Investments

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What is involved in investing?

Whatever your reason for investing it is important to select an investment that suits your needs and objectives.

Key elements of your investment plan should include:

Your Tolerance Toward Risk

You will need to understand the risks associated with your investment. Risk is normally measured in terms of the likelihood or probability of your investment achieving an expected return over a given period of time. Returns from lower risk investments tend to be more certain and higher risk investments less certain. Risk is also considered in terms of volatility of return or the expected range of returns that might be expected from your investment over time. With higher return comes higher risk. Your tolerance toward risk can help determine particular investments that may be inappropriate for you. Of course, lower risk investments will likely provide a lower return so there may be a trade-off as to the likelihood of achieving your financial goals.

Investment Horizon

You will usually need to achieve your investment objectives within a specified time frame. This is your investment horizon and could be short, medium or long term. Generally, the longer period you have to invest the more risk you are able to accept since the impact of fluctuations in return or volatility tends to reduce over time. You may still require confidence and steadfast determination in your investment strategy though to brave market downturns.

Need for liquidity

Your personal circumstances can change so before making an investment it is important to consider how quickly you might convert your investment to cash. Some investments are highly liquid while others may provide little or no liquidity. For example it may take up to six months or longer for you to sell a direct property investment.

Structuring Your Investment

The return you achieve on an investment will be subject to tax. It is therefore important for you to consider the potential taxation consequences of your investment prior to investing or changing an existing investment. Consideration should be given to selecting an appropriate legal structure to legally minimise tax. An investment might be best held in your personal name or through a separate structure such as a superannuation fund or allocated pension for retirement monies and a trust for non-super monies.

Diversification

Diversification or spreading your risk across a number of investments is an important part of any well structured investment plan. Incorporating a mix of investments in your portfolio can help to reduce the impact of fluctuations in return from any single investment. You should look to diversify across a number of investments providing an attractive return. Individual investments should be considered in the context of your overall portfolio and financial position.

Ongoing Investment Review

An investment plan is not about setting and forgetting. Once a plan has been prepared and implemented, you will need to revisit it periodically to track progress and to make adjustments when necessary. Fine tuning of your portfolio will ensure it is continues to run smoothly and keep your dollars working hard for you.

Managed Funds

A managed fund is a collection of stocks, bonds, property, infrastructure or other securities. Investors pool their money into the fund and purchase shares of the managed fund that is then managed by a professional investment company. Investments in these managed funds are designed for the medium to long term time frame. This range is from 5 to 7 years.

A typical managed fund holds anywhere from 20 to 40 different securities that offer some measure of diversification - a sharp decline in an individual security won't be nearly as damaging to your portfolio as it would be if you only owned a few securities.

Managed funds are professionally managed. Some of the finest managers in Australia and overseas devote their attention to buying and selling securities according to the goals of their funds.

And managed funds often have a minimum investment of only $1,000 - some will accept even less.

When you buy into a managed fund, you are usually one of many investors in that fund. This "pooling" of money provides the individual investor with a number of benefits including:

The investments are managed by a team of investment professionals who concentrate on managing your money - something most people don't have the time or the expertise to do.

Small investors can access investments that may otherwise be out of reach.

The costs of investing and managing investments are spread over the whole fund pool delivering greater cost efficiencies for the individual investor.

Types of Managed Funds

The term "Managed Investments" covers a wide range of pooled investment products from superannuation to pensions and many other forms of saving schemes. Below are descriptions of a wide range of different types of investment types.

Within these broad terms, which relate principally to the tax effect of the investment, investors' have huge choice depending on how much risk they want to take (see Investment Types) and what sort of companies and industries they want to invest in (see "Investment Options")

Tax Paid Investments

Insurance Bonds

The key features of insurance bonds are summarised below:

- Life insurance companies issue them.

- Investment returns are taxed inside the life insurance company at a nominal tax rate of 39% (the actual rate of tax is normally lower than 39% due to available deductions and/or dividend imputation).

- If you hold the insurance bond for more than ten years, the earnings on your investment are not assessable for income tax (tax-free).

- If you withdraw before eight years the earnings will be assessed at your marginal tax rate but you will receive a tax rebate for the 39% tax already paid in the fund. Withdrawals made in the ninth year have two thirds of the earnings assessed and withdrawals in the tenth year have one third of the earnings assessed. In all cases the investor receives a tax rebate of 39% of the assessable earnings.

- No provisional tax is payable on your earnings.

- Are a low maintenance investment as income accrues within the bond and tax is paid within the bond.

- Are regulated by the office of the Deputy Commissioner, Life Insurance within the Insurance and Superannuation Commission.

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Can have different assets, asset mixes and management styles.

Friendly Society Bonds

The key features of Friendly Society Bonds are summarised below:

- They are similar to insurance bonds but are issued by a friendly society and taxed (currently) at a nominal rate of tax of 33%.

- Regulated by the appropriate state body as a member of the Australian Financial Institutions Commission.

Investment Trusts

There are a number of different types of investment trusts. The key features of each are summarised below:

Unit Trusts

- Issued under a trust deed, managed by a fund manager and monitored by an independent trustee.

- Each investor is allocated a unit or units in the trust, with a unit having a value based on the value of the underlying assets in the fund and determined by valuation rules set out in the trust deed.

- Tax is not paid by the trust. All taxable income is distributed and the investor pays tax on this income at their marginal tax rate.

- Capital Gains Tax is payable on gains made on the sale or redemption of units however the cost base used to calculate capital gain may be indexed to increases in inflation (where the investment has been held for more than 12 months).

Unlisted Unit Trust

You may withdraw your investment directly from the trust at the unit value which is determined in accordance with the valuation principles in the trust deed.

Wholesale Unit Trust

Usually designed for institutional (large scale) investors and is subject to a minimum investment amount of $500,000.

Listed Unit Trust

Listed on the Australian Stock Exchange. There is no facility to withdraw your money directly from the trust. Units are bought and sold via a stockbroker and are subject to stock market fluctuations.

Master Funds

The key features of a masterfund are summarised below:

- A managed fund product that invests in other managed fund products, gives you access to a number of fund managers through one investment.

- A Discretionary masterfund allows the investor to choose the combination of managed funds which suits them (also called "member choice").

- A Fund-of-Fund masterfund is where the investor selects the general risk level but the master fund manager selects the combination of funds from a range of external fund managers

- Can be structured as a unit trust or a life policy.

- Can be designed specifically to receive superannuation money or for general investment.

- Its purpose will determine how tax is paid.

- Fees are charged by both the masterfund manager and the underlying fund manager (these may be at a wholesale or discount rate).

Superannuation

Superannuation products are designed to take maximum advantage of the tax benefits offered to people saving for their retirement. Fund earnings (returns) are only taxed at 15% and this tax is paid by the fund (not by the investor). Most tax is effectively deferred until you retire or withdraw your investment from the superannuation environment. The taxation rules applying to superannuation are complex and should be explained in more detail in the brochure for any superannuation product.

There are a number of superannuation/Rollover alternatives. The key features of each type of superannuation/rollover fund are highlighted below:

- Approved Deposit Funds (ADF's)

- Used when a person leaves a superannuation fund and seeks to preserve benefits within the superannuation system.

- Can only receive Eligible Termination Payments (ETP).

- Like a unit trust but tax is paid by the fund at a nominal rate of 15%.

Deferred Annuities (DA's)

- A type of rollover fund issued by a life insurance company.

- Designed so that it can pay you an income after your 65th birthday.

- Before the 65th birthday, it acts like an insurance bond but is taxed at a nominal rate of 15%.

- The money used to invest in a DA must already be superannuation money. That means you can't invest money straight from your bank account into a deferred annuity.

- Can only receive Eligible Termination Payments (ETP).

- Used when a person leaves a superannuation fund and seeks to keep benefits within the superannuation system.

- Defers tax until you retire at which stage your tax rate will generally be lower.

Superannuation Bonds

- An uncomplicated way for lump sums to be invested in superannuation.

- Like an insurance bond for superannuation purposes.

- Designed for retirement savings.

- Can receive rollovers, Eligible Termination Payments (ETP) or direct contributions.

- Benefits are paid as a lump sum when you retire, after age 65, on death or when you choose to make withdrawals.

- Tax is paid inside the bond at a nominal rate of 15%.

Superannuation Trusts

- Like a unit trust but specifically designed for superannuation purposes.

- Can receive rollovers or direct contributions.

- Tax is paid within the trust at a nominal rate of 15%.

- Benefits must be paid when you retire, after age 65, on death or when you choose to redeem your investment.

Allocated Pensions and Allocated Annuities

Retirement products allow you to invest your superannuation payout into a pension account so you can have regular income and defer the tax that you pay. The Government wants retirees to fund their own retirement (rather than rely on the age pension) and there are a number of concessions if you invest your superannuation money into one of these pension paying products.

To receive these concessions,
you must receive a minimum income stream which consists generally of the earnings on the investment plus some return of capital (your original investment). This is why these products are often referred to as "cash back pensions". Over time the lump sum you invested reduces.

If you are aged 55 or over,
investment earnings (returns from the fund) are not taxed. You pay tax on income at the time pension payments are made.

Allocated Pensions and Allocated Annuities

The key features of allocated pensions and allocated annuities are summarised below:

- Products for after retirement.

- An account based product into which an eligible termination payment (ETP) is deposited.

- Designed to provide the investor with a regular income stream in their retirement.

- The income stream generally consists of earnings on the capital (your investment) plus some of the capital (your investment returned to you).

- Over time the lump sum invested will reduce to nil unless withdrawn.

- The amount of the income payment can vary, however the Government does impose minimum and maximum levels of income.

- Is taxed similarly to immediate annuities.

- Allocated pensions are issued by superannuation and pension funds.

- Allocated annuities are issued by life insurance companies.

- Immediate Annuities

The key features of immediate annuities are summarised below:

- Designed to pay a pension income.

- The purchase price (original investment amount) secures a series of payments for scheduled dates over a specific term or lifetime.

- The issuing institution guarantees the payment of that amount for the duration of the policy.

- Can be designed for single lives, joint lives, reversions (ie. on death the policy reverts to another person) or last survivor.

- Lifetime annuities are calculated based on life expectancy tables.

- Some annuities offer indexation of payments (payments that rise in line with inflation), protected term and payment of residual capital value (RCV) on death.

- The income component of the regular payment is taxed in the investor's hands at their own rate of tax.

- Part of the payment can be a return of capital that is not taxed.

Investment Options

Some investments are riskier than others and some produce greater return. Seeking greater returns will always entail taker greater risks. With managed investments choosing the right product with the level of risk that suits your circumstances and attitudes is very important.

This section describes the most common areas of investment for Australian Managed Funds.

Capital Guaranteed

- Usually invested in the full range of asset types with limits on the amounts of shares and property.

- Your original investment plus declared earnings are guaranteed.

- Money is put aside in a reserve to support the guarantee.

- An annual earning rate is declared after tax, expenses and transfers to the reserve.

- The declared earnings are added to the account balance, capitalised and guaranteed (usually) in full.

- Withdrawal may be subject to some spreading over time to allow the manager to manage its guarantee obligations in an orderly fashion.

Diversified - Stable

- There are several approaches taken in the design and management of these funds but all hope to achieve good stability of capital over the medium term.

- Stability of capital is usually taken to mean a low chance of negative returns over a 12-month or slightly longer period.

- Investment is usually predominantly in cash and fixed interest.

- Amounts held in shares may be limited.

- Sometimes derivatives are used to supplement the asset strategies.

- Sometimes a limited form of guarantee is available.

Diversified - Balanced

- A balanced fund will have a more or less equal spread over property, fixed interest, shares and a lower amount in cash.

- Usually invests in the full range of asset types with the objective of achieving a sustainable growth in the value of capital invested.

- Focus on diversification and risk control.

Diversified - Growth

- A growth fund will have more invested in "growth" type assets such as property and shares.

- Growth funds are more growth oriented while the diversification, and therefore risk control, is higher for balanced funds.

Sector Funds

- Usually invest in a single asset type with a small amount in cash to manage liquidity.

- "True to label" funds will usually maintain high amounts in the designated asset sector even when short-term prospects falter.

- These funds are often used by investors who wish to tailor and manage their own portfolio asset allocation mix.

- The types of single sector funds available include:

Australian Share Based Funds

These funds invest in Australian listed securities with some allocation to cash in order to manage liquidity requirements. There are a number of variations of Australian share based funds which can be differentiated by their investment strategy in focussing on different areas of the Australian share market.

Imputation Funds

These funds predominantly invest in companies that pay franked dividends and offer potential for solid capital growth over the longer term.

Australian Share Based Smaller Companies Fund

These funds focus on investing in smaller companies (as measured by their stock market capitalisation) that provide the potential for strong growth over the longer term.

Australian Share Based Resource Companies Fund

These funds invest in Australian companies whose primary business is involved in mining and/or mining services. The focus is on those companies likely to provide strong capital growth over the longer term.

Australian Fixed Interest Based funds

These funds primarily invest in Australian fixed interest securities such as Commonwealth Government Bonds, State Government Bonds, corporate bonds, convertible notes, capital notes, mortgage-backed securities and preference shares.

Cash Based Funds

These funds invest in cash and/or cash equivalents such as bank bills, certificates of deposit and treasury notes.

International Share Based funds

These funds invest in companies listed on other country's (outside Australia) stock exchanges with the aim of providing investors with strong capital growth over the longer term. International share funds come in two forms as described below.

Global Share Funds

Global share funds invest in company shares from a wide number of countries where the investment manager decides the country allocation of the fund.

Country Specific Funds

These funds invest in company shares of a specific country or region. For example, a South East Asian share fund would invest in shares listed on stock exchanges from the South East Asian region.

International Fixed Interest Based Funds

These funds invest in the fixed interest securities of overseas countries. This can include investment in Government and corporate bonds.

Property Based Funds

These funds invest in property based assets such as physical property (buildings) and/or property securities (listed property trusts).

Dividends

What Are Dividends?

When considering the profit they make on shares, many investors assess the gains they have obtained based on the appreciation of the share on the open market or the gains they obtained after selling the share for more than the original purchase price. However, it's also wise to include the income acquired from share dividends, if any.

Dividends are taxable payments to shareholders from a company's earnings. These payments generally come from retail profits and tend to be distributed in the form of cash or stock. They are usually paid quarterly, and the amount is determined by the company's board of directors.

Dividends are most often quoted by the dollar amount each share receives, put simply, the dividends per share. They can also be stated in terms of a percent of the current market price, designated as a dividend yield. The dividend yield is the annual dividend income per share divided by the current share price.

Many mature, profitable companies offer regular dividends to shareholders. However, if a company experiences losses during the year or needs any earnings to be reinvested back into the business, it's always possible that it could decide to suspend dividends. It's important to remember that a company can decide to increase, decrease, or stop paying dividends at any time.

Rather than pay dividends to shareholders, many companies with current high growth rates choose to reinvest their earnings back into their businesses. On the other hand, some stable companies that haven't experienced much growth might pay dividends to provide an incentive for investors to purchase their stock.

When investing in the share market, it's important to remember that the return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost.

Risks to Investing

What Investment Risks Should I Know About?

Taken by itself, the word "risk" sounds negative. But broken down into what it really stands for in terms of investing, it begins to be a little more manageable. By understanding the different types of risk and keeping an eye on your investments, you may be able to manage your money more effectively. Remember, strategic investing doesn't mean "taking chances" so much as "making decisions." Long-term investing and diversification may be some of the most effective strategies you can use to minimise investment risk.

Inflation Risk

The main risk from inflation is the danger that it will reduce your purchasing power and the returns from your investments. If your savings and investments are failing to outpace inflation, you may wish to consider investing in growth-oriented alternatives such as shares, managed funds, annuities, or other vehicles.

Interest Rate Risk

Bonds and other fixed-income investments tend to be sensitive to changes in interest rates. When interest rates rise, the value of these investments falls. After all, why would someone pay full price for your bond at 6 percent when new bonds are being issued at 8 percent? Of course, the opposite is also true. When interest rates fall, existing bonds increase in value.

Economic Risk

When the economy experiences a downturn, the earnings capabilities of most firms are threatened. While some industries and companies adjust to downturns in the economy very well, others - particularly large industrial firms - take longer to react.

Market Risk

When a market experiences a downturn, it tends to pull most of its securities down with it. Afterward, the affected securities will recover at rates more closely related to their fundamental strength. Market risk affects almost all types of investments, including shares, bonds, real estate, and others. Historically, long-term investing has been a way to minimize the effects of market risk.

Specific Risk

Events may occur that only affect a specific company or industry. For example, the death of a young company's president may cause the value of the company's share price to drop. It's almost impossible to pinpoint all these influences, but diversifying your investments will help manage the effects of specific risks.

Dollar Cost Averaging

What Is Dollar-Cost Averaging?

Every investor dreams of buying into the market at a low point, just before it hits an upswing, and garnering a large profit from selling at the market's peak. But trying to predict market highs and lows is a feat no one has ever fully mastered, despite the claims by some that they have just the right strategy that enables them to buy and sell at the most opportune times.

Attempting to predict which direction the market will go or investing merely on intuition can get you in trouble, or at the very least may cause you a great deal of frustration. One strategy that may help you avoid these investing pitfalls is dollar-cost averaging.

Dollar-cost averaging involves investing a set amount of money in an investment vehicle at regular intervals for an extended period of time, regardless of the price. Let's say you have $6,000 to invest. Instead of investing it all at once, you decide to use a dollar-cost averaging strategy and contribute $500 each month, regardless of share price, until your money is completely invested. You would end up purchasing more shares when prices are low and fewer shares when prices are high. For example, you might end up buying 20 shares when the price is low, but only 10 when the price is higher.

This strategy has the potential to reduce the risk of investing a large amount in a single investment when the cost per share is inflated. It also helps protect an investor who tends to pull out of the market when it takes a dip, potentially causing an inopportune loss in profit.

Dollar-cost averaging is a long-range plan, as implied by the word "averaging." In other words, the technique's best use comes only after you've stuck with it for a while, despite any nerve-racking swings in the market. When other panicky investors are scrambling to get out of the market because it has declined and to get back into it when the market has risen, you'll keep investing a specific amount based on the interval you've set.

Note: Dollar-cost averaging does not ensure a profit or protect against a loss in declining markets. This type of investment program involves continuous investment in securities regardless of the fluctuating price levels of such securities. Investors should consider their financial ability to continue making purchases through periods of low and high price levels. The return and principal value of shares fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost.