Profile's Corner

Winter 2014
Issue 17

IN THIS ISSUE

PROFILE
FINANCIAL SERVICES

www.mosttrustedadviser.com

PROFILE UPDATE

Welcome to Volume 17 of our quarterly client newsletter. In this section I provide an update on what's happening at Profile.

By Sarah Abood, CEO

- How satisfied are you?
- The winner of our travel voucher draw
- New appointments in the planning team
- A heads-up on our coming move in Parramatta

We recently received the results of our Client Satisfaction Survey for 2014. Longstanding Profile clients will have noticed a few differences this year, as we have changed to a provider that runs surveys for many planning firms – allowing us to directly compare our results with other similar firms.

We are very pleased with the results! For overall satisfaction, clients gave us an average rating of 9 out of 10, well above the average for similar firms (8.4). Each of our main advisers also received very strong ratings. I am proud to say this has qualified them to be included in a new initiative recently launched by the survey firm - a "Most Trusted Adviser" app. Please feel free to pass on the website address (on the left) to friends and family looking for an adviser who can deliver exceptional client service and performance as rated by their own clients.

Of course there is always room for improvement. We are reviewing the detailed findings to ensure we capture all the insights and suggestions, and will be making changes accordingly. We will let you know about these changes as they occur.

All clients who responded to the survey were entered in a draw with the prize a $500 travel voucher. The lucky winner was Ray Hughes! Congratulations Ray – have a fantastic time wherever you decide to use the voucher.

As Profile is growing we are making a number of changes in our planning team to ensure that clients continue to receive excellent levels of service. **Scott Ungaro** (who wrote our client profile in this newsletter) has been promoted from Associate to Financial Planner. Scott has been with Profile for almost three years now and has impressed us all with his capability, dedication and professionalism. He has formed great relationships with Profile staff and the clients he is supporting, while also showing great commitment to improving his professional skills - adding an Advanced Diploma in Financial Planning to his Masters of Financial Planning. Scott is now starting his CFP studies.

We have also recruited a new Associate Financial Planner, **Rachael Arnold**. Rachel has completed a Bachelor of Business at UTS (with a very distinguished academic record) and her Diploma of Financial Planning. She can also speak basic German, is a frequent traveller to London, the US and Switzerland, and very talented at lawn bowls! Rachael was previously at Centric Wealth, working in a similar role. She is looking forward to progressing her career with Profile and getting on to the path to being a Senior Financial Planner. She will be working very closely with Scott initially as she settles in to the role.

Our Head of Financial Planning, **Phillip Win,** is also taking on more of a role in mentoring and training our growing planning team within Profile.

Many clients will already be aware that Profile is planning to **relocate our Parramatta office** in coming months (we will still retain offices in both the Sydney CBD and at Parramatta).

After reviewing available alternatives in the city, we have decided to extend the lease at our 261 George Street office for one more year.

We will however be moving soon from our current North Parramatta location. Our current space, Creagh Cottage, is a beautiful heritage building but the communications infrastructure is degrading fast, the building requires maintenance and our landlords are planning to sell. Consequently we are in the final stages of negotiation for office space in the Parramatta business district. Our aim is to secure a high-quality space with easy parking for clients and access to public transport, as well as high-speed and reliable digital communications. We will let you know as soon as our new location is finalised!

INVESTMENT UPDATE

By Jai Parrab, Portfolio Manager

Interest rates: friend or foe –or both?

Period returns to 31 July 2014 (%)

ASSET CLASS*	1 MTH	3 MTHS	1 YR
Australian shares	4.4	3.6	16.2
International shares ($A)	-0.5	2.0	13.2
Fixed interest	0.3	2.5	5.5
Cash	0.2	0.7	2.7
Gold ($US)	-3.4	-0.7	-3.2

In late 2007 the strength of the local share market over the preceding five years meant many investors were reluctant to move to cash or bonds. So much so that at the time I remember taking a photo on my phone of a Westpac advertisement offering investors a special rate of 8.0% on a 5-year term deposit! Compare that to the dividend yield on the Australian share market at the time - between 4 to 5%, and 10-year Australian government bonds - about 6.0%.

Fast forward to today. The average interest rate being offered by the major banks on a 1-year term deposit is 3.3%. The dividend yield on the Australian share market is 4.3% and the yield being offered on a 10-year Australian government bond is 3.4%.

With year-on-year inflation at 3.0% (as at end June) the returns after inflation on many investments are very skinny indeed. For those on fixed incomes, particularly retirees, times are exceedingly tough with traditional cash and bonds just not viable investment options.

Worryingly, in reaction many investors are being forced into the riskier asset classes just to stay ahead of the game. When equity markets are harsher than they have been recently or when large investors are more reticent to take on risk – as they inevitably will be – that sets the scene for more badly advised retirees losing significant amounts of money.

Is Governor Stevens the answer?

Is the solution simply higher interest rates? If the Reserve Bank of Australia raised interest rates from the current 2.5%, so the argument goes, retirees could sell their risky assets, move to a more diversified portfolio across cash, bonds and some equities, and still derive a reasonable income to fund their lifestyle.

Unfortunately, the answer is not that simple. There are three moving parts when it comes to the more defensive end of the cash and fixed interest spectrum:

1. Very short-term Australian cash rates, driven by the Reserve Bank of Australia (RBA),
2. Term deposit rates, which are determined by cash rates and how easily Australian banks are funding their balance sheets. If they need more deposits, they will bid up the margin between term deposit rates over the relevant cash rate; and
3. Longer-term bond rates, decided by future expectations for growth and inflation.

The cash rate position

The RBA has lowered short-term interest rates from 7.25% (August 2008) to 2.5% today (since August 2013). It has done this to support domestic growth in the face of a number of recent headwinds: weak offshore conditions, a strong Australian dollar, a cutback in mining investment and a lack of business confidence.

The major reason for the importance of the RBA's decisions to the general population is that they are a central plank in the pricing of variable rate home mortgages. As the RBA has cut cash rates, so too have the banks cut mortgage rates, with the standard mortgage rate almost halving since late 2008 and providing a huge boost to the Australian household.

For retirees, the rate cuts have cut into living standards hard, as discussed above. But the RBA's rate cuts have also kept the economy going, thereby supporting government revenues and accordingly largely preserving benefits heavily relied upon by older Australians (such as health and pensions) from the Government's budget cuts.

The term deposit rate

As noted above term deposit rates are determined by a combination of cash rates and how easily Australian banks can fund their balance sheets. If banks need more deposits, they will bid up the margin between term deposit rates over the relevant cash rate.

A bit of history: for the ten or so years leading up to 2008, banks in general offered 1-year term deposit rates at an interest rate approximately 0.0% to 1.0% **lower** than the 1-year government bond rate. This was primarily driven by their ability to easily and readily access offshore funding to satisfy their capital requirements.

The crisis of 2008 brought that party to a quick close. To raise money in Australia instead, banks were forced to compromise on profits and offer term deposits at a premium over the 1-year bond rate. Since 2008, banks in general have offered 1-year term deposit rates at an interest rate approximately 1.0% to 2.0% **higher** than the 1-year government bond rate.

In essence, high term deposit rates in 2008 reflected the high cash rate but also the desperation of banks needing to raise capital. While this was great for retirees wanting the income, it reflected a banking system under pressure, which impacted both their profits (and dividends), and also their ability to lend to households and businesses.

The long-term bond rate

Interest rates, or yields, being offered by long-term bonds reflect investors' expectations of longer-term growth and inflation. If bond investors believe that growth and/or inflation will be higher, then longer-term interest rates are likely to rise. If growth is the primary driver, then one would assume this is a good outcome for everyone. Retirees are able to source lower risk income, and consumers and equity investors should benefit from the higher growth environment.

While this in theory is correct, it does come with one big risk. What if the economy and share market are only doing well because long-term interest rates are so low? The other risk is if those rising interest rates are being driven by inflation concerns, especially if they are unaccompanied by growth. In this environment, retirees may earn a higher income but this will be matched by a higher cost of living.

High inflation is typically also bad news for share markets, since rising costs tend to put pressure on company profits. This would not only impact stock investors, but may also have broader economic ramifications if companies decide to lay off staff to cut costs.

Balancing higher interest rates with portfolio returns

Our job is very simple. In an environment of ultra-low interest rates, we need to assist in the generation of real returns at an understood and accepted level of risk. Hmmm - maybe it isn't so simple now! Today, share markets are fully valued, if not overvalued, and economic conditions are still fragile. The significant gains on Australian banks' share prices along with their strong yield recently experienced cannot be expected to continue.

Term deposits and bonds show a similar story. Five years ago we could lock in some very nice rates, while today those rates are barely above the inflation rate, and in some cases lower. So is it possible to leave the safety of cash and bonds in pursuit of higher yield or growth, without getting caught up in bubbles?

We think it is. Of course, some risk must be taken to generate returns. This is not simple. However, by understanding the complexities of different markets – their benefits and their risks - within a proactively managed portfolio and sticking to a disciplined investment strategy, we believe there are still ways for savvy investors to make money and protect their existing capital - without jumping into the abyss.

DON'T WASTE A CENT OF YOUR CHARITY DOLLAR

By Kurt Ohlsen, Senior Financial Planner

When people give to their favourite charities, I am sure they are thinking mostly about the people they are helping. While I think this is and always will be the main reason for charitable giving, recently I have been talking more with clients about how to get more bang for their philanthropic buck.

A deductible gift recipient (DGR) has been vetted by the ATO as satisfying a number of requirements. For example, it must fit into at least one of 40 categories including health promotion charities, school building funds, overseas aid funds and registered cultural and environmental organisations. When you make a contribution to a deductible gift recipient (DGR), you will generally receive a tax deduction, putting you in a better financial position. Of course, this may allow you to gift even more!

Method 1

The first way contributions to DGRs may assist is simple, but takes some planning to implement. If you are part of a couple, you should both discuss what charities you would like to give to over the coming financial year, and how much you would like to give together. You can then also make a best guess of what both of your marginal tax rates will be, and make sure that the person with the highest marginal tax rate actually makes the gift. While this does seem obvious, the very personal nature of giving and charity can often see the person on the lower marginal tax rate making gifts, because he or she may be the individual more often approached for a contribution.

Let's say we have a couple where:

- Partner A earns $200,000 a year,
- Partner B is managing the house and kids and not earning an income; and.
- They would like to donate $5,000 to charity.

If Partner B makes the donation of $5,000, that is $5,000 gone from the family budget in after-tax terms. However, if Partner A makes the same $5,000 donation, the benefits of the tax deduction earned means it will only cost the family budget $2,750.

Partner A could actually increase the donation to $9,090 – 82% more - and it would have the same impact on the household budget as Partner B making a $5,000 donation (NB: there is a higher cost upfront until the relevant tax return has been done).

Method 2
This method takes into account the timing of your donation. For example, suppose you are:

- Normally on a relatively low tax rate,
- Plan on donating $2,000 a year on an ongoing basis; and
- This year as a one off you will have a higher marginal tax rate because of a good capital gain on an investment property.

In this situation it would be worth considering bringing forward a few years' donations into the current year, where the value of the tax deduction is maximised.

While this can be a great strategy, there can be risks associated with doing this. For example, you may continue to gift in future years, blowing your longer-term donations budget, and it does not allow you to adjust your donations along the way.

This method is particularly relevant for people approaching retirement. Assuming the majority of your wealth is held in your superannuation fund, perhaps bring forward a few years of donations prior to your retirement, while you are still paying tax. After retirement, the majority of your assets will be held in a pension which does not pay any tax.

Method 3
Retirees can help both their charities and their (grown up) children in both financial and educational ways.

There are two false mindsets that younger people can be prone to falling into: the 'I can always save later' mindset, and the 'I will give to charity later when I am in a better financial situation' mindset. I know I fell into this second trap and it was my father who helped educate me about the need to just start something now!

So how do you help the charities, educate your kids and potentially even help them out? Firstly, start talking to them about charitable giving and who they would like to help.

Some of my clients have then come to an agreement with their adult children, that they will help the kids out with their general living expenses on the proviso that the children make a similar size donation to the charities that they want to support.

The charities get the money, the kids get the value of the tax deduction (assuming they have higher marginal tax rates than you do) and they get into the habit of philanthropy.

There are plenty of different options to consider and your personal and family circumstances can make a big difference. Your Financial Planner can help, and will be happy to discuss it with you.

WHAT'S WRONG WITH FINANCIAL PLANNING?

By Sarah Abood, CEO

Anyone reading the financial press over the past couple of years could be forgiven for thinking the entire industry needs to be tossed out and started again from scratch. Far too often we hear stories about unsuspecting clients being dudded by ruthless, corrupt and sometimes fraudulent financial "professionals".

As CEO of a financial planning firm that prides itself on operating in the interests of its clients, I find these headlines very disheartening. I wonder, how on earth can the average person know who to trust anymore? Financial services have become so complex and highly regulated that judging whether you're getting good or bad advice is getting very hard for anyone outside the industry to do.

That said, there are a few basic principles to go by and questions to ask that can be a very useful guide to judging quality of advice. I've listed some of these below, and explained Profile's approach. I am not intending to attack other firms or business models - there are many ways to run a good firm and institutions in particular have a role to play in providing affordable advice to Australians. Rather, my theme is transparency. You should be clear and realistic about your own expectations and you should understand who is calling the shots and how they are paid.

If it sounds too good to be true, it probably is

An oldie but a goodie. I still remember the advertising Estate Mortgage used to run in 1990 – just before they went under along with their clients' life savings. "High returns – nice and safe!" was the headline. A contradiction in terms, unfortunately.

A more recent example comes from the fallout from the "Global Financial Crisis" or GFC of 2008. A financial planning firm called Storm Financial had been advising clients to gear themselves up heavily to invest in the sharemarket. The worst cases were age pensioners who had been 'triple geared' - advised to borrow against their homes, use that money as collateral for a margin loan, then buy investment products which also used gearing. The GFC hit, and many investments froze and/ or lost the majority of their value. These people were left with no investments, heavy debts and no income to service them. In many cases they lost not only their life savings, but their homes as well, and were bankrupted into the bargain.

This was an appalling advice failure, and the planning firm (as well as two of the banks which provided the margin lending facilities) have been rightly pilloried for their behaviour.

However, I wonder whether greed – or at least wishful thinking - also played a role for some investors. They were told of the fabulous returns they could earn with these strategies and they wanted to believe it was possible to become rich this way. Sharemarkets would keep going up, dividends would pay the interest on the debt, and they would be able to fund their own retirements and help their children and grandchildren into the bargain.

The Australian sharemarket – the equal best-performing market in the world over the long term (level-pegging with South Africa) – has averaged real total returns of 7.4% pa over the past 113 years [1]. Anyone promising you investment returns much greater than this is asking you to take on risk much higher than the sharemarket's. You should know that there is a good chance you will do your dough.

At Profile, we are cautious about projecting high returns from investments. We focus on real (that is, after inflation) returns and minimising downside risk for our clients. We sometimes lose potential clients to other firms who are promising higher returns, but we think ours is a more sustainable approach and that over the long term our clients will be better off.

Who owns the planner's firm?

It's still not widely known how dominant the "big 5" (the four major banks and AMP) are in the financial planning industry. In fact just over 70% of Australian financial planners work in firms owned by one of the big 5[2]. According to the latest Roy Morgan survey[3], 55% (previously 51%) of Financial Wisdom clients think their planner is independent (it's actually owned by the Commonwealth Bank) whereas most clients of Commonwealth Financial Planning understand that it is owned by CBA (86%). So it seems clear that branding is the problem - it creates confusion for clients when their planning firm has a different brand to its ultimate parent.

Why is this a problem? In my view, it's about expectations. You probably expect to be recommended a Commonwealth product by a Commonwealth financial planner, and that's probably fine! But if you are recommended a Commonwealth product by a Financial Wisdom planner, you may not realise that there could be bias in that recommendation, if you don't know that CBA owns the firm. It doesn't mean it is a bad product. But there should be a higher burden of proof that it's the best product for you, if a differently-branded institutional parent is involved.

Profile is owned 100% by its directors and staff, and our unitholders agreement specifies that only a natural person (or their trust) can be an owner.

Who licenses the planner's firm?

Licensing is another little-known aspect of our industry. To offer "personal" financial advice in Australia – advice that purports to be tailored to your own circumstances and to be in your best interests – a particular type of Australian Financial Services License (AFSL) is required. These licenses can be difficult to qualify for and are very onerous and expensive to maintain. Many financial planning firms outsource this aspect, 'renting' a license from another provider which takes on the compliance, monitoring, training, professional indemnity and so on for an ongoing fee.

So far, so good. But problems can emerge when an institutional parent owns the licensor. One of the aspects the AFSL holder controls is the products that a planner can sell – called an Approved Product List (APL). These are products that are regularly researched by the licensor and are ideally the 'best' by some impartial measure in their respective fields. There is a huge amount of choice in Australia – Morningstar estimates there are over 10,000 managed funds available, for example[4]. It's impossible for anyone to be across them all, so focused research is essential. The problem comes if products offered by a parent institution are given a favoured position on the APL and those products don't offer competitive fees, performance and/ or service.

Some of the institutions play this a different way. As part of a succession planning strategy they offer to buy a financial planner's business at some time in the future. Called "buyer of last resort", these arrangements can give a planner an incentive to use the institution's products on their APL, even if he or she is not currently owned by the institution. Why? The price the institution will pay for the planner when it does buy that planner's business is often higher on a like-for-like basis for products it manufactures than for those it doesn't manufacture. So the planner knows they are increasing the ultimate value of their firm by recommending that institution's products to clients.

It can be even harder to find out who licenses a planner than to find out who owns them. The document to check is called the Financial Services Guide (FSG), where this information is required to be disclosed. You might need to dig further though if you don't recognise the name, because many institutions own license providers with different brands.

Profile owns and operates its own AFSL.

How is the planner paid?

There is a lot of debate in our industry right now about what is the best way for a planner to be paid.

Profile was one of the first planning firms in Australia to adopt 'fee for service' – meaning that broadly speaking we are paid an agreed fee by our clients rather than commission by product providers.

But we are not one of the (very few) firms in Australia that can meet the definition of 'independent' under the corporations act. The reason for this is legacy. Some of our clients have been with our firm for 30 years or more and when those clients joined us, the product landscape was very different. Investment products had ongoing commission built into their fee structure and for a range of reasons some of those clients still hold those products. So in these cases we keep the commission, with the agreement of the client, and it's offset against the usual advice fee.

Another vexed area is insurance. For several reasons we often agree with clients to be paid via commission on insurance products. One is that this operates as a kind of 'success' fee – it is tough as a client being asked to pay a fee for service up front if, for example, you end up being declined! Another issue is timing. A big part of our role in insurance is assisting clients to claim on their policies– a time of your life when you may be very ill, grief stricken or otherwise at a very low point. We are challenged by the idea of having to ask clients to pay us a possibly substantial fee for our assistance at such a time. The last point is similar to the investment point – many insurers reduce the client premium by less than the amount that we forgo, if we don't take commission. Sometimes the margin can be quite large and we think that is outrageous.

Another area of discussion is the pros and cons of asset-based fees. That is another article altogether. Suffice to say transparency is again the key. We clearly disclose all fees to our clients in the Statement of Advice, the Ongoing Service Agreement and the Fee Disclosure Statement. We are about to commence a project to look again at the way we charge and ensure that our fees remain in line with our clients' needs and expectations and offer good value.

You should be very clear on who you are paying, what you are paying them to do, and how much you are paying them. This sounds simple but in the complex area of financial services it can sometimes be hard to find out!

Some final thoughts

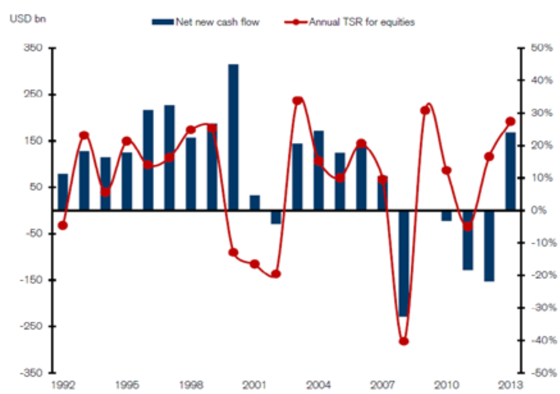
Two other warning signs are worth mentioning. If you are classified as a "wholesale" or "sophisticated" investor, you might have a much harder time recouping losses from the firm if things go wrong because you were badly advised. If you are not in fact super-rich and don't have an accountant's certificate, you should question this classification.

The other warning relates to risk profiling. The clients I mentioned earlier who suffered losses at Storm Financial were generally classified as 'aggressive' investors – meaning they apparently felt able to withstand significant investment losses. If you don't really feel this way, your investment results are likely to be disappointing.

The chart below shows the very strong historical link between market returns and net flows (investments). We tend to buy when returns have been strong, and sell when returns have been poor - behaviour that's guaranteed to hurt the value of our assets!

Source: Investment Company Institute and MSCI.

Note: MSCI World Index results are based on total returns including gross dividends.



This is why we focus our investment advice primarily on clients' goals. We look to recommend investments that will get you where you want to go with the least possible risk, rather than trying to beat markets, or match a risk 'preference' or 'profile' that may well change, often at the worst time for you.

It's my hope that the much-altered and still uncertain "Future of Financial Advice" (FoFA) legislation will go at least some way towards addressing the issues I've discussed, and restoring the trust of Australians in a profession that is vital to the future financial wellbeing of this country.

[1] Credit Suisse Global Investment Returns Yearbook 2014. Returns measured from 1900 – 2013. Real total returns are above inflation and assume reinvestment of dividends.

[2] Money Management Magazine, Money Management 2014 Top 100 Dealer Groups research.

[3] Roy Morgan 2014 Single Source survey.

[4] Quoted in "Make sense of managed funds", News.com.au, January 23, 2012

CLIENT PROFILE – JOHN & LAUREN MCMAHON

By Scott Ungaro, Financial Planner

John and Lauren McMahon have recently succeeded in three ways – they are new parents, new homeowners and new clients of Profile!

John grew up in the small town of Airdrie (population: 30,000) near Glasgow, Scotland. He spent most of his boyhood playing football (soccer) and - he says - staying out of trouble. Later, his studies toward a management degree at the University of Glasgow gave him the opportunity to complete an internship in Indianapolis, USA, which eventually led to living there for an additional 12 months once he graduated.

Deciding it was time to return to family and friends from the US, John moved back to Glasgow in 2003 where he reunited with an old friend – Lauren. With absence making the heart grown fonder, their friendship deepened into something more.

However, there was another suitor for Lauren's affections – Australia! Rather than separating, they both settled in Sydney and were almost immediately employed – Lauren as a registered nurse and John in sales for a media company.

Finding life in Sydney with Lauren was a dream come true, John decided he, Australia and Lauren could make a beautiful team. So in the 2009 Christmas holidays they were married in front of family and friends in Scotland, marking the start of their new family. The choice to return to Sydney was relatively easy: "The weather, lifestyle, job opportunities and work-life balance outweighs the difficulties of being so far away from our families," he says.

Skip forward a few years and John felt he needed a new challenge, moving on to a larger media company. Combined with the happy birth of their first daughter, Isla, in September 2012 things were getting busier – and more expensive.

John and Lauren had always been good with their finances and had a general understanding of the topic, but felt the decisions they faced could be assisted by a professional. They approached Profile for help. John's genes certainly pointed him in the right direction when it came to this - his mother is a Financial Planner back in Scotland!

Lauren gave birth to another little girl, Ivy, in June 2014. With their growing family, John and Lauren have now moved from the hustle and bustle of the eastern suburbs to the suburbs south of Sydney. John realises that the commute will be longer but they are excited about settling into a place of their own. Because John and Lauren were smart with their finances at an earlier age, they were able to accumulate enough funds to cover the deposit on the house they wanted.

Lauren plans to go back to work part-time once the girls are a bit older, but just for the moment she loves being a mum. She can be found walking the girls around the park or beach, and tries to sneak in a swim whenever she can. John continues to play soccer with friends whenever he can, but his new responsibilities make that difficult. He hopes to one day start his own company but clearly has his hands full at the moment.

Good luck to Lauren and John and we are very glad that Profile has been of service to them in navigating their financial futures.

PROFILE FINANCIAL SERVICES PTY LTD
Level 8, 261 George Street, Sydney NSW 2000
63 Sorrell Street, North Parramatta NSW 2151
PO Box 2500, North Parramatta NSW 1750
T: +61 2 9683 6422 F: +61 2 9683 4658

admin@profileservices.com.au
www.profileservices.com.au