

Retirement Challenge

Our investments need to pay the bills for the next 30 years

Investment Risk/Return Trade-off

Inflation Risk

- Inflation erodes our buying power –
- At 4% inflation, prices double in 18 years

Impact of Ageing

- Increased medical expenses
- Increased rate of disability
- Cost of nursing homes

Legislative Risk

- Will the government still be as generous in 20 or 30 years time?
- Age pension age - eligibility - level of support
- Rule changes in Superannuation

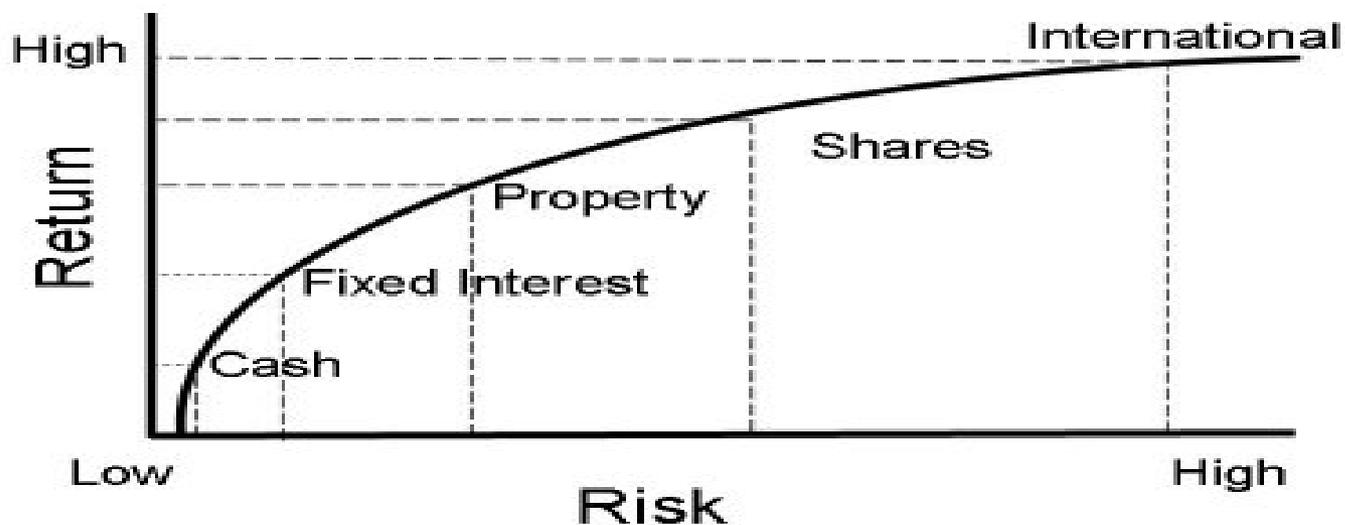
Longevity Risk

- Your money expires before you do
 - Life Expectancy:
Males – 81; Females – 84
 - We have a 70% chance of one of us living for another 30 years
 - 50% of couples live longer than that
NetActuary.com.au
- The biggest risk for retirees is outliving their retirement savings, not the investment risk of down markets
Nick Callil, consulting actuary, Watson Wyatt Australia
- The only way to avoid running out of money in retirement is to have an investment asset mix that generates strong and steady income.

Russell Investments

Investment Risk / Return Trade-off

Assets Risk/Return



Asset allocation: the most important decision

Investment return or risk management or both?

If I am a trader

- trade on the prospect of a selling at a higher price

Risk is **volatility** in market prices

- traders carefully manage this risk

Managed funds are active traders

- so are their clients

Risk Profile sets the Asset Allocation

- Conservative / Balanced / Assertive / Aggressive
- Appetite for **volatility**

Risk Management

- For clients, the only risk protection against volatility:
 - **A more conservative portfolio (asset allocation)**

The effect

- Reduced exposure to growth assets reduces effects of volatility
 - Minimize downside
 - Also minimize upside
 - Lower return long-term
- Longevity risk

Note

- Long-term investment returns are largely set by asset allocation (risk profile)

Asset allocation: the most important decision

Investment return or risk management or both?

We invest in shares for Income

- Invest on the prospect of profits
- Income security in retirement is critical

Our risk is lower than expected returns

- Our income depends on company profits
- Blue Chip Shares provide can secure (reliable) income
 - Especially inside a SMSF

With income security

- We are never **forced** to sell assets
- Volatility is not a risk to profits/dividends nor our incomes
- Investing in shares is much less stressful

Risk Management

We manage our income security risk with

- a reliable income stream
 - careful selection of assets
- a cash reserve for safety to smooth out cash flows

We have no need to manage volatility

- If we set our asset allocation to manage volatility we increase our longevity risk
- But volatility is not a risk!
- The biggest risk for retirees is outliving their retirement savings, not the investment (volatility) risk of down markets
- Volatility is temporary
- Running of money is permanent

Blue Chip Shares

Dividends are a reliable source of income

	1	2	3	4	5	6	7	8	9	10
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
BHP	0.51	0.39	0.24	0.23	0.25	0.36	0.48	0.59	0.79	1.16
Comm Bank	1.30	1.36	1.50	1.54	1.83	1.97	2.24	2.56	2.66	2.28
Westpac	0.54	0.62	0.70	0.78	0.86	1.00	1.16	1.31	1.42	1.16
NAB	1.23	1.35	1.47	1.63	1.66	1.66	1.67	1.82	1.94	1.46
ANZ	0.64	0.73	0.85	0.95	1.01	1.10	1.25	1.36	1.36	1.02
Telstra	0.18	0.19	0.22	0.27	0.26	0.40	0.34	0.28	0.28	0.28
Woolworths	0.23	0.27	0.33	0.39	0.45	0.51	0.59	0.74	0.92	1.04
Wesfarmers	0.73	0.87	1.11	1.27	1.40	1.62	2.15	2.25	2.00	1.10
Rio Tinto	0.94	1.09	1.30	0.97	0.90	1.09	2.53	1.44	1.70	1.01
Westfield	0.14	0.16	0.21	0.26	0.29	1.03	1.10	1.05	1.07	0.53
Combined Income	6.44	7.03	7.93	8.29	8.91	10.74	13.51	13.40	14.14	11.04

Source: www.asx.com.au

Blue Chip Shares:

Capital growth as well as growing dividends

Shares	Share Price 3-Jan-00	Share Price 31-Dec-09	\$ Value 3-Jan-00	\$ Value 31-Dec-09	Change in Value	Total Dividends	Combined
BHP	\$8.84	\$43.12	\$10,000	\$48,778	\$38,778	\$8,086	\$46,864
CommBank	\$26.23	\$54.85	\$10,000	\$20,911	\$10,911	\$31,092	\$42,004
Westpac	\$10.51	\$25.30	\$10,000	\$24,072	\$14,072	\$15,433	\$29,505
NAB	\$23.30	\$27.40	\$10,000	\$11,760	\$1,760	\$25,679	\$27,438
ANZ	\$10.65	\$22.88	\$10,000	\$21,484	\$11,484	\$16,597	\$28,080
Telstra	\$8.28	\$3.37	\$10,000	\$4,070	(\$5,930)	\$4,363	(\$1,567)
Woolworths	\$5.24	\$28.00	\$10,000	\$53,435	\$43,435	\$8,840	\$52,275
Wesfarmers	\$10.37	\$31.27	\$10,000	\$30,154	\$20,154	\$23,432	\$43,587
Rio Tinto	\$25.81	\$74.89	\$10,000	\$29,016	\$19,016	\$20,965	\$39,981
Westfield	\$9.74	\$12.54	\$10,000	\$12,875	\$2,875	\$9,429	\$12,303
Total			\$100,000	\$256,555	\$156,555	\$163,916	\$320,471
Term Deposit			\$100,000	\$100,000	\$0	\$53,500 *	\$53,500

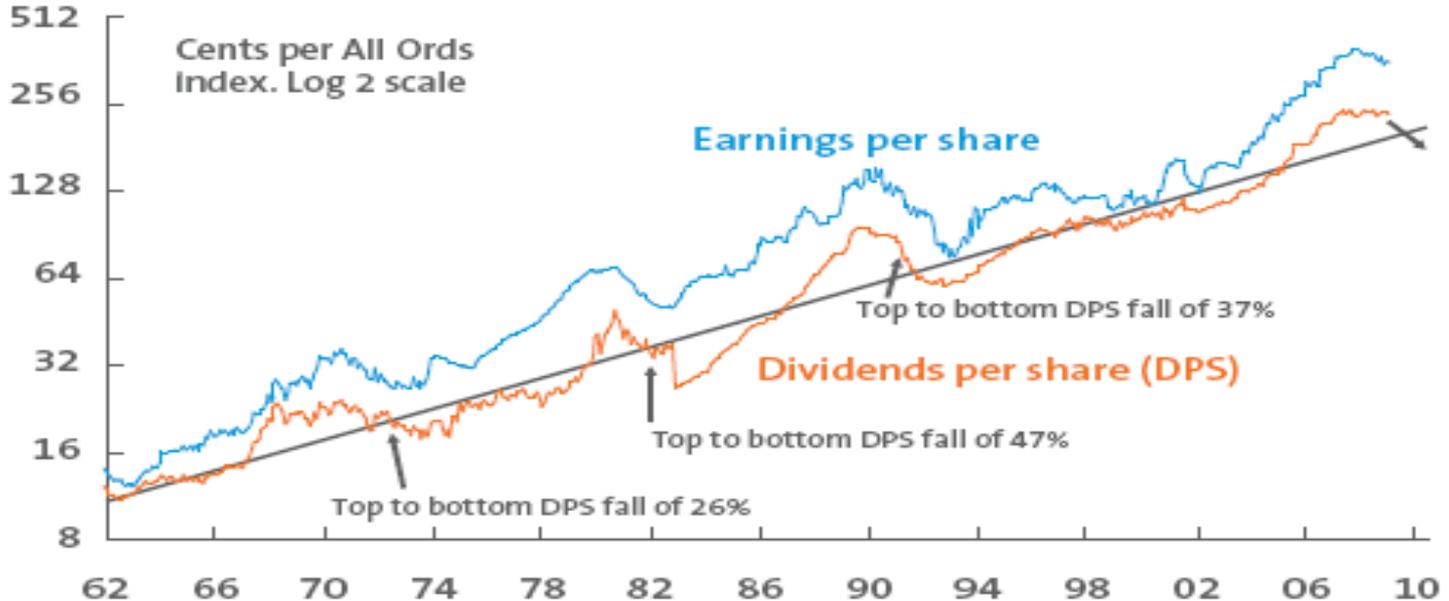
*Assumes \$100,000 invested in 1 year term deposit receiving official cash interest rate at start of calendar year.

Would you sell this income generating
machine?

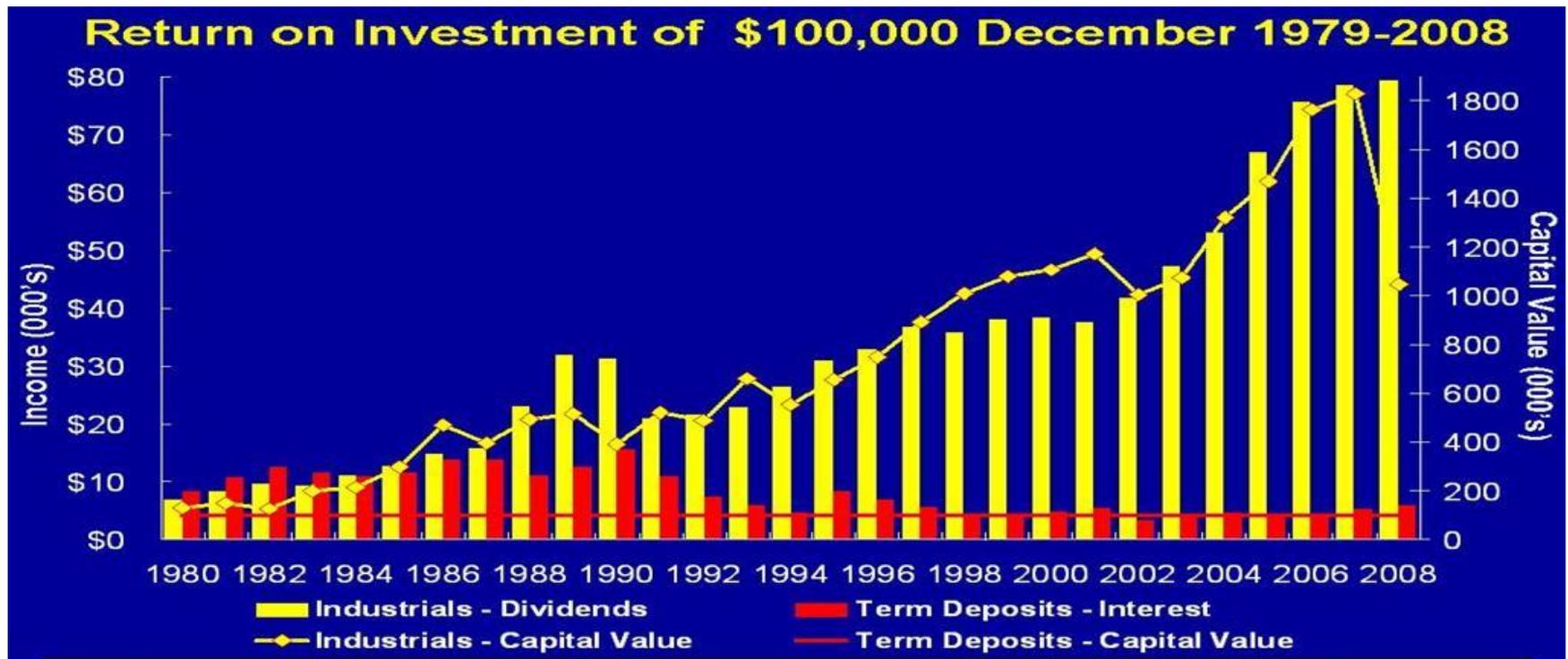
Dividends are closely linked to company earnings

- Payout Ratio

Australian dividends per share



Income from “risky” shares compared to “safe” term deposits



Dividends are less volatile than share prices



Investing in shares for income **lowers our risk**

- Dividends are paid from company profits – remarkably stable
 - a signal of financial strength
 - cash is king
- Company profits grow over time
 - Dividends pay the highest income over time
- Dividends/earnings are much more reliable - less volatile than share prices
- Dividends = money in the bank
Capital gains = maybe money
- Our risk is a fall in earnings/dividends
 - Our risk is not price volatility

Our income stream is low risk:

- Stable, predictable, reliable
- Regular payments
- A perpetual “bond”
- Growing faster than inflation
- A term deposit on steroids

Our longevity risk is lower:

- A much greater growth asset allocation than a balanced fund
- Higher likely long-term return
- Less likely to run out of money
- More likely to leave an inheritance for the kids

An actuarial view of asset allocation

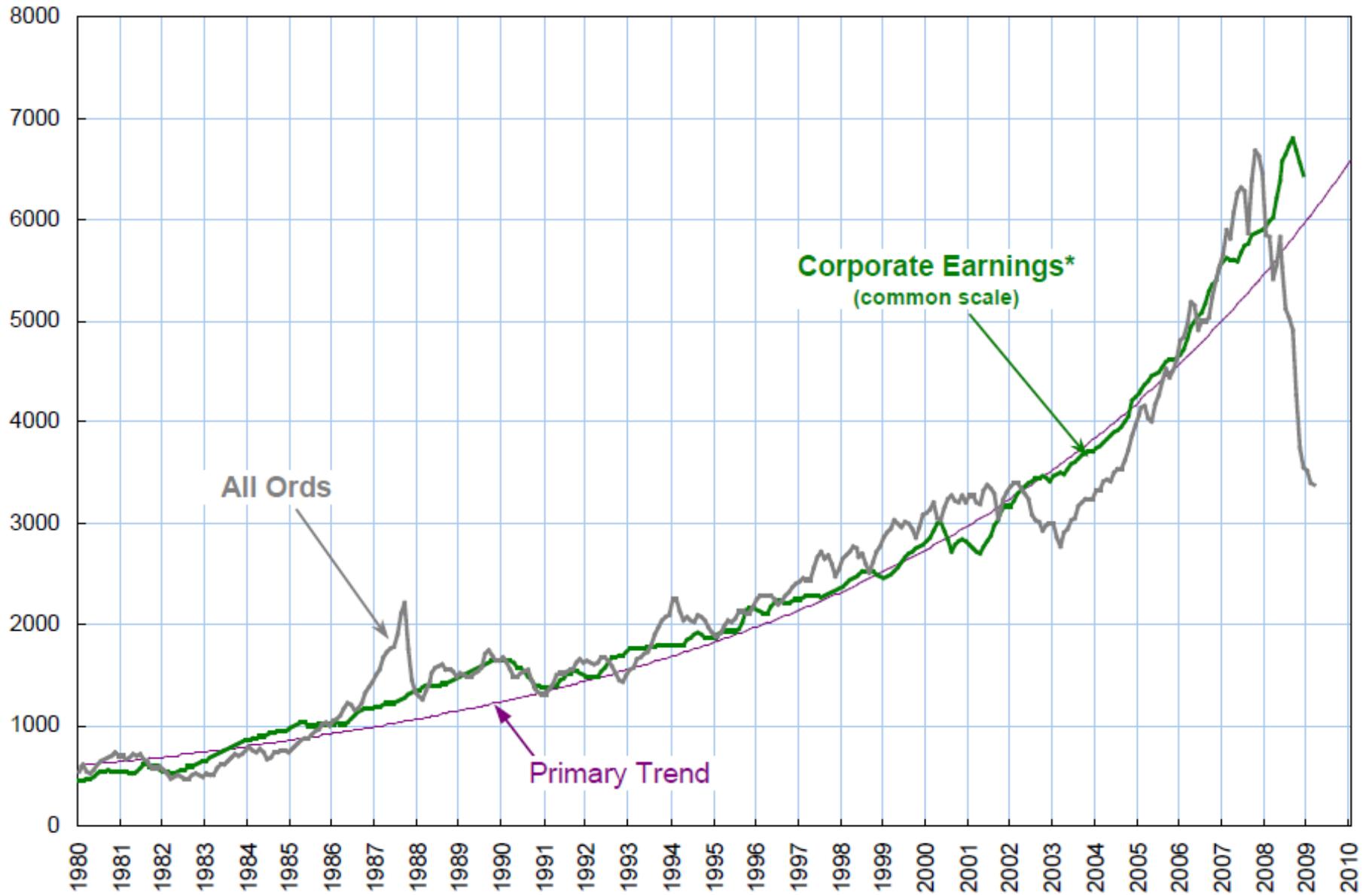
David Kerr “Risk – What Risk?”

ACTUARY AUSTRALIA NOVEMBER 2007

For superannuation fund members:

- (a) equities are a more conservative asset class than fixed interest
- (b) volatility of capital is not a significant risk
- (c) diversifying assets to reduce volatility (a non-risk element) at the expense of long-term return (a risk element) actually increases risk
- *So anyone who includes fixed interest in their asset mix to cover retirement savings is probably increasing volatility, lowering return and increasing the risk of not saving enough*
- *Any trustee that does not provide a low-risk (100% share) investment option is exposing their members to unacceptable risk*

Comparison of Price Trend Growth with Corporate Earnings



ASX Blue Chip 10 Year Performance

Companies with great earnings

RBS Morgans

Company	10 yr Compound Return	Dividend	Capital
ANZ	12.8%	42%	58%
ASX	12.7%	34%	66%
BHP	19.8%	13%	87%
CBA	12.4%	38%	62%
CSL	18.3%	9%	91%
LEI	26.2%	18%	82%
NAB	7.5%	72%	28%
ORG	31.4%	11%	89%
PPT	11.5%	63%	37%
QBE	15.3%	34%	66%
RIO	16.6%	15%	85%
TOL	24.9%	18%	82%
WBC	12.8%	38%	62%
WES	15.6%	39%	61%
WOW	21.4%	19%	81%
WPL	18.5%	20%	80%
Average	17.0%	30%	70%

Asset Allocation

- If you have income security and a 30 years time horizon
 - You should have a growth asset allocation
- In retirement, we also have a secure income and a 30 year time horizon
 - A cash reserve for safety
 - All of our remaining funds can be allocated to shares for both income and growth
- Assume our income needs = \$50,000 pa

Cash reserve (2 years)	\$100,000	(10%)	\$100,000	(5%)
Shares for income	\$900,000	(90%)	\$1,900,000	(95%)
Total	\$1,000,000	(100%)	\$2,000,000	(100%)

- If this was a balanced fund, 30% or more would be allocated to cash/bonds
- That seems a lot of growth to forfeit to manage volatility risk when this is not a risk for income investors

Example Portfolio: Julia & Tim Super Fund Est. 11 Nov 2010

How much income this year?

Co	Qty	Cost	Total	Div -11	Dividends	Yield	Rate	Frank	Unfrank	Credit	Gross	Yield
ANZ	4000	\$23.72	\$94,880.00	\$1.48	\$5,920.00	6.24%	100%	\$5,920.00	\$0.00	\$2,537.14	\$8,457.14	8.91%
BHP	2000	\$44.59	\$89,180.00	\$1.18	\$2,360.00	2.65%	100%	\$2,360.00	\$0.00	\$1,011.43	\$3,371.43	3.78%
LEI	3000	\$32.10	\$96,300.00	\$1.50	\$4,500.00	4.67%	100%	\$4,500.00	\$0.00	\$1,928.57	\$6,428.57	6.68%
MYR	25000	\$3.89	\$97,250.00	\$0.24	\$6,000.00	6.17%	100%	\$6,000.00	\$0.00	\$2,571.43	\$8,571.43	8.81%
NAB	4000	\$24.15	\$96,600.00	\$1.58	\$6,320.00	6.54%	100%	\$6,320.00	\$0.00	\$2,708.57	\$9,028.57	9.35%
QBE	5500	\$16.68	\$91,740.00	\$1.28	\$7,040.00	7.67%	20%	\$1,408.00	\$5,632.00	\$603.43	\$7,643.43	8.33%
TAH	10000	\$7.35	\$73,500.00	\$0.44	\$4,400.00	5.99%	100%	\$4,400.00	\$0.00	\$1,885.71	\$6,285.71	8.55%
TOL	12000	\$6.11	\$73,320.00	\$0.23	\$2,760.00	3.76%	100%	\$2,760.00	\$0.00	\$1,182.86	\$3,942.86	5.38%
WES	3000	\$33.31	\$99,930.00	\$1.90	\$5,700.00	5.70%	100%	\$5,700.00	\$0.00	\$2,442.86	\$8,142.86	8.15%
WOW	3000	\$28.10	\$84,300.00	\$1.30	\$3,900.00	4.63%	100%	\$3,900.00	\$0.00	\$1,671.43	\$5,571.43	6.61%
CASH			\$100,000.00		\$6,000.00	6.00%	0%	\$0.00	\$6,000.00	\$0.00	\$6,000.00	6.00%
TOTAL			\$997,000.00		\$54,900.00	5.51%				\$18,543.43	\$73,443.43	7.37%

How much income next year?

We invest in shares for income rather than property

Dividends provide:

- Income Yield
- Favourable tax treatment
- Liquidity & Diversification
- Low cost of ownership
- Passive investing
 - Ease of management
- Income + Growth
 - Growth asset - not just inflation but productivity - linked to the economy
 - **Growing Income Stream**
- Perpetual income stream
 - We should never need to draw capital

Inside a SMSF:

- A pension fund pays no tax on income or capital gains
- The fund gets a tax refund for imputation credits
- Actual income is the dividend PLUS the tax credit
 - Higher gross yield – less capital needed
 - Income security
- Pension payments are tax free (over 60)
 - Does not appear on tax return
- Non-super income benefits from tax-free threshold and tax offsets

Our SMSF – In Operation

Simplicity itself

Our SMSF holds only Australian shares and a cash reserve

- A cash reserve for safety held in SMSF bank account or term deposit
- All shares held directly by SMSF – no managed investments
- As trustees we make all investment decisions – use a full-service broker

Minimum costs/no fees

- Once-only brokerage – No fees paid to fund managers or advisers
- We use an administrator for compliance, tax return and paperwork: on-going fixed fee

SMSF funds our lifestyle

- All income is paid into SMSF bank account
 - Dividends are paid twice per year
 - Imputation credits are refunded annually by ATO
- Pensions drawn from SMSF bank account - at least the minimum, at least once per year
- Any income above the minimum is discretionary - lifestyle or reinvest

We call this our orchard

- Our shares can be expected to generate even more income next year

That gives us peace of mind