Personal Wealth Adviser

Managing your personal finances

ISSUE 8

HLB MANN JUDD
ADVISORY AND ACCOUNTING

Our Sydney personal wealth management team provides you with a simple solution for your personal wealth needs. We have specialists in wealth management, superannuation, self-managed superfunds, estate planning, debt advisory and insurance services.

THIS ISSUE ALSO INCLUDES ARTICLES ON:

- Investors feel negative gearing pain as rate rises bite
- Risks to consider when nominating charities as super beneficiaries
- HECS debt changes in affect but 'sleeping giant' remains
- Investing when rates are expected to be higher for longer
- Rate rises reverberate through shares but property spared

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MICHAEL HUTTON

Partner, Personal Wealth Management

INVESTORS FEEL NEGATIVE GEARING PAIN AS RATE RISES BITE

Investment or holiday houses brought when rates were low face tough decisions as holding costs may prove too expensive.

For the first time in many years, investors are becoming reacquainted with the pain that can accompany a negative gearing investment strategy.

Negative gearing is where the costs of owning an investment outweigh the income generated. The aim is to earn a capital gain when the asset is sold, as well as claiming a tax deduction on the losses while the asset is held.

Borrowing to invest raises the risk profile in two ways:

- It heightens investors' exposure to gains but also losses. Investors are investing more than they have, so gains and losses are magnified.
- It rarely makes sense to borrow to buy a stable cash-style investment – essentially paying interest to earn interest. Normally, the target asset will be a growth-style, more volatile asset, such as property or shares, so it is inherently riskier.

While negative gearing is usually used on investment properties, it can apply to any investment where investors borrow to make the purchase, such as shares, managed funds or even artwork.

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The costs of owning the asset are tax-deductible only if the asset is earning income or available to earn income. A property is treated as available to earn income if it is actively advertised as such and is suitable to be rented, regardless of whether any income is earned during the period. There should also be no conditions or restrictions making it impractical or unattractive to be occupied by tenants and not reserved for personal use, such as a holiday house during peak holiday periods.

Over the past few years, investors have been able to borrow at low interest rates to buy an asset such as property. For example, one client borrowed $2 million to buy an apartment to downsize to in a few years, at which point they would sell their house and repay the loan. The difference between the rent received and interest paid was minimal, so the property was "neutrally" geared – neither a gain nor a loss.

Increase in costs

But with official interest rates rising from 0.1 per cent to 4.1 per cent in record time, and loan interest rates also typically rising 4 per cent, this downsizer property is costing an extra $80,000 a year to hold. Of this, tax of 47 per cent is saved, bringing the increase in holding costs to about $42,000 a year. They have tried to increase rents to help combat this increased cost.

Another client borrowed to buy a holiday house for $2 million, and chose not to make it available for rent. The $2 million loan is also now costing an extra $80,000 a year, but this is not tax-deductible, so they are rethinking whether it should be made available to rent. Another option is to sell the property.

For some investors, the tax deductions from negative gearing may outweigh other financial concerns, although tax considerations are rarely a good reason to hold on to an investment. Nonetheless, tax plays an important part in a negative gearing strategy as the losses incurred may be tax-deductible against other income during the time the asset is owned.

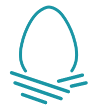
Interest usually represents the main cost of holding a negatively geared property. Other holding costs for a property include strata fees, council and water rates, insurance, maintenance and repairs.

On the positive side, rents do seem to be rising, and property values appear to be holding up, so long-term capital gains may offset any losses.

Those with a self-managed superannuation fund holding commercial property, where the commercial property is rented to the family business, may be able to get higher rent reassessments. This is handy where the investor is trying to get extra money into super in a tax-effective manner, not subject to contribution limitations and rules.

Michael Hutton has a monthly opinion piece in the Australian Financial Review. This article first appeared as part of this series on 25 September 2023.

Michael Hutton is a director of HLB Mann Judd Wealth Management (NSW) Pty Ltd (AFSL 526052) ABN 65 106 772 696



PRUE CHEESEMAN-GOODES
Director, Personal Wealth Management

RISKS TO CONSIDER WHEN NOMINATING CHARITIES AS SUPER BENEFICIARIES

A surviving spouse wishing to nominate their super to go to a charitable cause needs to follow a few key steps to ensure it is done correctly - and without animosity from other beneficiaries.

In the first instance, it is usually preferable for a spouse to nominate their partner as their super beneficiary. That is because, as a super dependant, the monies can stay within the super environment and be paid as an income stream with no tax paid on that money. However, should one pass away and their spouse wants their super monies to go to a charity, it is important to note that they cannot directly nominate a charity as their super beneficiary on the super death benefit nomination form. Otherwise, it will not be valid because a charity is not a super dependant.

While most surviving spouses have the best of intentions, these are futile if the documentation is executed incorrectly. The correct way for someone wishing to nominate their super to be paid to a charity is by having a super death benefit nomination to their Estate.

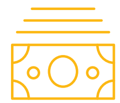
To ensure this occurs it is important that it is done as a binding nomination and is redone every 3 years before it lapses and converts to a non-binding nomination. Having a non-binding nomination means that the trustee will have discretion to determine where the benefit should be paid, and this could bypass the Will and not end up with the charity that the client chose. It must then be clearly set out in the Will that the money from the client's super is to go to a charity or split between charities.

This is just one example of why the administration of super beneficiaries is so important and why getting legal advice will ensure your assets are dealt with according to your wishes. When considering a charity, it is important to choose a reputable charity that aligns with your personal values.

Spouses usually nominate a charity where they have previously volunteered or have already been making regular donations. We also see situations where clients will spread the money between three or four different charities. However, the very notion of charity is quite personal, and choosing which one to support will depend on a number of factors including life experiences that may prompt support of a particular cause.

Finally, should the surviving spouse still have children, it is worth the spouse having a discussion to address any risk that they may challenge their wishes. Even if the spouse nominates a charity, the children might have a claim on their estate, so it is important the children understand their mother or father's intentions and what they have put in their Will.

If the spouse has children and decides not to give them money but instead, gives it to charity, it is recommended they include an explanation as part of their Will. In the event it is contested, the letter can be used as supporting evidence in court. Having an accompanying Letter of Wishes that explicitly states those wishes will provide an explanation for the decision and increase the likelihood of wishes being followed.



BILL NUSSBAUM
Director, Tax Consulting

HECS DEBT CHANGES IN AFFECT BUT 'SLEEPING GIANT' REMAINS

With an estimated three million people adjusting to Higher Education Contribution Scheme (HECS) indexation rate increases, many Australians living and working overseas remain unaware of their HECS repayment obligations.

From 1 July 2023, university graduates earning more than $51,550 per year are subject to an increase in repayment thresholds, reflecting the higher rate of inflation. Australian taxpayers working abroad are also now subject to a HECS repayment, having previously been exempt prior to 1 July 2017.

In the past, they've been excluded from paying the HECS debt. People naively thought they could move overseas and not worry about the debt, but now, they need to declare any foreign income earned to the ATO. Previously, they haven't been required to lodge a tax return in Australia; now, the rules have changed where they are required to disclose their income for HECS purposes, even though it's not taxable and make a HECS repayment.

Following the change in rules, the government was able to start recouping student loans from people living overseas. These requirements can be a sleeping giant as they're not typically a focus area in the media and aren't widely communicated.

Taxpayers who have a HECS debt and plan to live and work overseas are required to update their contact details and submit an overseas travel notification within seven days of leaving Australia (if you have an intention to reside overseas for 183 days or more in any 12 months), and lodge their worldwide income or a non-lodgement advice.

There has been an increasing number of clients – largely the parents of university graduates and students – seeking advice on how best to manage the increased indexation rates, particularly given broader cost of living pressures. The indexation rate increased from 3.9 per cent last year to 7.1 per cent, representing a 12-fold increase since 2021.

Parents might think they would prefer their children owe them money rather than the government, but a lot of parents don't understand the system very well.

Over the last few years, it hasn't been front of mind for most but with the increased rates coming into effect, people had to consider paying some of it off to reduce the impact of the new 7.1 per cent rate.

There remains confusion for many on the application of indexation rates, particularly given that historical low rates meant many were oblivious to the impact of the debt.

The indexing is applied on 1 June and does not account for withholding amounts paid throughout the year. For example, withholding amounts relating to HECS throughout 1 July 2022 - 1 June 2023 will not reduce the balance prior to indexing on 1 June 2023 as these repayments are captured on lodging an FY2023 tax return.

There will likely be another increase next year, so people will need to assess their individual circumstances and determine whether they want to pay the debt down in combatting the increased indexation or prefer money in their account. It is really dependent on their working and financial situation.

LINDZI CAPUTO
Director, Personal Wealth Management

INVESTING WHEN RATES ARE EXPECTED TO BE HIGHER FOR LONGER

With the outlook for inflation and interest rates being critical for returns many investors are wondering how they should position their portfolios if interest rates are expected to remain higher for longer.

While inflation has been falling, it is proving more difficult for central banks to tame and bring down to their target level with the RBA not expecting inflation to return to its 2 per cent to 3 per cent target range until December 2025. Persistently high inflation means that central banks are now expected to keep interest rates at the current high levels for much longer than previously thought.

The stickiness we've seen in inflation is being caused by a surge in energy prices and very tight labour markets, which is the narrowing gap between available jobs and people available to fill those jobs. The tragic events unfolding in the Middle East have added to concerns of inflationary pressure as world oil prices have been pushed higher.

We've seen increased volatility in equity markets in response to this growing expectation of central banks keeping interest rates higher for longer. Predicting short-term market movements is difficult, but taking a longer-term approach minimises the noise and gives more clarity to forecasts. The outlook for equity markets over a 10-year period remains positive (particularly for Australian equities and international equities ex US) so investors shouldn't react to current news and geopolitical events by making major changes to their portfolios.

A more sensible approach would be to tweak portfolios with a gradual increase in exposure to asset classes that are likely to give better than expected returns if inflation remains high for some time. Some examples of such asset classes are global infrastructure, high yield debt and inflation linked government bonds.

Global infrastructure assets invest in the physical networks and facilities essential to the functioning of society such as power, transport, waste, water and so on. This asset class has underperformed over the past 12 months but is now attractively priced and expected to deliver strong returns over the next 10 years.

High yield debt comes in many different forms and with different risk and liquidity characteristics. Broadly high yield debt produces returns that are close to those of equities, but with lower risk. They are loans where there is a meaningful chance of default, but the investor is paid higher interest rates to compensate for potential losses. High yield debt assets have a forecast average return of 8% pa over the next 10 years.

Inflation linked government bonds are government bonds that are indexed to inflation, so their principal and interest payments rise and fall with the rate of inflation.

With rising interest rates secure fixed interest assets are now providing more attractive yields so investors may also consider adding to this asset class, in particular longer dated investments targeting a 5% plus yield to their portfolios.

In this higher for longer environment investors should take a measured approach and stick with their long-term equity investments and consider adding exposure to global infrastructure, high yield debt and inflation linked government bonds within their secure fixed interest assets.

JONATHAN PHILPOT
Partner, Personal Wealth Management

RATE RISES REVERBERATE THROUGH SHARES BUT PROPERTY SPARED

A slew of interest rate rises has unequivocally impacted the share market but have yet to make a dent on local property prices. But having weathered short-term pain, will stocks shine in the medium to longer-term?

The Reserve Bank of Australia (RBA) has handed out 12 interest rate rises totalling four per cent since May 2022. While this has had an impact on both the Australian and global share markets, as well as the listed property market, residential house prices have largely recovered this year to be near all-time highs.

Share markets are forward looking and any negative impacts on the market are often felt sharply, more so than other areas of investing. But as 2023 has already shown, even when rates are still rising, the share market will bounce off the bottom and commence the next rising phase.

Longer-term higher interest rates do have a big impact on the share market. The price-to-earnings (PE) ratio will often be high when interest rates are low and people are therefore prepared to pay more for shares. However, when interest rates are high, the PE ratio of the market will be low.

Some sectors of the market are evidently hit harder than others, with the listed property space in particular still down about 15 per cent from the first interest rate rise in the first half of last year.

So, if shares have borne the brunt of the rate rises to date, what is the outlook for residential property prices? And just when will the impact of higher rates start to bite?

Perhaps most critically is the issue of borrowing capacity. Despite house prices largely remaining at the same level, variable interest rates having risen from two per cent to six per cent in a relatively short space of time. The average borrower is now impacted by a 40 per cent reduction in their borrowing capacity. To put it into perspective, this means that if an average family could borrow $1 million in early 2022, they are now only able to borrow $600,000.

There are clearly other supply and demand issues going on in the residential property market. In particular, immigration numbers are still very high from the COVID catch up. But as this all starts to return to normal levels, the higher interest rate environment will undoubtedly impact property prices.

Predicting the performance of the residential property market or, indeed, the share market, in the short-term is a foolish game. However, in the medium to longer term – beyond five years – given the share market was impacted by rates far quicker and sharper, it has a much stronger outlook than property, particularly in Sydney and Melbourne.

Now more than ever, it's important for investors to have a considered and thorough investment strategy, including appropriate asset allocation and level of liquidity. Historical data shows markets take major events in their stride over the long term. They are merely hurdles in a much longer race.

While asset allocation should be reviewed every couple of years to ensure market value is maximised, the smoothing of share market volatility over time means investors should focus on longer-term forecasting. This provides a more accurate reflection of market cycles and allows for volatility.

Jonathan Philpot has a bi-monthly opinion piece in Money Magazine. This article first appeared as part of this series on 19 October 2023.

Disclaimer
Jonathan Philpot is a director of HLB Mann Judd Wealth Management (NSW) Pty Ltd (AFSL 526052) ABN 65 106 772 696

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Meet our Sydney Personal Wealth Team

Personal Wealth Management

MICHAEL HUTTON
Partner, Personal Wealth Management
T: +61 (0)2 9020 4193
E: mhutton@hlbnsw.com.au

JONATHAN PHILPOT
Partner, Personal Wealth Management
T: +61 (0)2 9020 4196
E: jphilpot@hlbnsw.com.au

LINDZI CAPUTO
Director, Personal Wealth Management
T: +61 (0)2 9020 4284
E: lcaputo@hlbnsw.com.au

PRUE CHEESEMAN
Director, Personal Wealth Management
T: +61 (0)2 9020 4356
E: pcheeseman@hlbnsw.com.au

Superannuation & SMSF

ANDREW YEE
Director, Superannuation
T: +61 (0)2 9020 4213
E: ayee@hlbnsw.com.au

MELINDA MEASDAY
Director, SMSF & Aged Care Specialist
T: +61 (0)2 9020 4055
E: mmeasday@hlbnsw.com.au

Personal Tax Management

PETER BEMBRICK
Partner, Tax Consulting
T: +61 (0)2 9020 4223
E: pbembrick@hlbnsw.com.au

HELENA YUAN
Director, Tax Consulting
T: +61 (0)2 9020 4063
E: hyuan@hlbnsw.com.au

PETER BARDOS
Director, Tax Consulting
T: +61 (0)2 9020 4292
E: pbardos@hlbnsw.com.au

Other Personal Services

ANDREW KENNEDY
Risk Adviser, HLB Insurance Services
T: +61 (0)2 9020 4093
E: akennedy@hlbnsw.com.au

BETTY PRESHAW
Director, HLB Debt Advisory
T: +61 (0)2 9020 4226
E: bpreshaw@hlbnsw.com.au

ROBERT MONAHAN
Director, Estate Planning
HLB Estate Services
T: +61 (0)2 9020 4000
E: rmonahan@hlbnsw.com.au

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