

e-Newsletter October 2011

Focus on long-term growth not short-term concerns

by Chad Padowitz, Chief Investment Officer, Wingate Asset Management^

It can seem a paradox that while investors are generally buying assets for long-term growth, it is short-term fears that drive market sentiment.

At the moment, there is a lot to be concerned about in the short-term but the reality is that most of today's economic concerns are part of a long-term trend that started decades ago.

Fears of a double-dip recession in the US; concerns about Greece's future in the European economy; and talk of a slow-down in China; are all serious issues that are understandably worrying investors at the moment.

The big picture of what is happening in the world at the moment – basically, a mass deleveraging that is creating a major hangover for most economies – started well before the global financial crisis and the subsequent debt concerns in Europe and the US.

Since the end of World War II, the world has continued to find new ways to borrow more money, creating a situation of huge leveraging (see Chart 1 for the US example). Population growth has helped drive-up asset prices which have provided a platform for the leveraging, but in the long-term it has not been a

sustainable situation.

It's not normal, and not possible, to have this kind of debt accumulation without, at some point, needing to start to pay it back, and this is the phase that the developed world is now entering.

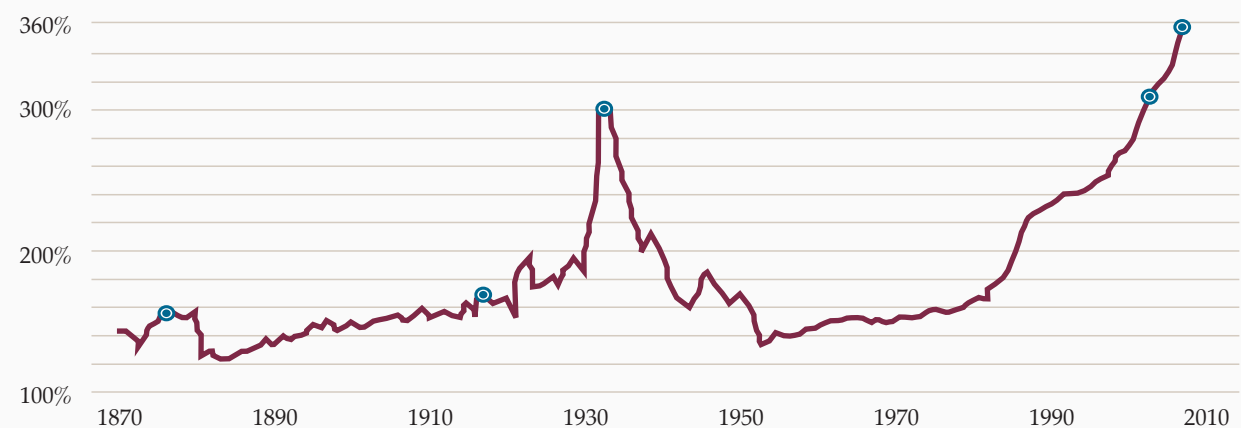
As a result, we have switched to a deleveraging phase for the first time in over sixty years.

Most working Australians simply can't remember a time when borrowing wasn't the norm, and therefore need to learn about new ways of doing things, as the old ways – including borrowing to the hilt – simply don't work any longer. Property is a good example of this – the experience of the last generation has been that property prices go up, and can be sold for more than it was bought for. The last few years have taught many people that this isn't necessarily the case, a hard and expensive lesson to learn.

Deleveraging

Deleveraging hasn't been unheard of in the post-War era. For instance, the Spanish inflation crisis between 1976 and 1980 was triggered by (or triggered) deleveraging in that country, and resulted in 50 percent of Spanish banks

Chart 1: Total U.S. Debt as a % of GDP Annual



Sources: Bureau of Economic Analysis, Federal Reserve, Census Bureau: Historical Statistics of the United States.

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being nationalised. The sovereign default in Mexico in the 1980s saw inflation reach 130 percent. In Malaysia, a financial crisis between 1998 and 2008 saw the stock exchange fall 65 percent, while during the Finnish financial crisis in the 1990s, house prices fell 50 percent. So deleveraging does happen – and when it does, it hurts. This is something that Australian investors – as well as UK and US investors – are just starting to learn. It is likely to lead to a lower living standard, less certainty about the future, and market returns being much less linear, with sharemarkets more volatile, and less likely to trend upwards.

There are three ways for governments and central banks to try to stop these trends. They can either pay down debt; inflate the debt away; or default.

If the ratio between debt and GDP is greater than 100 percent and the first two options are not feasible then default may be the only option remaining. This is always a bad outcome for workers, governments and retirees, but it does have the benefit of allowing a “reset”.

Impact on Australia

Australia is certainly not immune from these problems, particularly if China wobbles. Outside the mining sector, we have a relatively uncompetitive economy, and there is little diversity in the Australian sharemarket. The major sectors represented – resources and banks – are both vulnerable; resources to Chinese overinvestments, and banks to overvalued property prices.

Gross domestic product (GDP) growth rates will also be lower and it will therefore be easier for countries to slip into recession. We are already starting to see evidence of this, with some market commentators believing that Australia has entered a new expansion phase, and others convinced we are about to enter a recession. The gap between the two has narrowed, and it is increasingly possible to see good evidence for both outcomes.

At the same time, although Australian household debt is declining, it is still at historical highs and has a long way to go to achieve more sustainable levels (see Chart 2).

For investors, this “new normal” means there are fewer places to turn. Bonds are a good example. Historically, bonds could deliver returns of around six or seven percent, and still be low risk. Today, low risk bonds from stable countries are returning just one or two percent – Australia is at least for now a rare exception.

Returns from cash will likely be eaten away by inflation, and the deleveraging of property markets means that this asset class is also less attractive to investors, as property needs leverage to appreciate in value.

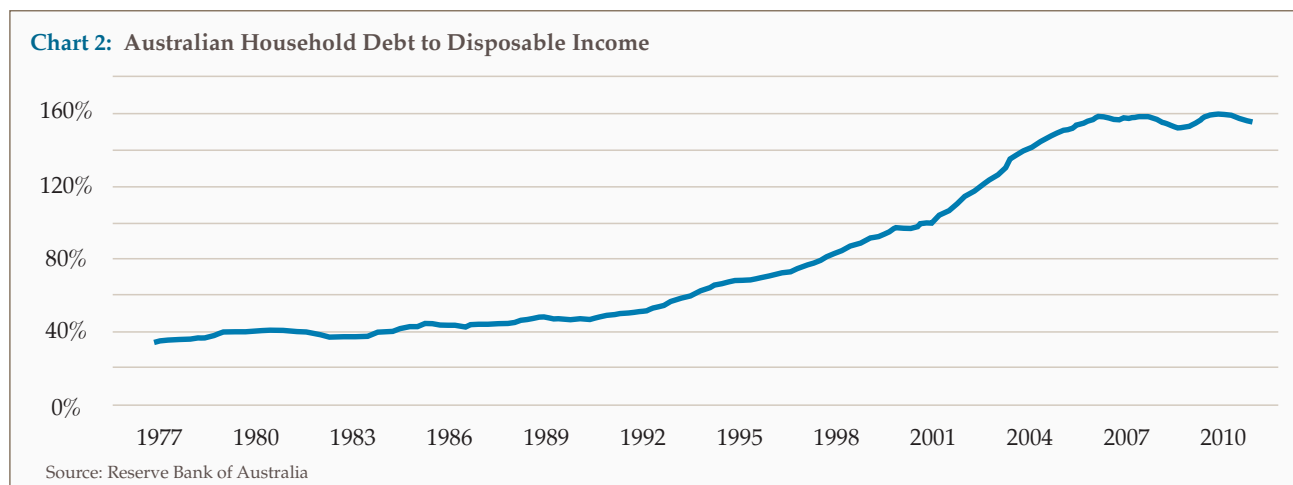
International opportunities

International equities still offer some good opportunities and benefits. They are reasonably cheap by historical standards and, for Australian investors, the still-strong currency means that they are very good value. There is risk, but this can be managed by avoiding anything with leverage, and seeking income from shares rather than only capital growth.

At Wingate, we also look for high quality international companies that have the resources to manage their way through difficult times, and have no, or very little, leverage risk. We also look for companies that earn their money from different countries. Nestle and Coca-Cola are good examples of this. Similarly, we prefer to invest in a global energy producer rather than one focussed on one market – for instance an oil company that derives most of its income from the UK is very vulnerable to policy changes in that country such as an increase in the oil tax.

So it isn't all doom and gloom, but it does mean that investors need to be even more vigilant and disciplined than ever before. The last 50 years are not how the world works, and this deleveraging, while painful, is needed. Sharemarkets will most likely track sideways for some time, and investors need to benefit from careful stock selection in order to ensure solid returns and minimum risk.

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Caution required before buying risk insurance from TV commercials

There has recently been a significant increase in the number of advertisements on TV selling 'quick & easy' risk insurance with supposedly very low premiums. They promise a 'no questions asked' approach, with no underwriting hassles and no time-consuming 'full medical history' questions.

They almost guarantee that the consumer will be granted cover, and that it will cost them 'the same as the price of a cup of coffee a week'. Unfortunately the low premium claim is often not true. They may actually charge up to two times more than retail insurers for the same level of cover (see case studies below).

The reason they charge more is because when insurers don't fully assess risk – as is generally the case with the TV insurers – they charge higher premiums to protect themselves. TV insurance is simple and convenient because they ask just three or four health related questions – and that is usually not enough for the insurer to know if it is safe for them to insure that person. As a result, they often charge significantly more than what a fully underwritten insurance policy would cost.

They may also include waivers which allow them to reserve the right to obtain full medical information at the time of a claim - and they may then decide if they are going to pay out the claimant or just refund their premiums and may state that they would not have insured them in the first place if they had done proper underwriting.

In other words, some people who buy this insurance on the TV may not actually be insured. They just won't know that until they or their family make a claim.

Why use retail insurance?

Apart from usually being much cheaper than TV insurance, retail or fully underwritten insurance policies give you a higher level of assurance that claims will be paid in accordance with the policy.

Retail insurances also tend to have definitions which are more favourable to the client. As an example, retail policies generally do not require a claimant to be unable to work in other occupations for them to pay out on an income protection claim.

Most TV insurance policies, in contrast, expect you to be unable to work in any occupation before they'll pay an income protection claim.

Similarly, retail insurance policies tend to pay trauma claims for major events like stroke, heart attack, malignant cancer and so on, as well as for other 'lower level' events like benign brain or spine tumour, chronic liver or lung disease, heart valve surgery, loss of limbs and Parkinson's disease to name a few. Most TV insurance policies do not cover many 'lower level' events.

In other words, not only are TV insurance policies generally much more expensive, but they also tend to cover a lot less. Another advantage of the fully underwritten insurance policies is that you can make sure you are insured for the correct amount to provide full financial security for yourself and/or your family in case the unexpected were to happen. The TV-style insurance usually has upper limits which will not suit everyone. And the TV policies generally do not allow you to increase your insured amount – once it is in place – to take into account changes in your situation e.g. an increase in salary or an increase in debt or having more dependants.

Interestingly, retail policies do not always require medical tests – for some clients, a full medical history (which is in most cases a 30 minute phone call with a medical professional from the insurance company) is all that is required.

Where can you get reliable advice on risk insurance?

At Australian Unity, we have access to policies from major, reputable insurers. If you need to discuss your risk insurance needs, or would like a review of an existing insurance policy, please give us a call to arrange an appointment.

In the meantime, please see the case studies below which compare TV insurers to retail insurers:

Case Study 1*:

Female, white collar, age 35, non-smoker

Income protection \$4,500 p.m. benefit, 30 day wait, 5 year benefit period

Cost with TV insurance	Cost with retail insurer
\$115.60 p.m.	\$67.16 p.m.

Saving: \$48.44 p.m. (or \$581.28 a year) PLUS a higher level of assurance that your claim will be paid in accordance with the policy, including a more generous assessment of 'ability to perform occupation'

Case Study 2*:

Male, 45 years, non-smoker

\$300,000 Life Insurance

Cost with TV insurance	Cost with retail insurer
\$57.00 p.m.	\$38.43 p.m.

Saving: \$18.57 p.m. (or \$222.84 a year) PLUS a higher level of assurance that your claim will be paid in accordance with the policy, and the ability to increase the cover amount if your circumstances change

*Case study prepared on 25 October 2011

Case study: How to safeguard your business if the unexpected happens

Mary, Wayne and John are co-owners of a successful business. John contracted a serious disease and died after a number of years. He left his share of the business to his wife, Betty.

Many years prior to John being diagnosed with the illness, the business had taken out \$200,000 of life cover on each partner for use as Business Ownership protection. However, no Buy/Sell agreement was put in place. After John's diagnosis, he was unable to obtain more life insurance.

Over the years, the business grew significantly where John's share was valued at \$780,000. The partners had not reviewed the insurance policies to maintain the cover levels in line with the value of the business. This left Mary & Wayne with a \$580,000 shortfall

This presented a dilemma for Mary & Wayne. They couldn't afford to buy out John's share of the business, nor could they afford to obtain a loan for that purpose. This left them with a number of unpalatable options, including:

- Accepting John's wife as a co-owner. The problem here is that Mary and Wayne do not get along with Betty... and Betty has no skills to help in the business. So Mary & Wayne would be doing all the work and giving a third of the profits to Betty.
- Or Mary & Wayne could find a third party to buy the business and use that money to pay out John's wife – but there aren't any obvious takers that Mary & Wayne know already. So they would have to take on a new partner who they don't know – possibly leaving them vulnerable to someone they won't get on with – either personally or professionally.
- Another option is to sell the business and pay out John's wife from the proceeds. The problem here is that, without John, the value of the business is a lot less. It is not the best time to be selling. In any case, Mary & Wayne both love the business and don't want to sell.
- The final option is to get Betty to agree to receive the initial \$200,000 and then receive regular payments under

a vendor terms arrangement. The problem here is that Mary & Wayne are effectively in business with Betty until she is finally paid out. This also means that the business needs to generate Betty's payment and pay it in addition to the existing costs of running the business.

What happened?

Mary & Wayne had numerous meetings with Betty and rather than the business folding, Betty's lawyers agreed to the following:

- Receive the \$200,000 insurance payout as an initial payment
- Receive \$9,000 per month, indexed each year for inflation for the next five years.
- At the end of the five years, subject to a valuation of the business, the payments would continue or Mary & Wayne could pay a final lump sum.

A better solution

It's too late now, but Mary, Wayne & John should have put a buy/sell agreement in place from day one. They could have funded it with an insurance policy that covers death, and serious illness or disablement.

Plus they could have obtained a valuation of the business from their accountant annually and adjusted the insurance sums insured accordingly.

As a result, on John's death, Mary & Wayne could have paid John's wife the agreed amount and Mary & Wayne would then have owned the business outright.

Based on the following parameters:

- Mary age 44, Wayne age 42, John age 40
 - Business valuation: \$2,340,000
 - Insurance cover required for Death, TPD & Trauma of \$780,000 for each partner
- the annual premiums from a leading insurer (25 October 2011) for the insurance cover would be: Mary \$4,691, Wayne \$3,692, John \$2,996.

That's a total of \$11,379 or just 0.49% of turnover.

What is business estate planning?

Business estate planning is the process of arranging your business affairs now to help ensure there is no unnecessary deterioration or loss of continuity in your business should it lose you or one of the other owners or other key people through illness, injury or death.

With appropriate business estate planning, there should be less risk of:

- A departing owner, or their spouse or estate, taking legal action over a valuation or pay-out figure
- A departing owner's spouse or child deciding – against the wishes of the continuing owners – to become an

active hands-on partner of the business (rather than taking the pay-out)

- The departing owner's spouse or family taking their legal right to claim a share of the business profits without having to work in the business
- A departing owner's spouse or estate selling their share of the business to a third party that may be unsatisfactory or unknown to the continuing owners
- The control of the business or its assets being frozen due to legal difficulties created by the departing owner, or their spouse or estate.

Consolidating loans *could help you save thousands of dollars*

Do you have a number of loans with differing terms and interest rate charges?

If you do, it might pay to consolidate them all into one loan (usually your mortgage because it usually has the cheapest interest).

Here's an example based on an Australian Unity client. Let's say they have three loans as shown in Table 1:

Table 1:	Amount	Interest & Term	Monthly
Car Loan	\$35,000	13% for 5 yrs	\$797
Credit Card	\$25,000	18%	\$375
Mortgage	\$300,000	7.7% for 30 yrs	\$2,139
Total	\$360,000		\$3,311

We would advise and help this person to:

- Find a home loan with a lower interest rate
- Borrow the entire \$360,000 as a home loan (using equity in their home to borrow against for the extra \$60,000)
- Pay off the car loan & credit card.

Their monthly repayments will then be as shown in Table 2.

Table 2:	Amount	Interest & Term	Monthly Repayment
Home Loan	\$360,000	7.0% for 30 years	\$2,395

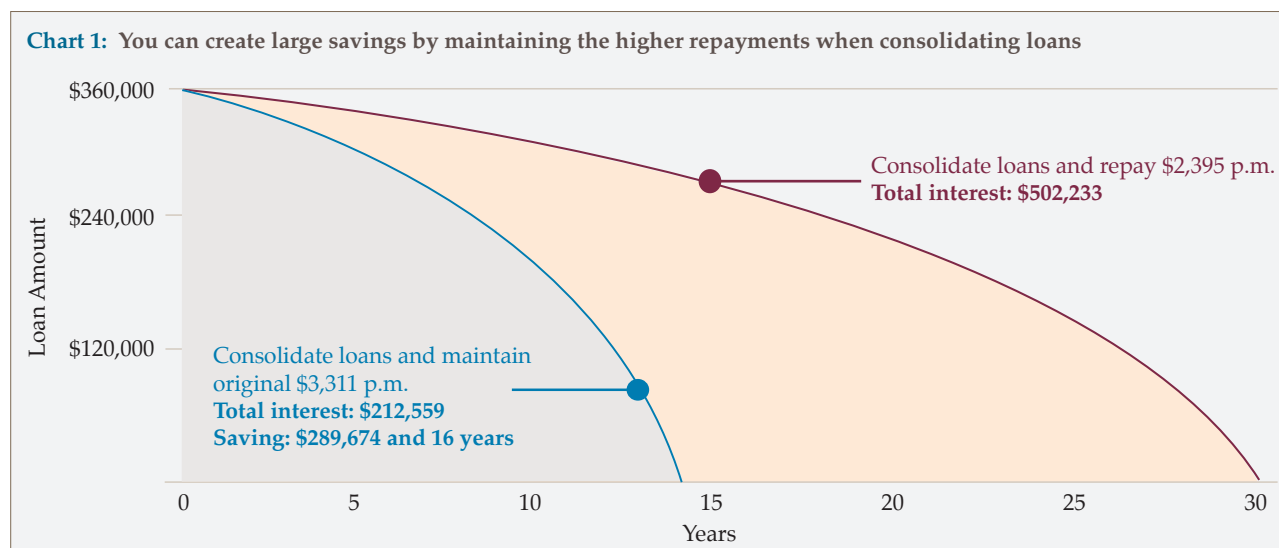
This is a saving of \$916 per month.

How to best use the \$916 saving per month

A trap many people fall into is to allow the \$916 saving per month to become spending money. As a result, the \$60,000 they have borrowed for the car loan and credit card will now be paid off over 30 years and they will pay interest on that of \$59,754.

They have turned short term debt into long term debt – and that always ends up being expensive. The solution is to maintain the repayments of \$3,311 a month they had originally.

This strategy ensures they quickly pay off the part of the new loan that relates to the car and credit cards, and it also gets them ahead on the rest of the new loan. If they maintain the extra repayments of \$3,311 per month, they will pay off the \$360,000 home loan in just 14 years... and save \$289,674 in interest repayments, when compared to paying off the loan at the required \$2,395 per month, as shown in Chart 1.



Are you paying the lowest rate you can for your home or car loan? Or your commercial loan?

If you are buying a home or car, or borrowing for your business, or if the interest rate on your current loan is too high, we invite you to have your loan position 'health checked' by us.

All you have to do is give your Australian Unity mortgage broker the details about your financial

objectives and loan position - we'll then analyse loans from the banks and other leading lenders to find you the most suitable loan we can. We'll call you with the result no later than five business days after you call us.

It's quick, it's easy... and it won't cost you a cent.

How your investment portfolio could benefit *from the 'silver economy'*

The world is living through a period of population ageing that is without parallel in the history of humanity. This process is a result of the combined effects of declining fertility and reducing mortality rates.

While the burdens posed to economies from ageing populations are well reported, the economic potential and investment opportunities that arise from the so-called silver economy are less appreciated.

On the economic front, the consumption potential of people entering retirement from now on will be much higher than the past. In the US and Australia, for instance, the Baby Boomer generation (those born between 1946 and 1964) have amassed significantly more wealth in their working lives than did their predecessors. Of no less importance, the Baby Boomers are used to a culture of consumption, and it is expected they will continue to significantly consume in retirement.

This will benefit economies generally, but which industries in particular are likely to benefit from the Baby Boomers consumption?

• Healthcare

Although people are living longer than in the past, the functionality of the human body inevitably declines over time, thereby increasing demand for healthcare services. It's a virtuous feedback loop, whereby as the Baby Boomers live longer, they spend more on healthcare; as they spend more on healthcare, they live longer.

Source: This article is based on a report prepared by Shahzad Farooq - Investment Commentator at Fidelity

Within healthcare, population ageing is likely to benefit product manufacturers and providers of healthcare services and facilities. For drug manufacturers, the ageing process will help those companies that target diseases that are more prevalent in older age groups.

• Financial Services

For financial services, the growing number of older people is a positive in several ways. In particular, as people become older, their interest in and demand for pre-retirement and retirement-related products and services tends to increase. Generally, this bodes well for asset managers, financial advisory firms and insurance companies that focus on the retirement and pre-retirement markets.

• Other industries

More people living into old age, for example, will benefit firms that specialise in providing care services and assisted-living facilities for the elderly.

There are also opportunities within the travel industry such as the holiday cruise market. And, unlike in the past, most older people in the future will be used to travelling long distances by air, which should support demand for travel services.

Older age groups tend to be more cautious and security conscious; this could help companies that specialise in home and personal security.

Does one of your friends or colleagues need prudent financial advice?

Your Australian Unity adviser will be happy to assist your friends and colleagues who need advice on:

- Wealth creation
- Retirement planning
- Redundancy planning
- Investments
- Superannuation
- Self managed superannuation
- Personal estate planning
- Business estate planning
- Personal risk insurance
- Business risk insurance
- Home loans
- Commercial loans
- Investment loans
- Equipment finance
- Car finance

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