

# Investment Solutions

Summer 2011

Welcome to the Summer edition of *Investment Solutions*.

The ongoing sovereign debt crisis in Europe has once again sparked concerns of a global recession, leading the US, Europe and UK to initiate further measures to spur on the global economy. Felix Stephen, Manager Strategy & Research at Advance, talks about his thoughts on the month's events and their impact on domestic and global share markets.

While there has been much going on regarding the latest carbon tax legislation, in this edition we look at how the carbon tax reform may impact the investments in your portfolio and what opportunities this may present to your overall investment strategy.

And with Christmas only a few weeks away, 'Keeping a lid on credit over Christmas' provides some simple tips on how to keep the budget under control during the festive season.

I hope you enjoy this edition of *Investments Solutions* and wish you and your family a happy and safe Christmas and a prosperous New Year.

## What's inside

- Market commentary • Keeping a lid on credit over Christmas
- How might the carbon tax affect your investments • Risk on, risk off – what's with the investment markets?

# Market commentary by Advance Investment Solutions

We talk to Felix Stephen, Manager Strategy & Research at Advance, about his thoughts on the month's events and the impact on domestic and global sharemarkets.

Ongoing concerns over the sovereign debt crisis in Europe and fears of a global recession led leaders in the US, Europe and UK to initiate further measures to spur on the economy.

## Taking action

The US Federal Reserve (Fed) enacted more monetary policy after its scheduled September Federal Open Market Committee (FOMC). 'Operation twist' will see the US central bank selling shorter dated bonds in order to buy longer dated bonds in an attempt to flatten the yield curve.

In the meantime, the European Central Bank (ECB) announced the resumption of covered bond purchases to begin early November. Also, additional liquidity extending to 12 and 13 months will be provided to the region's financial services companies.

In the UK, the Bank of England announced the resumption of quantitative easing (QE) with some £75bn of gilts to be purchased over a four month period.

## What impact has this activity had on the markets?

The poor performance in August continued through to what was a volatile September quarter. Global equities declined more than 15% while European equities underperformed the broader regions, falling nearly 25%.

Undoubtedly the biggest event hanging on market sentiment, driving much of the negative sentiment seen in markets was based on the concerns of the magnitude and contagion effect a Greek default may cause.

Compounding negative sentiment, Italy and several US and French banks had their ratings downgraded over the month. Investor confidence was boosted by France and Germany declaring their support for Greece to remain in the euro zone and the ECB announced joint action with five major central banks to increase liquidity. However, announcement for the US Fed's 'operation twist' failed to excite the market and provide any catalyst for stabilisation.

These concerns kept volatility elevated and were a significant factor in driving investors out of risky assets and global equities.

While the Australian market was broadly poor, the resources and smaller companies suffered the most from the extended investor risk aversion. Commodity prices fell as declining growth expectations erased any upside scenario from investor's minds hitting our resource market.

## What's the outlook for investment markets?

We expect the market to favour growth assets over defensive assets over the next two to three quarters. We then expect a forward looking market to become more defensive as we get closer to the end of 2012 where political uncertainties will remain elevated.

## Keeping a lid on credit over Christmas

The festive season is synonymous with overindulgence. But along with some unwanted kilos, Christmas can also leave us lumbered with a bloated credit card debt.

The pre-Christmas spending season traditionally sees Australians give their credit cards a solid workout. Last year we collectively spent \$3 trillion more on our cards in November and December than in any of the previous ten months.

Rather than undo all the healthy budgeting efforts made during the year, some simple strategies can help you keep credit under control over the festive season.

### Maintain a sense of perspective

Rather than get swept up in a frenzy of festive season spending, aim to keep up your regular financial regime.

### Follow Santa's lead

To avoid overspending, take a tip from the big man in red himself. Make a list. Then check it twice. Allocate a spending limit for each person you plan to buy a gift for.

### Shop smart

Hit the stores early to snare the best deals on gifts. Doing your gift shopping online is an easy way to make cost comparisons.

### Cash is king

If you're buying big ticket items this Christmas aim to pay with cash. And don't be afraid to ask for a discount.

With your finances in good shape and card debt under control, you're well placed to celebrate the festive season knowing you can take advantage of investment opportunities in 2012.

# Adapting to change – How might the carbon tax affect your investments?

Now is the time to review how your investment portfolio might be affected in a carbon-constrained economy and make any changes.

**There'll be winners and losers among businesses as they adapt to operating in a cleaner energy world. While the net effect of the Federal Government's carbon tax is relatively muted, it is expected to be noticed, to varying degrees, on the balance sheets of many companies.**

The direct impact, in particular for the heavy emitters such as coal miners, steel makers and electricity generators, will be offset in the short term by government assistance packages.

How smoothly these companies transition to a post-assistance environment will depend on a number of factors, including how easily they can pass on costs and what investments they have made in low emissions technology. Overall, it will come down to how well they are run.

## Check your portfolio

It's important you discuss with your financial adviser how investments in your portfolio are affected by the carbon tax – around 500 companies will have to pay for the pollution they emit while others may be indirectly affected.

You could check news reports, company annual reports and their press releases to learn if the companies you invest in have embarked on energy efficient measures to reduce the carbon footprint of their products and services. Do they have access to low-cost clean energy generation or can they make cost-effective improvements in energy efficiency?

## Look for opportunities

Investing in the renewable energy sector may seem like an obvious strategy with the carbon tax designed to shift us towards a cleaner, greener economy but investment in many of the alternative energy companies remain speculative and trying to pick winners can be a high-risk activity.

Most renewables companies are still developing their technologies and spending heavily on research and development. This makes them difficult to

value and investors should avoid 'gambling' on companies that don't have proven technology, good management and a sound business case. Many small renewable energy companies are not in a position to pay dividends and won't be for some time.

## Weighing up the tax

The income tax reform measures that form part of the carbon tax compensation scheme also need to be considered carefully because they will change capital gains paid on investments and tax paid on franked dividends.

The income tax changes are designed to benefit people on low incomes. They include a jump in the tax-free threshold from \$6000 to \$19,400 by 2015, a lowering of the low income tax offset and an increase in marginal tax rates. These will rise from 30 to 33 per cent for people earning between \$37,000 and \$80,000. People in this bracket may include part-time workers, retirees or pre-retirees who only have a portion of their income subject to tax.

Speak to your financial adviser to determine how the income tax reforms might affect you.

by Sue Peacock (freelance writer).

## Carbon tax at a glance

- The carbon tax starts 1 July 2012. There'll be a transition to an emissions trading scheme (cap and trade) from July 1, 2015.
- A once-off rise of 0.7 per cent in the CPI index is expected, resulting in an average \$9.90 per week increase in costs for households.
- Revenue raised by the carbon tax will be used to compensate households by an average \$10.10 per week through tax cuts and increases in Centrelink and family assistance payments.
- Some emission intensive industries will receive government assistance to cover the costs of the tax but assistance will be reduced each year to encourage industry to cut pollution.

### Q. Will I have to pay the carbon price?

A. No, it's not a tax on households or small businesses – around 500 large polluters will be required to pay for their pollution under the carbon pricing mechanism. They account for around 60 per cent of our carbon pollution.

Source: [www.cleanenergyfuture.gov.au](http://www.cleanenergyfuture.gov.au)

### Proposed tax scales

|          | 2011–12 (Current) |               | 2015–16        |               |
|----------|-------------------|---------------|----------------|---------------|
|          | Threshold (\$)    | Marginal Rate | Threshold (\$) | Marginal Rate |
| 1st Rate | 6,001             | 15%           | 19,401         | 19%           |
| 2nd Rate | 37,001            | 30%           | 37,001         | 33%           |
| 3rd Rate | 80,001            | 37%           | 80,001         | 37%           |
| 4th Rate | 180,001           | 45%           | 180,001        | 45%           |

Source: Australian Government, Household assistance – tax reform, Clean energy future fact sheet, 10 July 2011.

# Risk on, risk off – what's with the investment markets?

With the end of 2011 only a few weeks away, many investors find themselves stretched to the limit with escalating frustration at the state of the markets, battered by hair-trigger volatility. As soon as it seems to be time to go “risk on,” the switch is flicked back to “risk off”.

The enduring adage is that there are only ever two influences at work on the sharemarket – fear and greed driving the cycle. When greed prevails, risk assets such as shares, commodities and emerging-markets are all the rage. But when fear is everywhere, it's “risk off”, and there is a flight to assets that are perceived to offer safety, such as cash, gold and bonds.

There is no doubting that the combination of the problems that markets are now faced with is fearsome, especially as the developed worlds' economies are experiencing slow growth and are weighed down by the mountain of debt in the government and household sectors, as well as the prospect of heavy write-downs in the event that Greece defaults on its debts.

The US is also desperately trying to stimulate its economy through quantitative easing (pumping money into the economy through buying bonds), as it has no room to cut interest rates and to redress a runaway budget deficit. In addition, it seems that the stimulus poured into the economy so far has not created the job growth the US has hoped that it would.

But the critical fact about markets is that they will recover – it's just a matter of when. Markets always concentrate more on the future than the present.

This means that they're not looking at the end of the financial world, they are looking at economic recovery, when the debt crises in Europe and the US are at least made manageable, and economies seem like they can actually be reflat.

At what point markets will become convinced that the worst is behind them, no-one can say.

One thing we know from previous downturns is that once the switch is flicked to “risk on”, and the pent-up demand for stocks flows back into global sharemarkets, the initial recovery moves can be quite sharp.

Shares have had a lot of their allure tarnished in the last few years, but they still represent an attractive risk/return trade-off over long periods of time – which makes them a critical component of long-term investment portfolios such as retirement investment plans.

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