



Living with volatility

The past six months have been extremely volatile in investment markets. Some would say they have been reminiscent of the Global Financial Crisis (GFC), particularly in early August this year when markets experienced wild price swings on a day-to-day basis.

The catalysts for this higher volatility have been well documented:

- The long term nature of deleveraging and the price it is extracting from the global economy.
- Fears of another global recession with clear signs of weaker growth in the US and Europe;
- On-going financial instability and insolvency problems in Europe given the heightened risk of a Greek debt default, a dithering European political response, and some European banks requiring emergency ECB overnight funding;
- Expectations that the US Federal Reserve would implement more policy easing in September but with equity investors ultimately being disappointed with the yield curve flattening strategy chosen by the Fed;
- US retail investors choosing to withdraw from markets completely, until the outlook becomes clearer - August was the first month since September 2008 that there was a net outflow from US equity, bond and cash funds. The same pattern is evident in Australia as investors favour term deposits, despite declining yields.

As the Graph 1 (over) shows, we are nowhere near the pre-GFC levels of market volatility of 5%pa and it may be that market volatility at levels around 10%-15% is to be expected for the foreseeable future.



IT'S ALL ABOUT DELEVERAGING

We are moving into an uncertain world which is putting stresses and strains on economies and financial institutions. The developed world is in a period of deleveraging which is likely to impact markets for a considerable period of time. This is because the amount of leverage in the global economy is huge and was accumulated over a long period of time (at least the last 20 years). So unwinding the leverage cannot take place overnight. A recent study by McKinsey indicated that 6-7 years was a reasonable expectation of how long it might take. One only has to look at the experience of Japan after its speculative real estate bubble burst in the early 1990s to see just how long deleveraging can take. In the decade following the bust, Japan experienced seven calendar years of sub-2% growth and the Japanese share market fell by 65%!

While the US real estate bubble was nowhere near as large as Japan's,

unwinding the leverage in the US economy will still take time. The current deleveraging cycle started with the GFC in 2008 when the US government stepped in to bail out ailing financial institutions that had lent far too much money to the US housing market. At that time, government assistance helped US banks and corporates to start deleveraging but, in reality, the problem was simply passed to the US government that purchased much of the debt. In addition, US government spending rose significantly under the Bush Administration and taxes were cut, so the US government is now so indebted that it needs to do its own deleveraging to avoid an unsustainable fiscal position in years to come.

Similarly in Europe, the current bout of uncertainty over sovereign debt levels and the insolvency of the banking system have their roots in the explosion of leverage that took place after the creation of the Euro in early 1999. European authorities (the ECB and national governments in the core) are now being called upon to bail out European banks and insolvent peripheral countries or face the prospect that some may default or be forced to exit the monetary union.

DELEVERAGING HAS A PRICE

The other aspect of deleveraging that markets must deal with is the cost – in this case, the contractionary effect it is having on the global economy. Reducing debt to more sustainable levels requires a period of austerity, lower government spending (and the flow-on into the provision and employment in all government services), higher taxes, reduced consumption and increased household saving. All this is clearly evident in Europe and the US at present and are likely to continue for some time.

These themes are not conducive to stability, confidence and strong economic growth. A prolonged period of slower earnings growth may be looming for the major developed economies. Global ▶

Volatility continued

earnings forecasts are already being downgraded for FY12 in response to all these developments. The International Monetary Fund predicts very low levels of growth in the developed economies, as shown in the table below.

THE ROAD AHEAD

Regardless of how markets are gyrating, the Australian economy is in a much better position than the US and Europe at present. Australia's sound banking system (with negligible exposure to Europe), very low level of sovereign debt (only 6% GDP) and monetary policy that has the scope to ease if the economy enters a period of significantly weaker growth, help explain the relative attractiveness of Australia compared to other developed economies at present.

Another one of the reasons that the Australian economy is holding up so well is the increased integration of Australia into the economic cycle in Asia, particularly China, due to our vast supply of natural resources and Asia's corresponding demand for these products. To illustrate this point, consider the destination of Australia's merchandise exports - over the twelve months to end July 2011, 26.5% went to China whilst only 3.7% went to the US.

All this suggests that the Australian economy should be partly insulated from further weakness in the US due to its links to China where growth

World Economic Growth (% change year on year)

	2009	2010	2011E	2012E
World	-0.5	5.0	4.0	4.0
Developed Economies	-3.4	3.0	1.6	1.9
United States	-2.6	3.0	1.5	1.8
Germany	-4.7	3.6	2.7	1.3
France	-2.5	1.4	1.7	1.4
Italy	-5.2	1.3	0.6	0.3
Spain	-3.7	-0.1	0.8	1.1
Japan	-6.3	4.0	-0.5	2.3
United Kingdom	-4.9	1.4	1.1	1.6
Other	-1.2	5.8	3.6	3.7
Emerging Economies	2.7	7.3	6.4	6.1
Russia	-7.8	4.0	4.3	4.1
China	9.2	10.3	9.5	9.0
India	6.8	10.4	7.8	7.5
ASEAN – 5	1.7	6.9	5.3	5.6
Middle East and North Africa	1.8	4.0	4.0	3.6
Latin America	-1.7	6.1	4.5	4.0

Source: IMF Estimates Sept 2011

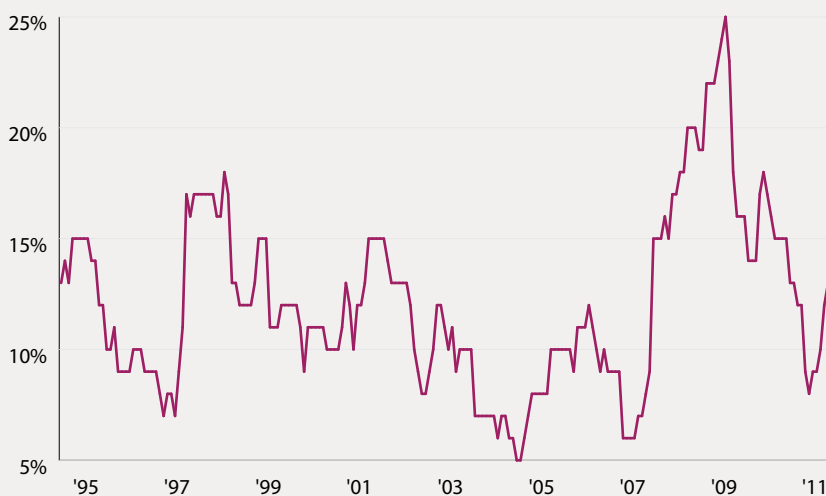
appears more robust and sustainable. The main risk for Australia is if the People's Bank of China PBOC is forced to tighten policy more aggressively in the face of a reacceleration in inflation. In this scenario, Chinese growth could slow more sharply and for a prolonged period. This would clearly be a negative

development for the resource sector of the Australian economy which has been the main engine of growth for Australia in recent years. Resource shares would be vulnerable in this environment.

Looking forward, markets are likely to remain volatile as the outlook for global growth is uncertain and investor confidence is unlikely to return until a lasting solution to Europe's debt problems is negotiated. There is much uncertainty, and the one thing that investors hate most is uncertainty. However, it is important to try and look through periods of volatility in markets and having a long term view of your investments. This may be easier said than done, but panicking and selling your investments when markets get volatile can often result in you missing out when the investment environment settles down and markets start to recover. Share price weakness may not be justified, as periods of extreme volatility often result in indiscriminate selling of all stocks in the market regardless of their longer term prospects. In this environment, volatility can create investment opportunities. ●

Sources:
Aviva Investors; International Monetary Fund

Graph 1: Australian shares (rolling annual volatility, standard dev %pa)



18% of Australia's Top Financial Advisers work for Shadforth

Shadforth Financial Group has been again confirmed as one of the leading financial advice groups in Australia with Wade Ritchie named as the top ranked adviser in the AFR Smart Investor magazine's annual Master Class.

Mr Ritchie, an integral member of the Shadforth team in Melbourne, is one of nine Shadforth advisers named in the Master Class Top 50.

Launceston based Nic d'Emden and Brisbane based Daniel White were ranked in the Top 10. In addition, Chris Elliott and Matthew McConnell from Tasmania, Sally Huynh and Cameron Wenck from Brisbane, Darren Higgs from Sydney and Patrick Carden from Perth were named in the Top 50.

Shadforth advisers have consistently achieved top rankings in nationwide assessments. The success in the Master Class follows the recent announcement that another Shadforth adviser, Charles Badenach from Hobart, was named Money Management's Financial Planner of the year 2011.

The Head of Shadforth Financial Group, Nick Bedding said today that the performance of the advisers was outstanding, and reflected Shadforth's dedication to building a team of advisers that excelled in the profession resulting in great outcomes for clients.

"This is excellent news after what has been an exciting and busy 12 months for the Shadforth Group," Mr Bedding said.

"The year was highlighted by the merger with Snowball Group Limited, now SFG Australia Limited, and the performance of our advisers is really at the heart of the merger, that is: we offer clients a point of differentiation from advisory groups that are owned or controlled by banks, fund managers, life insurance companies or product providers.

We employ some of the most qualified and experienced advisers who put clients first and focus on providing truly high quality financial advice and service. The performance also demonstrates Shadforth's breadth of advisers across a genuinely national firm."

AFR Smart Investor has run the Master Class since 1998 to help its readers identify financial consultants who they could trust with their financial affairs. Participants sit an online exam set by some of Australia's leading consultants.

The survey aims to assess the technical knowledge and expertise of advisers and the effectiveness with which that the adviser applies it to client situations and requirements, in such areas as financial structures, tax, superannuation (including self managed super funds) asset allocation, social security and investment strategies. Market environment and macro economic factors are also considered.

Shadforth advisers also performed well in a recent client survey performed by an independent body across approximately 1,000 Shadforth clients. The results confirmed that more than 90 per cent of clients were satisfied or extremely satisfied with the professionalism, overall manner, knowledge and client understanding of the Firm's advisers.

Mr Bedding said that, given all the debate about the professionalism of financial planners and advisers and the recent history of financial markets, the results were very encouraging.

"The survey results clearly showed Shadforth's clients were very positive about their advisers and the advice they were receiving, and most notably the integrity, honesty, knowledge and expertise of their adviser. Shadforth has always been dedicated to ensuring we employ the very best advisers and these results again demonstrate that we have been successful in growing a national firm of the highest quality." ●



Photos top to bottom:
Wade Ritchie, Nic d'Emden, Daniel White, Chris Elliott, Matthew McConnell, Sally Huynh, Cameron Wenck, Darren Higgs, Patrick Carden, Charles Badenach.

The power of compounding



Albert Einstein described compound interest as the “greatest mathematical discovery of all time”. For a person who made several significant discoveries in science, this statement highlights the power of compounding – that is the ability to generate long-term returns on not only the original sum invested, but earnings generated along the way.

In essence, if you put your money in an investment that delivers a return – and then reinvest those earnings as you receive them - the snowball effect can be quite significant over the long term. This is particularly true for retirement savings, where principal is allowed to grow for many years in the concessional taxed superannuation environment.

Compounding is the ideal ‘Get Rich Slowly’ scheme. All that is needed is an initial sum to invest and the patience to allow the effect of compounding to take hold. The effect of compounding can be enhanced by making additional investments along the way.

For example, let’s assume you have \$100,000 in your bank account and decide to put it into an investment with a net 5% annual return. Over the space of the first year, you earn \$5,000 on your investment, giving you a total of

\$105,000. If you leave those earnings alone, rather than pull them out to spend, the second year would deliver another \$5,250, or 5% on both the original \$100,000 and the \$5,000 gain. Your two-year total: \$110,250 and climbing.

At time passes, the effect of compounding becomes more

pronounced as more earnings are generated and that 5% return is applied to a larger balance. In fact after 20 years in our example, the investment would have grown nearly three-fold to more than \$265,000.

However in order to demonstrate how effective compounding is, let’s consider another example. For the purposes of this example, let’s assume that Jolene and Christine make the following regular annual contributions:

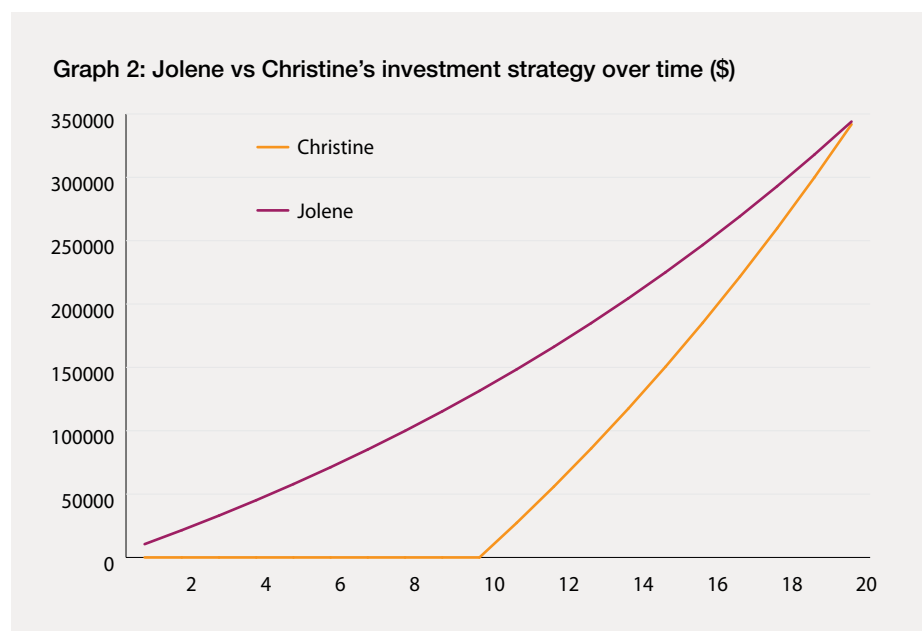
	Years 1 to 10	Years 11 to 20
Jolene	\$10,000	\$10,000
Christine	Nil	\$20,000

Let’s assume that the investment generates a gross annual return of 8%, is invested personally, and that both Jolene and Christine are on the 38.5% marginal tax rate (including Medicare levy)

Intuitively, one would expect that making an annual investment of \$10,000 over 20 years and 20,000 over ten years, at the same net rate of return, would produce a similar outcome as the total investment being made is \$200,000.

In fact, at the end of 20 years, Jolene’s investment would have grown to around \$344,000, while Christine’s would be \$262,950; this is \$81,050 or 31% higher! This is highlighted in Graph 2.

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Federal Government news

Recently, the Federal Government released its Mid-Year Economic and Fiscal Outlook (MYEFO).

Generally, this would not include any significant announcements which may impact your financial planning, however given the impact that Global events appear to be having on the Federal budget and the government's desire to honour its commitment to return the budget to surplus, this year's outlook is an exception to the rule.

On the upside:

- The age limit for receipt of superannuation guarantee contributions will be abolished from 1st July 2013. This means that, regardless of age, any employed individual will generally be eligible for the mandated employer contributions into their superannuation fund.
- The 25% reduction in the minimum payment from Account Based Pensions will continue throughout 2012/13.

On the down side:

- Various initiatives announced in previous Federal Budgets have been deferred. For example, the 50% discount on interest income will not commence until the 2013/14 financial year (originally this was to commence from the 2011/12 financial year). In addition the introduction of standard work deductions have also been deferred to 2013/14.
- Indexation of the superannuation contribu-

tion caps will not occur until 2014/15 at the earliest.

- The superannuation co-contribution will reduce to a maximum payment of \$500 with its availability also being restricted.
- The baby bonus will reduce to \$5,000 for children born after 1st September 2012 with indexation of the payment being frozen until the 2015/16 financial year.

While some of these announcements are positive, the majority restrict an individual's ability to contribute to superannuation and access various tax concessions.

If you have any questions relating to your personal circumstances please contact your adviser. ●

Twenty years, no stumbling

Australia recently reached an economic milestone. At the end of June, the Australian economy marked two decades without a recession. A report released in September by the Australian Bureau of Statistics showed that Australia's economy grew 1.2% in the June quarter, to give 1.4% growth for the financial year. This was the 20th consecutive year the economy has grown, for our last recession ended in the June quarter of 1991.

The "recession we had to have" seems a distant memory now, and since then we have forged ahead without serious pain while many other countries have stumbled.

This record for uninterrupted growth highlights



how well Australia is placed to cope with the challenges besetting the global economy, including the lack of investor confidence in Europe that has undermined global share markets in recent weeks. While the woes in Europe and the US have dented business and consumer confidence in Australia, our economy shines in comparison with much of the developed world. Unemployment is 5.1%, which is more or less regarded as full employment. Inflation is within – albeit just within – the Reserve Bank's 2% to 3% target range. Consumer prices advanced 2.9% in the year to June.

The terms of trade (the prices we get for our exports compared to imports) have surged by 36% in the past two years and are at their highest level since records began in the 1870s. Our high dollar means, in effect, that we have all had a pay rise – we can afford more imports or overseas trips – even if the strong dollar makes life tougher for exporters. Even with a high currency diminishing the value of foreign-sourced revenue, our companies are posting solid earnings and have strong balance sheets.

There are no reasons to be especially gloomy about Australia's economy in coming years. The Reserve Bank, unlike many of its peers, has the ability to cut interest rates to revive the economy, if required, as it is beginning to do again with two recent rate cuts. The Australian cash rate is now at 4.25% whereas in Europe, Japan and the US the cash rates are 1.5%, effectively zero and close to zero

respectively.

Our financial system appears sound. Our banks avoided the excesses of their global peers and are among the highest rated in the world. Our government debt is low as a proportion of GDP, being at a ratio of 22% compared with, say, 225% for Japan, about 80% for Germany and about 60% for the US.

Most importantly of all, Australia is benefiting from the rises of China and India that are expanding at annual paces of about 9% and 8% respectively. While returns from the stock markets of these countries have been mediocre, Australia is benefitting as the industrialisation of these giants is boosting the prices of our commodity and food exports while bolstering sales in volume terms. Businesses have committed to long-term investment plans to ensure Australia has the capacity to meet the heightened demand from India and China.

That should not be construed as assuming that there will be no bumps on the way. With Europe struggling to find its way out of its insolvency crisis and the US seemingly on a 'muddle through' course to gradual revival, there will be times when confidence falters and the economy slows.

Australia has economic challenges such as a perennial current-account deficit, high foreign debt, hefty consumer debt and an overvalued property market. But with all its advantages, there is no reason why Australia's economy can't extend its growth run for a while yet. ●

Source: Fidelity

Compounding continued from page 4

In order to have a similar investment value to Jolene, Christine would have had to increase her investment to \$26,000 per annum. In other words, Christine would have to invest \$260,000 between years 11 to 20, to catch up to Jolene who invested \$200,000 evenly over twenty years.

SUPERANNUATION CAN INCREASE THE POWER OF COMPOUNDING

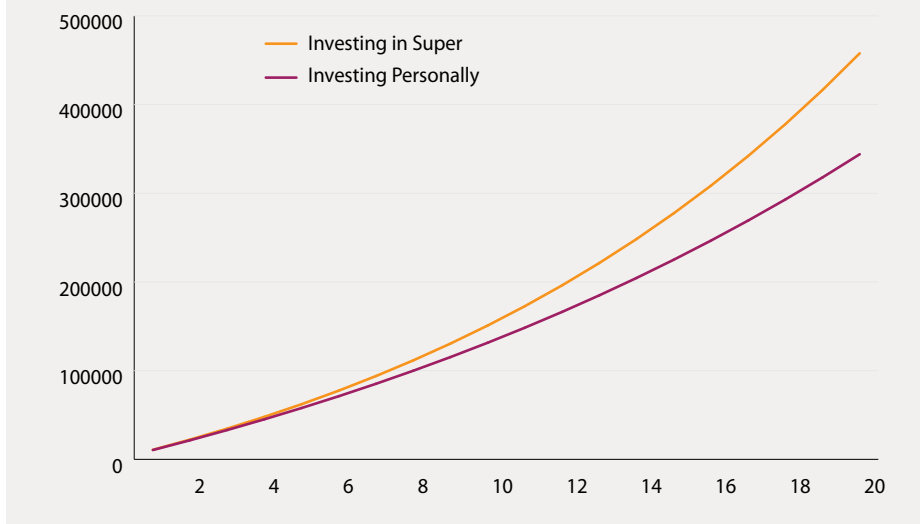
In the above example, Christine and Jolene invested the amount they contributed annually in their personal names. What would be the outcome if the annual amount was contributed into superannuation?

The effect would be to enhance the effect of compounding due to the lower rate of tax applied to earnings within superannuation compared to marginal rates of tax applied to investing personally. Earnings in superannuation are generally subject to a maximum tax rate of 15%, while earnings generated by investing personally can be taxed at up to 46.5% (including Medicare levy).

Let's consider what would happen if Jolene had invested in superannuation rather than in her own name using the above assumptions and that earnings in superannuation are taxed at 15%. The outcome is illustrated in Graph 3.

Jolene's investment value, by investing annually in superannuation rather than personally, has increased from \$344,000 to \$457,800; an increase of \$113,800 or 33%. This increase is not as

Graph 3: Investing over time (\$)



a result of Jolene taking on more investment risk, but simply due to the reduction in the tax applicable to the returns her investment is generating together with the compounding effect of this benefit.

Overall Jolene has increased her final investment value from \$262,950 to \$457,800 (a difference of \$194,850 or 74%) by doing two things:

- Starting to regularly invest earlier rather than later; and
- Diverting the amount she invests into superannuation rather than investing personally.

The key point here is that it is generally better to invest smaller amounts now and gradually build up that investment over time as an individual's capacity to invest increases.

In addition, increasing the tax-effectiveness of returns generated can also have a significant impact.

Depending on an individual's needs, objectives and personal circumstances, this may place them in a better position to achieve their financial goals over the long-term. ●



Shadforth Financial Group

To contact us call 1300 308 440 or visit our web site at www.sfg.com.au

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