



## FINANCIAL PLANNING

### THE ADVISORY NEWSLETTER

Autumn 2011 Issue Includes:

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  - Critical facts of critical illness
- Bond fund or term deposit? The two compared
  - You're a long time retired

**Stop Press.....Self Managed Super Fund Seminar – Tue 5<sup>th</sup> April**

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## The fear of regret and its impact on investor decisions

Investor confidence, emotions and psychology play a powerful role in driving investment decisions. Past experiences, pre-conceived ideas and fear of regret are just a few of the biases and behaviours that can lead investors to make emotional and often irrational decisions.

Identifying and understanding these behaviours can help investors avoid many investment traps and lead to better investment outcomes.

### **Regret – afraid to make the wrong decision**

The key underlying premise for this behaviour is an investor's fear of incurring losses. This fear of making the wrong decision often means investors don't assess risk correctly – they tend to over-emphasise risk which can actually lead to wrong decisions or inertia in making a decision. Investors need to ask themselves which risk is greater: the risk of making a decision that could lose them money; or the risk of missing out on an opportunity that could make them money? Studies have shown that people tend to have the highest level of regret for actions they didn't take rather than actions they did take.<sup>1</sup>

An example of regret is an investor's difficulty in selling a losing stock. The feeling of regret is strongest when the loss is crystallised – until that point the investor holds out hope of the stock returning to its 'former glory' and avoids generating feelings of regret by holding onto it. Another aspect to this is that if the investor made the original investment decision by themselves, the feeling of regret is much greater than if they were following someone's advice. It's not so much about the pain of making a loss, but rather the pain of being responsible for making the decision. This could explain why investors sometimes find it easier to outsource their investment decisions (i.e. to a financial adviser) – apart from needing professional advice, it also means some of the burden of making decisions is shared.

The fear of regret often leads to inertia in making decisions. In some respects this could be one of the reasons why around 80% of Australians have remained in the 'default' fund in their superannuation plan, despite encouragement from the heavily publicised 'Super Choice' campaigns. As the default option tends to be a balanced fund, this can mean a significantly lower superannuation payout on retirement than if invested in a higher growth option over an individual's full working life. Not making a choice therefore potentially exposes

investors to greater risk – they are swapping the risk of losing money with the risk of not having enough money in retirement. Given many super investors have a very long time horizon the latter risk is likely to be significantly higher than the former.

Emotion and the human psyche are indeed powerful forces, often leading investors to make irrational decisions, or sometimes even worse, not making any decisions – both of which can be detrimental to the long-term performance of an investor's investment portfolio. By removing these emotions and psychological behaviours from the decision making process, investors are in a better position to make logical and rational decisions. Seeking professional investment advice from a financial adviser, taking a long-term view, constructing portfolios based on an investor's risk/return profile and investing with professional fund managers are steps an investor can take to help them achieve this.

#### **Source: Tyndall Investments**

<sup>1</sup> Source: Hersh Shefrin (2002) "Beyond Greed and Fear, Understanding Behavioral Finance and the Psychology of Investing", Oxford University Press

## Critical facts of critical illness

Life is full of risks. Some are preventable, some are avoidable and some are unforeseeable. You cannot predict what might happen. However, with critical illness insurance you can minimise the financial impact a critical illness has on you or your loved ones as you journey through the twists and turns of life.

#### **What would you do if you became critically ill and could not work?**

Life insurance cover gives you and your family the protection you need from any unforeseen event that ultimately results in your death. But what would happen if you become critically ill and could no longer work and provide a regular income to cover your lifestyle and expenses?

Many Australians have adequate insurance in place for material possessions such as motor cars, and their home and its contents, but many still steer away from insuring the most precious thing in the world – themselves and their family.

We can be overly optimistic about our health and have the 'she'll be right' attitude that falling seriously ill won't happen to us. The reality is illness does not discriminate and it can happen at any time and to anyone. In fact, it is a risk not to have adequate protection in place.

Many of us consider our material assets to be our greatest assets, but the reality is that it would be difficult to hold on to these if we didn't have our health and a consistent reliable income. The facts are:

- around 3.67 million Australians are affected yearly by heart, stroke and vascular diseases<sup>1</sup>
- 50,000 Australians have a heart attack every year and a stroke occurs every 12 minutes<sup>1</sup>
- one in three men and one in four women will be diagnosed with a malignant cancer before age 75<sup>2</sup>
- the average age of diagnosis of the most common chronic nervous system condition, Multiple Sclerosis is 30 (87% are of working age)<sup>3</sup>
- just under 50% of Australians with arthritis-associated disability are aged 15 to 54.<sup>4</sup>

#### **A sobering health check**

With critical illness insurance, you can insure yourself against a range of illnesses – such as cancer or a stroke. The amount of cover you need depends on a range of factors such as age, income and debt levels. It can pay a lump sum amount or a fixed monthly amount if a specified critical illness is suffered. Its aim is to protect your lifestyle and assets in the event you suffer a critical illness and are unable to earn a regular income. This can help you remove large debts such as your mortgage and unforeseen medical expenses that ordinary health insurance doesn't cover.

#### **Seek insurance advice**

If you recognise that you are underinsured or are not covered at all, don't wait until it's too late. Make a commitment to you and your family and act today by talking to one of our financial advisers. We can help you

find the right types of cover for your needs and set your cover at the most appropriate level.

- 1 Heart Foundation, Australian Facts 2004: Heart, Strokes and Vascular diseases 2004.
- 2 Cancer Council: ([www.cancer.org.au](http://www.cancer.org.au)), *Cancer in Australia: an overview, 2008 Australian Institute of Health and Welfare (published December 2008)*.
- 3 MS Australia (2005) MS The Mystery Disease. Sydney: MS Australia 2009 Media Kit.
- 4 Australia's Health 2008, Australian Institute of Health and Welfare, June 2008.

**Source: Aviva Australia, 2010.**

## Bond fund or term deposit? The two compared

### **Bond fund or term deposit?**

Fixed income investments have returned to popularity on the back of recent market turmoil. So what is the difference between bond funds and term deposits?

The Global Financial Crisis precipitated a significant change in thinking as people reassessed the risks of their investments, especially those designed to give them a steady flow of income. With world equity markets falling to bear market lows in 2009, investors have turned back to traditional income investments like bonds and term deposits. So what are the advantages of bonds over term deposits?

### **What are the advantages of bond funds over term deposits?**

Before making a choice, it pays to look at the main differences between an investment in bonds, and an investment in a term deposit.

Firstly, a bond fund is a diversified portfolio of investments, so it effectively spreads your investment risk. A term deposit is a deposit with a single issuer bank or complying financial institution, therefore it is not diversified.

Secondly, a bond fund investment provides two types of return: income return through the receipt of bond coupon payments; and the potential for capital growth through appreciation in the market value of the underlying bond. Of course, there is also the potential for value depreciation. However, the coupon on most bonds is usually fixed, so income should remain the same, even though the market value of the underlying bonds fluctuates. Term deposits do not generate capital growth.

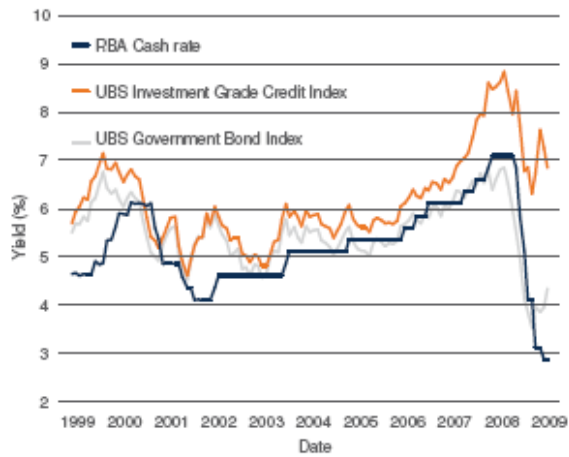
Term deposits pay a fixed rate of interest, but they are not tradeable, they must be held to maturity, that is, they are illiquid. While this means that depositors receive their full value back on maturity, it also means that there is no potential for any capital growth on a term deposit. If you break a term deposit before maturity there are penalties in the form of an interest rate reduction.

### **Returns compared**

Because of their credit risk, corporate bonds typically pay yields above the cash rate. It is possible to earn higher yields from bonds than with bank term deposits which is why bonds are attractive to investors. Of course, this credit risk spread above cash is because corporate bonds come with more risks than cash.

The attraction of a bond fund is that an investment manager can secure highly rated bonds and potentially remain ahead of cash. The following chart illustrates the yields of an investment grade bond index (UBS Investment Grade Credit Index) compared with the RBA Cash Rate and the UBS Government Bond index.

### **Comparison of yields over a ten year period**



Note: past performance is not a reliable indicator of future performance. Source: AMP Capital Investors using UBS indices

### Active management, credit risk and diversification

The key issue for investors is whether the potential for higher yields offered by a bond fund, and the additional risk, is offset by the diversification benefits an active manager can obtain by investing in multiple underlying bonds.

### Bonds and risk

Term deposits are liabilities of their issuing financial institution, and therefore usually carry the same credit rating as that institution. Bond fund portfolios typically include a mix of government and corporate bonds. Therefore, the risk of a bond fund is the blend of credit risks of all the underlying bond issuers. Active bond managers rank the risks according to Standard & Poor's or other ratings agencies.

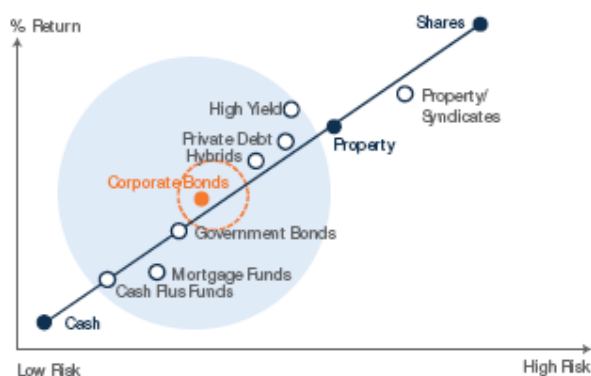
There are other risks in bond portfolios. These include liquidity risk, equity risk, sovereign risk, currency risk and event risk. To compensate for these higher risks bond investors require higher returns than cash.

### The benefits of active management

Through active management, the investment manager of a bond portfolio has the benefit of being able to diversify risk by holding multiple bonds, while aiming to earn a higher yield than cash. Moreover, a dedicated portfolio manager typically has the resources to analyse the credit risk of all bond issuers, and can trade away from risk in the portfolio in a timely fashion, or secure higher yielding bonds where credit risk levels are considered appropriate.

### Where does a bond fund sit on the risk curve?

Typically bond portfolios sit in the orange coloured region identified in the following chart. However, the balance between government (less risky) and corporate (more risky) means that overall a bond portfolio can sit anywhere in the grey area on the risk curve.



Source: AMP Capital Investors

## Bond funds and term deposits compared

Features	Bond Funds	Term Deposits
<b>Income based on</b>	Portfolio return based on bond yields – coupon payments plus any appreciation in bond values	Fixed rate of interest paid by issuer, usually a bank
<b>Management style</b>	Actively managed portfolio to beat the relevant benchmark – UBS Composite Bond (All Maturities) Index	Passively managed, simply a deposit with a complying financial institution with a fixed term and interest rate
<b>Value can appreciate or depreciate</b>	Yes, with changes in interest rates because bond values adjust to interest rate changes, hence the value of a bond fund changes too	No, generally a term deposit has a fixed rate of interest and the redeemable value remains the same and is redeemable on maturity
<b>Backed by</b>	Credit of underlying bonds – mix of government, bank and corporate issuers	Individual bank issuer balance sheet
<b>Credit risk</b>	A mix of ratings based on the blend of underlying bonds	Generally the same credit risk as the issuing financial institution
<b>Other risks</b>	Liquidity risk, equity risk, sovereign risk, event risk, and currency risk	Sovereign risk, and event risk

### Summary

Investors look to bond funds as a means of potentially earning more than the underlying cash alternatives available from financial institutions. Unlike term deposits, bonds can generate capital growth. Term deposits are not diversified, and they are relatively illiquid – early redemption is penalised. Active management of a bond portfolio can secure higher returns with the benefits of credit and risk analysis, and diversification. However, on the risk spectrum investors need to ensure they are aware of the additional risks associated with bond investments.

**Source: Jeff Brunton, Head of Credit Markets, AMP Capital Investors**

## You're a long time retired

Forward forecasting and predictions from the Australian Bureau of Statistics (ABS) tells us that, with improvements in Healthcare, we are going to be around for some time after we retire.

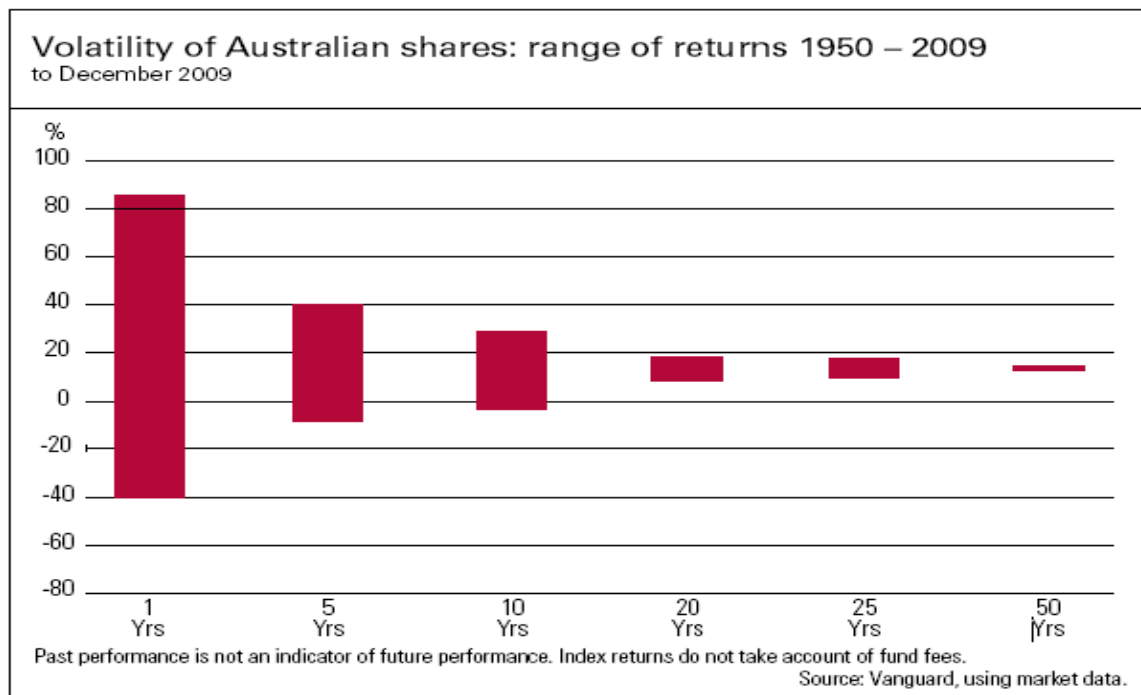
The ABS estimates that the life expectancy for an Australian man is now around 78.5 years and, for women, it's expected to be around 83 years. The forward projections are in 2050 men living to age 95 and women to age 98.

Therefore if you are to stop working at 60 or 65 then you are going to be retired for a very long period of time. So the question is – do you have enough invested to ensure you can support yourself for this entire duration? In finance jargon this is known as longevity risk - the risk that the amount of money an individual saves for retirement might not be enough to sustain them, due to increased life expectancy.

It is a difficult topic to consider and address if you are still in your early years but failure to, first, recognise and, second, to act will almost result in one of two outcomes – you will be working longer than you had hoped to or

you will circumvent accepting a basic existence in retirement, and that's not living.

One of the most basic and intuitive methods of countering longevity risk, and investment risk for that matter, is to simply give yourself more time, as shown in the following graph.



Looking at the graph you can see that with a shorter investment time frame of just one year the annual returns range between approximately -40% to over 80%. However, with a longer investment time frame this variability in the annualized rate of returns drops quite significantly.

Consider then someone in their late 50's or early 60's that is planning to retire at age 65. Having realised that they do not have a sufficient amount of investment capital for retirement they start investing in shares in order to get their assets working harder for them. In such an instance, not only are they taking on more risk in order to, hopefully, benefit from greater returns – their investment timeframe is likely to subject them to greater variability in their returns.

Unfortunately, for most, their superannuation is not forecast to be sufficient to allow them to retire comfortably. But it is, nevertheless, a significant asset that deserves focus and attention.

Taking an interest in your superannuation now, managing it carefully in line with your investment timeframe, and ultimately shaping its long term performance should result in a nice nest egg in retirement. There are certainly no guarantees in the investment game but I'd certainly like to think that more attention to your investments, either by yourself or in conjunction with an adviser, should translate to a better long-term outcome.

In summary, time is a key function in all investment decisions. It works against us when we are retired and trying to ensure that we have enough investment capital to see us through our retirement. And, yet it works for us when we are still young and saving for our retirement by reducing the volatility in our returns over TIME.

### **Michael Savy – Financial Planner Empower Wealth.**

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