can be seen to control the trust, (the control test) ALL the assets in the trust may be attributed to you for Centrelink purposes. Similarly, if the assets in the trust came from you originally, (the source test), ALL of the assets in the trust may be attributed to you for Centrelink purposes.

### Conclusion

There is nowhere to hide income and/or assets from Centrelink and there are severe penalties for false disclosure. Furthermore, Centrelink requires notification of your changed financial circumstances every fortnight.

The only financial asset that is not subject to Centrelink assessment is the family home. It is difficult to judge when, or if, that will ever be included in the Centrelink assessment for the age pension, but, seeing the new developments in how aged care fees are much more focused on user-pays, and that assessment includes the family home for the first time, it may be only a matter of time before the family home is no longer sacrosanct.

If age pension eligibility is an issue for you now or in the future, professional financial advisers can provide advice. The Financial Information Service, run by the Department of Human Services, conducts free seminars and provides individual assistance to plan for retirement. Their job it to help people ensure their claim for the age pension is correct. They do not provide advice on products or investments.

**Disclaimer:** *The above is a summary of the AIA's understanding of the Centrelink income and assets tests that determine the age pension and the changes that are scheduled to take effect from 1 January 2017.*

*This document should not be taken as advice but as a prompt to review your own situation and to seek advice as appropriate.*

### Changes to residential aged care rules since July 2014

#### Jon Kalkman & Brian Spies

Before 1 July 2014, a resident's entry into a residential care facility was determined by an assessment which determined if they needed either high care or low care. A high care patient was essentially a patient whose fees were paid by the Commonwealth Government but a low care patient had to pay an accommodation bond which was open to negotiation and manipulation as facilities tried to avoid high care patients and tried to maximize the bond payable from low care residents.

The rules surrounding residential aged care changed from 1 July 2014. There is no longer a distinction between low care and high care and now everyone is expected to contribute to their accommodation costs and the costs of their care, according to their capacity to pay.

Residents of a residential aged care facility must first be deemed eligible for entry to a nursing home on the basis of their nursing needs. This is determined by the Aged Care Assessment Team (ACAT). Once determined as eligible, the costs faced by the resident are determined by the Centrelink income and assets tests.

As such, residents can be roughly divided into 3 groups.

- Group A receives the full age pension.
- Group B receives a part age pension and
- Group C receives no age pension at all and is the group of self-funded retirees.

Under the new cost structure, residents in receipt of the full age pension pay no more than the basic care fee, as they did under the previous set of rules. Residents who receive a part age pension have access to income and assets that reduce their pension and are therefore able to contribute more to their care and accommodation in residential care. Residents, who are ineligible for any age pension because they have income and/or assets in excess of the thresholds, are expected to contribute the most to their aged care.

For self-funded retirees, it may be prudent to apply some careful planning to ensure that there are sufficient assets to meet these liabilities at some time in the future.

#### Fees

Aged care facilities can now charge four types of fees, each paid concurrently.

##### 1. Basic Care Fee

This is set at 85% of the age pension. This is payable by everyone, including those residents whose only income is the age pension. At April 2016 that fee is about \$17,611pa.

##### 2. Accommodation Fee

The accommodation fee can be paid as an up-front lump-sum, or a daily accommodation fee or some combination of both. The lump sum is now called a Refundable Accommodation Deposit (RAD) and replaces the old accommodation bond. It is refundable on departure or death but no interest is paid, rather like an interest-free loan to the facility. It is set by the facility, transparently available on their website and cannot exceed \$550,000 without permission from the government. Many people choose to sell the family home to pay this RAD.

If a resident chooses not to pay any or part of the lump sum, they need to compensate the facility for the interest it could have earned on the portion that was not paid as a lump sum. That interest rate is set by the government and at April 2016 was set at 6.22%. For example, if a facility set its RAD at \$400,000, and the resident chose to pay this as a daily fee it would be \$24,880pa or \$68.16 per day.

For most people this fee requires considerable thought and advice because selling the house means the cost of care goes up because there are more assets available and the age pension decreases because of the same assets test. Renting out the family home can affect the Centrelink pension via the income test. It can be further complicated if a spouse needs to continue to live in the family home.

Most people earn less than 6.22% income from their investments, so it makes no sense to hold this capital in a term deposit earning 3% while paying the RAD as a daily payment of interest at 6.22%, particularly when the RAD paid as a lump-sum is exempt from the assets test for pension purposes.

#### Comment

Self-funded retirees are not affected by Centrelink considerations so the only question is a financial one. If the rate of income earned from the capital tied up the RAD is better than the mandatory interest rate of 6.22%

it would earn for the facility, it may be better to retain that capital and use the income it generates to pay this annual interest rate. That would allow these retirees to benefit from any rise in market prices on this capital (capital gains) as well.

### 3. Means-tested Care Fee

This is an additional care fee where residents, with adequate resources, will be expected to contribute more to their own care and accommodation. It is means tested against income, but the important point is that this fee is capped and with a maximum of \$25,939.92 per year in 2016 and it has a life-time cap of \$62,255.85. Both caps are indexed but once they are reached there is no more to pay.

In addition, if a resident has accessed a home care package (which is also means tested) prior to entry into a nursing home, the fees paid for the home care package are counted towards the life-time means-tested care fee cap.

### 4. Extras fees

This fee is for optional extras negotiated with the residential facility that might include silver service dining or additional community access outings.

### Conclusion

Many people have the mistaken belief that because they have had some experience of a loved one entering a nursing home that they are familiar with the rules. The fact is that these rules have changed significantly since 2014 and, as such, require a new range of planning tools.

The AIA recommends that members consult the my age care website: <http://www.myagedcare.gov.au/> and use the online calculator to plan how they might meet these substantial costs in a number of typical scenarios such as one spouse needing residential care while the other spouse remains in the family home.

We think you will find it sobering.

**Disclaimer:** *The above is a summary of the AIA's understanding of the changes to the rules around residential aged care that came into effect from 1 July 2014.*

*This document should not be taken as advice but as a prompt to review your own situation and to seek advice as appropriate.*

## 10 hints on realising capital losses for EOFY

### Marcus Padley – Marcus Today

The end of the financial year is a good time to assess your capital gains and work out if you have a net capital gain from stocks sold. If so, you should also be looking through the portfolio for stocks with losses that you could sell to offset paying tax on the gains.

You know the stocks, those duds you didn't sell when it was obvious you should sell. Those stocks that you shut your eyes to and hoped against hope they would rebound miraculously ... but they kept falling. Those stocks. Those small illiquid stuff ups that you regretted buying but let linger in your 'portfolio'. All those short-term trades that became long-term 'investments'.

Now is the time to think about selling them, especially the illiquid ones because by the time everyone else wakes up to their capital gains tax loss in the last two weeks of June, these stocks will have been dumped, making your emotional turmoil even harder to squeeze a trade out of. So better you assess and sell now before the bloodbath starts, which it does every year, in every small trading stock that has gone down.

### Selection is personal

I have had an email asking which stocks are likely to be most affected by tax loss selling. From your point of view, it is simply which stocks are in your portfolio, have not performed well this year and are small and illiquid and likely to get sold off by tax loss sellers. There are no 'good' stocks to take a loss on generally ... just your own stocks. The stocks to sell are staring you in the face.

I could print you a list of the worst performers this year but it wouldn't help. It's personal. What do you hold that you could sell and what do you hold that other people will sell?

The only 'game' to play here is as a trader buying stocks that are small illiquid bad performers if they have been pummelled running into the last week of June. Stocks that are trading favourites always have a lot of stale holders. They are killed in June and often resurrect in July.

### Hints for taking a loss

It is one of the hardest things to convince a broker, let alone a novice trader, to take a loss. So to help with the process, we have developed arguments to persuade you

(they don't seem to work on ourselves). If you are having trouble taking a loss, not enjoying your trading, are getting emotional and the stock is still in your possession ... read my 10 reasons for why you should think about letting go of the dogs. You will put the sell order on before you get to the end:

1. If a stock is going down it is far more likely to continue going down than it is to turn on a sixpence to suit you.
2. The further a stock falls the more intense the selling becomes as higher losses cause more selling decisions, so sell early – an early loss is the smallest loss.
3. If you sell 10 falling stocks, it will be the right thing to do in nine cases, but you will only remember the other one.
4. If you sell now, you are no longer exposed, and all you have to do is come to terms with the loss.
5. If you sell now you can always buy it back – you might even buy it back lower than you sold it. Be aware of the ATO's 'wash-sales' rules explained later.
6. If you sell now, you enter the eye of the storm and all becomes calm. You have a moment to think and you can watch from a distance. You can always choose to enter the storm again and you will be thinking more clearly and be armed with a plan.
7. If you are making a loss on a stock, think to yourself ... "if I had cash would I buy this stock now at this price?" If the answer is 'No', then why are you holding it? Sell it. Most people begin to 'hate' the stocks they lose money in ... so this argument always works.
8. Your state of mind has a value. What would your spouse pay (or you pay) to have you carefree at the weekend instead of ripping the heads off the kids. Look after yourself. There are not that many weekends in the year or your life. Don't ruin too many of them by keeping risky loss making positions until Monday because you didn't have the guts to sell them on Friday. There is no logic in being emotional about losses. If it's gone it's gone.
9. Averaging down is a mug's game. If you have money to invest you should be putting it in the best investment in the whole world. Do you really think that will be the very same stock you have already bought at a higher price and that is falling at the moment? Very unlikely. You already have an exposure ... why do you need more of something that has already proved itself to be a dog.
10. If in doubt, sell it. It crystallises a capital loss for this tax year. Why wait until the end of the year to take your

losses? Taking losses today could set you up for making and taking gains this year. You can always buy it back once you've made the sale.

### ATO wash-sales provisions

If you do decide to take a loss before 30 June but plan to re-adopt one or more of your dogs in the new financial year, be mindful of the ATO's position on wash-sales. If you repurchase the shares you sold very shortly after at a similar price, the ATO will look at that transaction unfavourably and you may be subject to anti-avoidance rules.

Hopefully you hold good long-term stocks and won't have to take a loss, but when you do, read this again and see if you can get to the bottom of the list before you have put on the order to sell.

*Marcus Padley is a stockbroker with MTIS Pty Ltd and founder of the Marcus Today share market newsletter. Marcus has been advising institutional clients and a private client base for over 34 years. This article is for general education purposes only and does not address the personal circumstances of any individual, nor does it cover all possible events. Professional advice should be sought before taking any action, including taxation and financial advice.*

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### Stop losses: Are they for you?

#### Angel Clark & Russell Markham

A Stop Loss is like a pane of glass. Once it gets hit, it's broken. The use of a Stop-Loss is one of the most controversial and misunderstood methods of selling stocks. Stop-losses are two-edged swords. They can cut losses and protect profits, or result in high turnover and lost opportunities. Are they for you?

Selling is a crucial part of successful investing. Yet, it is avoided like the plague. The reasons are clear. Buying a stock is fun, a positive event. It's the beginning of a hopeful relationship.

Selling is a negative experience, the end of the relationship. Hope of future profits is gone and losses become reality. Tax consequences must be addressed and the proceeds need to be re-deployed. Selling is not fun, but it must be done.

While there are no hard and fast rules for selling stocks, each investor eventually makes decisions to sell. The need



for funds, tax considerations and a myriad of other factors enter into these decisions. Whatever the reasons, the primary purposes of selling are:

- To control losses, and
- To protect profits.

Stop Losses are ideally suited to do both.

**STOP-LOSS.** The term “Stop-Loss” comes from the practice of selling stocks falling to specified prices. For example, if one of your stocks were at \$27 a share and you were concerned that it was going down in price you could place a “stop-loss” order to sell the stock at a specified price, say \$25. In this case the Stop-loss is \$25. Your broker would enter a “stop-loss” order to sell the stock if it fell to \$25.

A “stop-loss” order does not guarantee that your order will be executed at the Stop-Loss level. The price at which your stock is sold depends upon market conditions. In severe downturns, stocks may be sold well below the Stop-Loss, often called “gapping.”

Many advisors suggest that Stop-Losses be set at 10% below purchase prices. We have found that the Stop-Loss of a stock should be based upon its safety, fundamentals and price trend. Safe stocks with solid fundamentals can have “looser” Stop-Loss levels than those with weak fundamentals. These considerations allow investors to stay with solid stocks longer, and get out of weak stocks faster.

One of the major arguments against using a Stop-Loss is that they result in excessive trading and expose one's positions to “whip-sawing.” The likelihood of experiencing these events depends upon the type of stocks one owns. Safe, steady performers rarely hit their Stop-Loss, while risky, highly volatile stocks often break their Stops. Table I. shows the relationship between portfolio turnover rate in percent and stock safety.

*Table I. Portfolio Turnover Rate in Percent per Year as a Function of Stock Safety.*

Percent Turnover	Stock Safety
10	1.50
25	1.25
50	1.00
100	0.75
200	0.50

For the purposes of this research, we have computed Stock Safety from an analysis of the consistency and predictability of a company's financial performance, including debt to equity ratio, sales volume, business longevity, price volatility and other factors. Stock Safety is on a scale of 0-2 and stocks with a rating of 1.00 or higher, are above average in safety. Investors dealing in safe stocks would experience low turnover, while investors dealing in less safe stocks would have much higher turnover rates.

## USING STOP-LOSSES TO CONTROL LOSSES

The cardinal rule of investing is to keep your losses small. This goal may be achieved by virtue of the stock market's liquidity. It allows investors to specify both a buying price and a selling price at the same time. The best time to make these decisions is before buying a stock.

Investors should be aware that the period of highest risk is at the time of purchasing a stock. Taking brokerage into account, you're already starting with a loss. If the stock heads down in price, the loss increases. The name of the game, at this point, is to control further losses. Stops provide the discipline to do this.

The Stop-Loss should be raised if the price goes up. Once the Stop-Loss is above the purchase price, your risk of a loss has virtually been eliminated.

## USING STOP-LOSSES TO PROTECT PROFITS

Here are some of the various types of Stop Losses commonly used:

- Fixed Stop Loss
- Trailing Stops
- Volatility Stop

We will now explain some of the lesser known Stop Loss methods:

### 1. THE RATCHET SYSTEM

The most conservative and perhaps the most common use of Stop-Loss, is to raise the Stop-Loss as the price of a stock goes up. If one never lowers the Stop-Loss, it moves only in one direction like a Ratchet. This system ensures that most of the profits gained from a price rise will be captured. It is, however, susceptible to premature selling and “whip-sawing.” Consequently, the “Ratchet System” of using Stop-Losses does not necessarily lead to the best overall profit performance. This is the price one pays for reducing risk.

## 2. THE FLOATING SYSTEM

A slightly less conservative method of using Stop-Losses is that of allowing the Stop-Loss to float up and down as the price of the stock fluctuates. While this approach allows a Stop-Loss to drift downward, it reduces turnover, commission costs, and the probability of getting “whip-sawed.” While it may or may not provide higher profit performance than the Ratchet System, we prefer this method of using Stop-Losses.

When using the Floating System of setting Stop-Losses, one should never let the Stop-Loss go below their purchase price once it has gone above the purchase price. Why encounter a loss when you had profit?

## 3. THE GUIDANCE SYSTEM

Many investors prefer to use Stop-Losses as a guide to selling rather than trigger for selling. They feel that Stop-Losses are too mechanical.

This approach to using Stop-Losses is perfectly satisfactory for investors who follow their stocks closely. Investors who work full-time or are traveling, however, are vulnerable to bad news. In today's age of instantaneous communication and electronic trading, a stock may drop 30% in an afternoon. The guidance system of using Stops is the least conservative method of managing one's portfolio. For the right investors, it may be the most profitable.

## 4. VECTORVEST STOP-LOSS

This Stop-Loss is based upon 13-week moving average of closing price and is fine-tuned according to each stock's safety, fundamentals and price trend. As the price of a stock rises or falls, this Stop-Loss automatically raises or lowers its Stop-Losses. For more on this go to [www.vectorvest.com.au/stockanalysis](http://www.vectorvest.com.au/stockanalysis)

## 5. USING MENTAL STOP- LOSSES

Many investors use Stop-Losses, but do not use stop-loss orders. They want more control over deciding when a stock is sold. This practice, called using “mental stops,” is not the same as using the Guidance System of setting Stop-Losses. For example, one may use the Ratchet System of setting mental Stop-Losses, and decide to use closing prices to trigger sell orders. This approach provides close rein over their portfolios, yet reduces excessive trading due to intra-day volatility.

Other investors use mental Floating Stops on a week-to-week basis. They generally have a long-term view of the market, but are also concerned about controlling losses and protecting profits.

Whether you are a prudent investor seeking an extra margin of safety, or a Speculative investor looking for trading points, Stop-Losses can help control losses and protect profits. What you eventually choose will depend on your own investment style and risk appetite.

For more on VectorVest go to [vectorvest.com.au](http://vectorvest.com.au)

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**Australian Investors Association Ltd**

PO Box 1208

Oxenford QLD 4210

**Tel** 1300 555 061

**Fax** 07 5573 7319

**Email** [aia@investors.asn.au](mailto:aia@investors.asn.au)

**Web** [www.investors.asn.au](http://www.investors.asn.au)