Financial Wisdom

Insights

Financial issues affecting your lifestyle > Edition 16, Summer 2005

INSIDE

Invest for minors to give them a head start

The cost of raising a child is widely quoted as being in excess of $200,000, and can be as high as $400,000 if private education is included. What's available when investing for children?

Invest for minors to give them a head start

The cost of raising a child is widely quoted as being in excess of $200,000, and can be as high as $400,000 if private education is included. And the Federal Government's $5,000 baby bonus doesn't make much of a dint in a number as big as that.

Alongside the mortgage, the cost of raising and educating children is becoming a substantial and sobering cost for families.

Increasingly it is grandparents who are pitching in to help pay for the children's education. Many feel that helping with education costs is one of the best ways to help ensure a bright future for their grandchildren. More than one-third of grandparents of children aged 17 or under would seriously consider helping financially to send their grandchildren to private school in the future[1].

Whether it is to pay for education or to set a young person up with a 'coming of age' fund, there are a number of investment options you may think about.

What's available?

This article looks generally at how three types of investments for minors operate. As always it is important to speak to your financial adviser to discuss whether any particular investment is suited to your needs.

1 Education savings plans

Also known as scholarship plans, education savings plans are offered by friendly societies. The plan is essentially a life insurance policy specifically designed to help meet the costs of education for a nominated child.

Who holds the investment?

There can only be one nominated student/child per plan – the holder of the investment can be the child's parent, grandparent or an adult who is not related.

What about tax?

Liability for tax on benefits paid from these policies is borne by the recipient. Where the recipient is a minor (under 18), special rates of tax apply to the benefit received.

2 Managed funds for minors

A managed fund is an investment across property, shares, bonds and cash. You can choose a fund where the risk profile suits the term of the investment.

Who holds the investment?

Generally children cannot hold units in managed funds directly. Often a relative (over the age of 18) will invest as the legal owner on behalf of the child. In this case the child may be the beneficial owner of the investment.

What about tax?

Liability for tax on income earned will rest with either the adult who makes the investment, or the child, depending on who has beneficial ownership. Structuring the investment with a child as beneficial owner means special rates of tax apply to income earned, reducing the attractiveness of some investments. You should consult both your taxation adviser and your financial adviser to determine whether investing in this way would be appropriate for you.

3 Insurance bonds

Insurance bonds designed for investment with children in mind are known as 'child advancement policies' and are offered by life insurance companies. The bonds are capital growth investments.

Who holds the investment?

Child advancement policies are generally held in a parent's name with ownership transferring to the child at a vesting age (typically between the ages of 16–21) as nominated by the parent. At this time the child takes on full control of the insurance bond.

What about tax?

These investments are tax paid, meaning they are internally taxed at a maximum rate of 30%. However the tax rate payable by the parent holding the investment needs to be considered when appraising any form of insurance bond.

Find out more

The tax and social security rules applying to these different types of investments for minors can be complex, depending on individual circumstances. As well as the three options above there are also alternatives such as term deposits and direct shares which may be worth considering.

With careful analysis of your individual circumstances, your financial adviser can help you consider the best alternatives for providing for your children or grandchildren's future in a tax effective way.

---

1 Commonwealth Bank education savings survey. December 2004

A shift in the income rules may work in your favour

The Federal Government's focus on superannuation in the past two decades means more and more Australians will be self funding their retirement. The removal of the superannuation surcharge, along with the introduction of spouse contributions, and the co-contributions have helped increase super balances.

Given all the hard work involved in accumulating these funds it's important that they get put to good use. You should think about how best to structure and use your superannuation to maximise your lifestyle in retirement.

Income stream investments are an increasingly popular choice

They are available through either super funds or life insurance companies and you're able to draw down on your superannuation savings in a way that meets your individual income needs.

There are two main types of retirement income stream products offered by super funds – Allocated Pensions and Term Allocated Pensions (TAPs).

Both receive generous tax concessions, favourable Centrelink treatment, and can provide the certainty of a regular income. And a combination of the two types may also provide real benefits to individuals who are facing reasonable benefit limit (RBL) taxation issues.

A snapshot of Allocated Pensions

- An Allocated Pension (or annuity) investment is set up with the proceeds from superannuation savings.
- The holder can then draw a regular income from the investment. The income received must fall between the minimum and maximum amounts set each year and determined by the life expectancy factors of the account holder. Lump sum withdrawals can also be made but tax may be deducted.
- Allocated Pension funds can be invested in any number of options with different investment strategies. Each option will have its own objective and strategy and therefore carries a different level of risk and potential return.
- Income continues to be paid until funds in the account have been exhausted. If the account holder dies while there is still remaining capital in the investment this can be paid to:
  – A dependant as a lump sum;
  – To the investor's estate; or
  – To a beneficiary as an income stream.

A snapshot of Term Allocated Pensions

- Set up with the proceeds from superannuation savings.
- Complying income stream investments for Centrelink purposes. This means only 50% of the account balance is included in the assets test. In certain circumstances commencing a TAP can also allow clients to qualify for the higher pension RBL (see your financial adviser for further information).
- The holder receives an income stream for the term of the pension (which from January 2006 can be up to age 100). No lump sum withdrawals are permitted. At the end of the term the TAP ceases and no further payments are made.
- Funds can be invested in any number of options with different investment strategies. Each option will have its own objective and strategy and therefore carries a different level of risk and potential return.
- If the account holder dies while there is still remaining capital in the investment, this can be paid as an income stream to a spouse.

What's changing?

Recently, the Government announced the following changes to retirement income streams to increase their flexibility for retirees.

Term Allocated Pensions

- The option to extend the term that payments can continue until the member reaches age 100 (or until the member's reversionary beneficiary reaches age 100); and
- Allowing the annual TAP payments to vary between plus or minus 10 percent of their fixed amount.

Allocated Pensions

- Updating the minimum and maximum pension drawdown factors in line with current life expectancy factors.

These new rules will apply to new Allocated Pensions and TAPs from 1 January 2006. Pension providers may begin offering these changes at different times after this date, so you should check with your fund for more information.

How is your superannuation allocated?

Your financial adviser is well positioned to evaluate the different types of retirement income streams available and help determine which set up is best for you. Even if you have already established your income streams the changes from January 2006 may make it worthwhile revisiting your existing arrangements.

Talk to your financial adviser to find out more.

Markets bouncing back after an October dip

Australian shares

After five months of gains and new record highs, the Australian sharemarket fell in October. However, as November unfolded, share prices seem to have resumed their upward march.

In the five months from May to September, the sharemarket had risen 19%, driven by strong commodity prices and good profit outcomes. During October, inflation, oil and offshore sentiment worked together to pull the market down almost 4%. Then, in the first few weeks of November, reasonable results from banks and a recovery in the resources sector saw the market rebound almost 4%.

Global inflation concerns became apparent during October with the US producer price inflation rising at a rate of 6.7% – its highest level in over ten years. This pushed domestic long bond yields above 5.5% – the level that unsettled equity markets back in April. As bond yields rose, dividend yields from shares were comparatively less attractive and the market was sold off.

Over the past twelve months, strong energy prices helped drive the market higher. During October, the price of oil fell 9.8%, taking the energy sector and several materials companies down with it.

A final generic factor pulling the market down in October was falling global markets, with the Dow Jones industrial index down 1.2% and the FTSE 100 down 2.9%.

So what happened in November to halt the slide? Firstly, the US Federal Reserve lifted its Federal Funds rate to 4%. Soon after, the Reserve Bank of Australia left its official cash rate unchanged at 5.5%. As the US and Australian interest rate gap narrowed, the Australian dollar (AUD) fell against the US dollar (USD). This impacted resource companies.

Effectively, the price of gold and other commodities rose in AUD terms making Australian resource companies more profitable. Since the end of October, Lihir Gold has risen 14.3%, Rio Tinto was up 6.1% and Newcrest Mining has risen 5%.

A second factor in the market's turnaround was the banks. Westpac, NAB and St George all reported reasonable results. This, combined with stable interest rates and a strong economy, saw the finance (ex-property) sector rise 3.5% by mid November. Improvers included CBA up 5.5%, Macquarie Bank up 8.2% and St George up 5.1%.

As we enter 2006, the economy seems firm. The mining sector looks to be performing well, banks seem profitable and larger retailers are seeing sales growth. As profits grow this should support the Australian equity market.

International shares

International markets slid in October but staged a recovery in November. Like the Australian markets, international equity markets had risen from May to September. Investors were satisfied with US profit outcomes and the outlook for the US economy. A growing recovery in Japan also added to positive sentiment.

In October, all major markets were unsettled by fears of inflation in the US. Global bond yields rose and global equity markets fell. From the end of September to late October the FTSE 100 fell 6.1%, the S&P 500 was down 4% and the Nikkei fell 2.8%.

In late October and the first half of November, however, markets rallied on the back of positive comments by the Federal Government about the health of the US economy, lower oil prices and the announcement of Ben Bernanke as Alan Greenspan's replacement as head of the Federal Reserve.

If oil prices continue to be moderate, fears of inflation should recede as would fears of slower global economic growth. The latest figures out of Japan show that business confidence is lifting and that land prices are also beginning to rise. These are significant developments in the world's second largest economy.

From late October to mid November the FTSE 100 bounced back 2.8%, the S&P 500 rose 2.3% and the Nikkei was up 4%. To put these figures in perspective, over the year to mid November the FTSE is up 14%, the S&P 500 has risen 4.3% and the Nikkei is up 28.5%.

While the global economic outlook is positive, risks seem to be emerging for markets. The rise in the US Federal Funds rate from 2% to 4% over the past year is taking liquidity out of the market. Rising bond yields could also be putting pressure on borrowers. While these may not bring economic activity to a halt, they could dent cash investments.

Having said this, the global economic environment looks as if it is improving and this could lend support to equity markets.

The currency

The AUD has fallen 4.3% against the USD since the end of September. Higher interest rates in the US seem to have contributed to the decline with US interest rates now relatively more attractive. The AUD stood at US 76.37 cents at the end of September and by mid November had fallen to US 73.15 cents.

By Hans Kunnen, Head of Investment Market Research, Colonial First State

Note: all returns figures are for the period end September to 11 November 2005

6831/1105