

**Version 1.2**

# Reference Guide Investments



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## Section 1 - Investments

### 1:1 Instalment Gearing

#### What is Instalment Gearing?

Instalment gearing is a method of investing into managed funds over a period of time with small, regular investments, instead of investing a single lump sum. Depending on the minimum amount each Managed Fund requires, your monthly investment can be as small or large as your facility allows.

### 1:2 Negative Gearing

#### What is Negative Gearing?

Gearing refers to the act of borrowing money to invest. Negative gearing generally occurs when the expenses associated with an investment, including interest on the money borrowed, are greater than the income generated by the investment. If used correctly, borrowing to invest can be an excellent tool to accumulate wealth.

Negative gearing means that you are making an income loss on the investment. This loss is generally tax deductible. Because the loss is tax deductible, your overall tax is reduced. This helps to reduce the effect of the loss on your cash flow.

In the long-term, negative gearing only works if total returns from the investment, including capital growth, are greater than the short-term income losses. If there is insufficient capital growth to offset the income loss, you may not achieve a positive overall result from the strategy.

Whilst negative gearing can be an effective means of increasing returns on your investment, it also carries with it the risk of increasing your losses. In favourable investment conditions, gearing multiplies the returns and profits from an enlarged portfolio. In unfavourable investment conditions, gearing multiplies the disadvantages and losses.

Careful consideration and planning should be undertaken before you borrow to invest.

#### How does negative gearing work?

Most private investors think of negative gearing in relation to residential property. However, other income producing assets particularly shares and share trusts, can be negatively geared with favourable results over the long-term.

The following example illustrates the way negative gearing works. The investor has \$100,000 to invest but can borrow \$200,000 (at 9.5 % interest per annum), thus giving a total of \$300,000 to invest. Investment income is returned at 4.5 % and the investor's marginal tax rate is 46.5 % (including the Medicare levy).

Results:

	No gearing	Negative gearing
Total investment	\$100,000	\$300,000
Investment income	\$4,500	\$13,500
LESS interest paid on borrowing	\$0	(\$19,500)
Taxable income/(loss)	\$4,500	(\$6,000)

For the investment with no gearing, the after-tax income will be \$2,407. The negatively geared investment has a loss of \$6,000. This will provide a tax saving of \$2,790, reducing the after-tax loss to only \$3,210.

Although negative gearing may produce a loss on a year to year basis, it is necessary to look to the long-term to show the overall effects that a negative gearing strategy may have on an investment.

After ten years, assuming investment growth at 8.5% per annum and income of 4.5%, the investments are cashed in and the following results are obtained. We have assumed that all income is reinvested over the ten-year period and the investor utilises the 50 per cent CGT discount.

	No gearing	Negative gearing
Value of investment	\$339,500	\$1,018,400
LESS capital gains tax	(\$36,500)	(\$110,000)
LESS borrowings repaid	\$0	(\$200,000)
Less initial investment	(\$100,000)	(\$100,000)
Net return	\$203,000	\$608,400

In this situation, negative gearing has produced significant financial benefits.

#### **What are some guidelines for negative gearing?**

If you are considering negative gearing, you should keep in mind the following simple guidelines to ensure you achieve the desired results:

- Negative gearing is a long-term investment strategy.
- Continue to pay the interest on the loan even if the income from your investments falls.
- Consider gearing into investments that produce tax-effective income such as shares and property securities.
- Make sure you can make your interest payments if you are unable to work – income protection is a valuable part of your gearing strategy.

**Seek professional advice to ensure your gearing strategy is appropriate for your individual circumstances and requirements.**

### **1:3 Considerations for Gearing Strategies**

It is important to note that changes to your income situation may reduce the tax effectiveness of gearing strategies and they should be regularly reviewed to ensure their effectiveness for your situation and current circumstances.

The benefits of gearing also depend on the investment type and your ability to sustain asset price and interest rate volatility. A rise in interest rates not matched by a rise in earning ratio may mean you can no longer afford to continue the gearing strategy. If you are unable to accept market volatility (i.e. you panic in the event of a downturn in the market and you sell your investment) you may crystallise losses and incur penalty fees for early redemption.

The investment may not provide the returns you anticipate. Gearing not only magnifies profits, it magnifies losses as well. It is therefore possible that investment assets may actually fall in value, especially in the short term. If the market value of your investment falls enough to cause the balance of your loan to exceed the maximum lending value of your portfolio, you could be subject to a margin call and be required to pay the difference or sell down a portion of your portfolio.

The ability to fund interest payments must be factored into your budget and adequate insurance cover must be in place to ensure that minimum repayments can be met. Otherwise, a personal event such as loss of job, illness or divorce may force you to close the gearing package.

## 1:4 Margin Lending

Margin lending is a form of gearing using specifically-designed products which enable the investor to borrow money to buy financial products such as shares or units in a managed fund.

If the value of the investment falls below the level agreed upon under the contract, a margin call will occur (**See 1:5**). The amount that the investor can borrow is dependent on the loan-to-value ratio (LVR) offered by the lender on the security. The LVR will vary depending upon the lender and the stock on offer.

Risk	How to manage this risk
<b>Going into margin call</b>	To minimise the risk of a margin call: <ul style="list-style-type: none"> <li>• Gear conservatively</li> <li>• Diversify your investments</li> <li>• Frequently monitor your investments and loan balance</li> </ul>
<b>The loan valuation ration assigned to an asset may change over time</b>	By conservatively gearing, you can potentially reduce the likelihood that a reduction in the ratio could result in a margin call.
<b>Rising interest rates</b>	You should ensure that you have enough surplus cash flow to absorb an increase in interest payments. Consider fixing the interest rate on your margin loan to offer protection.
<b>Falling investment income</b>	You should think about ensuring that you have enough surplus cash flow to cover any income shortfall.
<b>Loss of salary due to illness</b>	You should consider if you have enough income protection and life insurance.

## 1:5 Margin Calls

A margin call will be made if the investor's equity (the value of the assets that they contributed to the investment) falls below the agreed lending ratio.

If this happens, the lender will ask the investor to provide additional funds to restore at least the minimum equity position.

To help protect against small market fluctuations, there is usually a "buffer" (typically 5% of the total portfolio value) within which a margin call may not be made.

A margin call requires prompt action (usually before 2pm on the third business day after the margin call) so it is important to plan what you would do if you were faced with one.

There are a number of ways the client can satisfy a margin call. They can:

- Provide cash to reduce their loan balance;
- Provide additional shares as security; and/or
- Sell shares from their portfolio and use the proceeds to reduce the loan.

If one of these actions is not initiated, the lender will act on the investor's behalf, usually selling shares to reduce the loan.

## 1:6 Insurance Bonds

Insurance Bonds (also known as Imputation Bonds) are tax-paid managed investments and are a growth accumulation investment. Insurance bonds do not pay income or dividends to investors – all income is retained within the bond fund and is automatically reinvested.

The bond's value increases due to retained interest and dividends, trading profit on purchases and sales of investments and unrealised capital growth.

As a tax-paid investment, any tax applicable is paid by the bond fund each year at a maximum of 30%. If you retain an Insurance Bond for at least 10 years, the increase in the value of the bond upon withdrawal will be free of further income tax liability to you, as the tax has already been paid at the company tax rate.

Withdrawals can be made at any time, however only withdrawals made after the 10 year mark will be tax free.

A death benefit from an Insurance Bond is tax free

Whilst Insurance Bonds are not as tax effective as superannuation, they can offer an alternative investment structure for those who have reached their superannuation contribution limits or who are unable to make contributions into superannuation.

### Additional Contributions

Insurance bonds can allow the investor to add to the bond and for it to retain its tax paid status, at the end of the 10 year period, provided contributions do not exceed 125% of the previous year's contribution.

If an investor does not make a contribution in a year, they cannot make any further contributions to the policy or the 10 year period will start again.

The 10 year period will also start again should an investor exceed the 125% contribution rule.

For the purpose of insurance bonds, 'year' refers to the policy anniversary year.

### Withdrawals

Withdrawals can be made at anytime. If withdrawals are made either in whole or in part within 10 years of the policy commencing, the portion of the withdrawn amount that is calculated as the investment gain will be subject to tax at the investor's marginal tax rate. However, the investor will receive a compensating 30% tax offset calculated on the assessable gain withdrawn, applied in the following manner:

Length of Time Held	Assessable Gain Taxed at MTR	Non-Assessable Portion	Offset on Assessable Amount
Up to eight years (redeemed during years 1-8)	100%	-	30%
More than 8, less than 9 years (redeemed during the 9 <sup>th</sup> year)	2/3 profit fully taxed	1/3	30%
More than 9, less than 10 (redeemed during the 10 <sup>th</sup> year)	1/3 profit fully taxed	2/3	30%
More than 10 years	Nil – Fully tax paid	n/a	n/a

## **1:7 Funeral Bonds**

A Funeral Bond is a way of putting aside money to pay for your funeral. In a way it is like a savings plan, where you put aside a lump sum or make regular payments until you reach a predetermined amount. A Funeral Bond will also safeguard your funds, so that they can only be used for paying the cost of a funeral.

For professional guidance regarding the expected cost of a funeral it is useful to speak with a funeral director. This will assist you in determining how much money you will need to place in your Funeral Bond to ensure your funeral is as you would want it to be.

### **How a Funeral Bond works for you**

A Funeral Bond allows you to save for the cost of future funeral expenses, either progressively or with a single lump sum contribution. You have the option of individual or joint ownership, and you can also assign ownership of the Bond to a funeral director to prepay your funeral.

### **Advantages of a Funeral Bond**

- Provides you with peace of mind, knowing that you have provided for future expenses related to your funeral.
- Generally offers a low risk investment strategy with the objective of keeping pace with inflation.
- Protects against inflation and rising funeral costs.
- Capital Guaranteed.
- Pre-select and pre-pay your funeral arrangements by assigning the Bond to a funeral director of your choice.
- Your Funeral Bond will usually be exempt from Centrelink pension asset and income tests.
- There are no health restrictions on your Funeral Bond.
- A choice of single or joint ownership.
- 30 day cooling-off period.

### **Access to funds**

Once funds have been deposited into your Funeral Bond they generally cannot be withdrawn prior to death (with the exception of the 30 day cooling-off period).

Notes:

