

**Australia, World Finance and the Economy -**

## **Perspectives for RV Clients**

### **World Financial Markets**

**Most clients will be aware that massive mortgage lending in the USA in the years running up to 2007 fueled a huge housing boom. It became apparent at that time that large numbers of loans were 'sub prime' – loans were deliberately made to people without the capacity to meet repayments once initial 'honeymoon' interest rates ended.**

The loans were packaged up and sold to third parties as mortgage portfolios. As borrowers defaulted the US housing market plummeted with consequent failure of major mortgage lenders and investment banks.

The 'debt bubble', the unprecedented level of worldwide debt that had developed over a decade in a world awash with cash, had burst.

Over the past eleven months there have been progressive falls in world financial markets interspersed with periods of stability. In the week commencing 6<sup>th</sup> October uncertainty deepened and there was a collapse of confidence among investors. This translated into a week of steep falls on global share markets.

The collapse of confidence was associated with paralysis of world financial markets – the seizing up of credit arising from financial institutions (banks) being unprepared to lend to each other.

Unless such a situation is able to be reversed it translates to the real economy. Without the lubricant of lending, investment ceases, businesses contract or fail, jobs are lost, house and other asset prices fall and widespread financial and social distress develops.

### **Government Responses Worldwide**

It is curious to observe that collective adversity can precipitate levels of co-operation between Governments that seem impossible in normal times.

In the past weeks Governments worldwide have moved to guarantee bank deposits and interbank loans, to inject liquidity into credit markets and to inject capital into individual financial institutions to stabilise them. In some cases Governments have been 'buying' their banks.

The actions have been directed towards restoring confidence in financial markets, freeing up lending and seeking to limit the extent of the effect on the wider economy.

What was initially a US problem has become a worldwide problem and the outcomes of Government actions remain uncertain.

### **Australia – Where to Now**

There is general acceptance that Australian markets have been oversold as a consequence of panic selling and that fundamental values have been ignored. In that sense Australian markets appear attractively priced.

The Australian economy and financial system have been resilient and the International Monetary Fund recently reported favourably on its underlying condition.

However significant risk remains. There is no certainty that the actions of Governments will be sufficient to rebuild and sustain confidence or counter the impact of further short term shocks.

Living standards worldwide will fall and, while Australia may be buffered to some extent, it will not be immune.

The Australian Government has embarked on major spending to stimulate the real economy. While this will assist economic activity it will not be sufficient to fully offset an economic downturn.

Jobs will be lost, interest rates are likely to continue to fall quickly and house prices in particular are likely to fall.

In Australia the combined effects of asset price reductions, falling interest rates and job losses will affect incomes and spending. In many cases it will be desirable or necessary for people to reduce spending and to defer capital purchases at least for the short to medium term.

### **RV Client Groups**

In broad terms RV clients fall into three groupings based on work status, age and access to Commonwealth benefits. In planning we identify discrete planning periods and establish an appropriate financial strategy for progression through the identified planning periods. Each period provides options and opportunities which derive from the interaction of the superannuation, investment, taxation and social security systems with individual needs and objectives.

Current conditions do not undermine the importance of long term strategy but in some circumstances the impact of market falls may warrant adjustment to

short to medium term models in terms of asset allocation or, in the case of pension funds, the level or frequency of income drawn.

#### **Full or Part-Time Work**

Clients in full or part-time work are normally in the initial planning periods. The opportunity presents to salary sacrifice part of gross salary to superannuation with consequent tax advantages in building their retirement pool.

Many clients with particular short term needs sacrifice to a 'cash' super fund.

Those with a longer term horizon may be sacrificing to super funds with some share and property exposure such as 'balanced' funds. The falls in investment markets have created an opportunity for market-linked fund investors to average their buying price over time. As markets fall their fortnightly sacrifice buys more than it did at higher prices. The effect is known as 'dollar cost averaging' and is risk reducing. As markets recover the additional 'units' purchased at lower prices enhance performance.

Increasing salary sacrifice during a market downturn can represent a real opportunity. Clients with the capacity in this phase to increase salary sacrifice can benefit from so doing.

#### **Fully Retired but not yet Age Pension Age**

Clients who receive allocated pension or account based pension income streams from market-linked funds are deriving an income from an account that has been falling in value over the past year.

It is generally desirable for income payments to be made from conservative investment options that hold up to three years of income payments. Where feasible, a reduction in the level of pension income drawn will assist capital recovery in the growth components of the fund.

Growth components in the portfolio are intended to service the longer term and in the present environment need recovery time.

(The Low Income Health Care Card will be available to some clients during this period because superannuation pensions are typically partially exempt from the assessment of income.)

#### **Age Pension Age Onwards**

From Age Pension age clients may have access to a part Age Pension and Pensioner Concession Card. RV uses Age Pension friendly models for clients taking account of the special nature of income and asset testing rules.

Clients receiving a part Age Pension may find that the fall in value of their assets offers the opportunity to increase Age Pension entitlement, thus reducing pressure on their own capital to provide income while maintaining their overall level of income. Ensuring that Centrelink has current asset values and tuning of the level of super pension income drawn can result in Age Pension increases.

Some people who were previously excluded from Age Pension by their asset or income levels may now be eligible if their assets or income have fallen below the means testing limits. (Most people excluded from Age Pension by their asset or income levels will still be eligible for a Commonwealth Seniors Health Card.)

Make sure that you are efficiently structured for Age Pension purposes and are receiving your correct entitlements.

#### **Looking Ahead**

Longer term portfolios need their proportion of longer term growth assets. In the present environment it is easy to lose sight of this. With interest rates falling quickly and Australian markets oversold, a retreat to cash will alleviate short term anxiety but is unlikely to provide longer term advantage.

It provides pause for thought to realise that a panic retreat to cash internationally will of itself destroy the real economy and the businesses and institutions on which it depends. Economic stability depends on the capacity of markets to function effectively as confidence is rebuilt.

As the folly of unregulated free market ideology lies discredited we are seeing the regeneration of regulatory democracy in economic management. It has taken three decades but it portends a better world.

#### **RV Office Xmas Closure 2008**

Close: Wed. 24<sup>th</sup> Dec. at 12.30 pm

Re-Open: Mon. 5<sup>th</sup> Jan. at 8.15 am

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