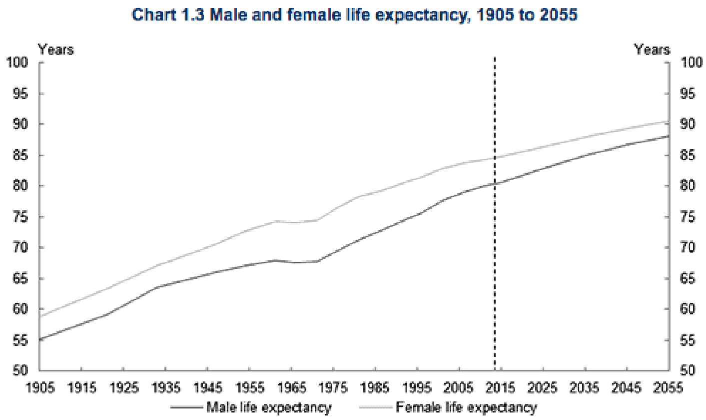
Generating Sustainable Retirement Income

Insights for sustainable retirement income

GEMCapital
Financial Advice

The risk of living longer than your money



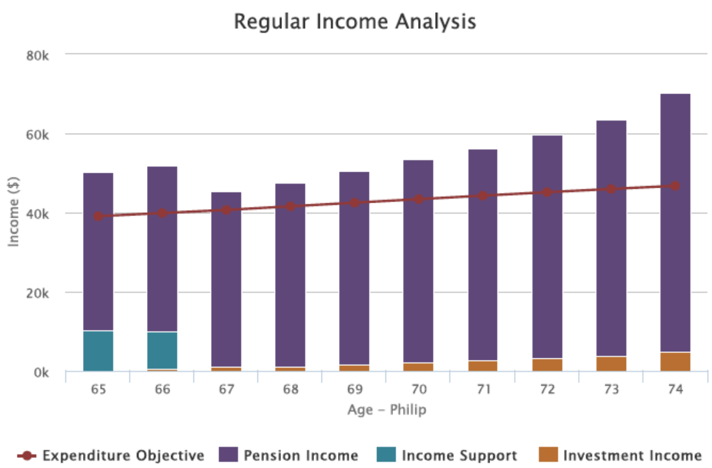
One of the most asked questions of financial advisers is "Do I have enough money to retire?" Fifty years ago a man retiring at age 60 generally only had to plan for less than 10 years of retired life. Today, according to the Intergenerational Report, 60 year old men are likely to live for 26.4 years, and 60 year old women for 29.1 years. The ageing of Australia's population will put strain on the Government's budget, which in turn is likely to result in retirees increasingly having to look after themselves in retirement. Retirement planning has never been more important.

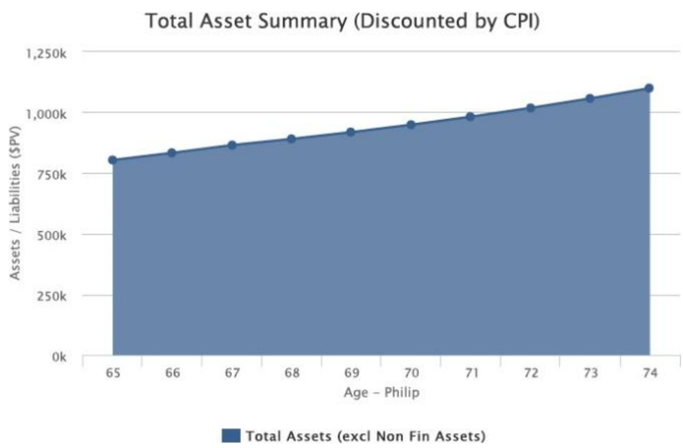
How much a retiree can sustainably spend ultimately revolves around some key areas:

1. Investment returns and other income
2. Tax paid
3. Level of spending
4. Access to Age Pension Benefits (where applicable)

We often remark in jest with our clients, "that retirement planning would be very straight forward if you knew when you were going to die" as retirees would know precisely how long they need to provide income for and could plan accordingly. In the absence of this, the next best tool to assist retirees is financial modelling.

Financial modelling inputs a retiree's assets, spending and personal details into a comprehensive computer model with a view of projecting financial information into the future. The computer model considers taxation, Centrelink entitlements and investment return assumptions and delivers a projected financial journey in retirement. We firmly believe that comprehensive modelling provides those in retirement with confidence to spend at a level, knowing they can afford it. We refer to this as 'Guilt Free Spending'. Below are outputs from GEM's financial modelling software.





Understanding Tax

Income Tax 101

In order to create tax effective retirement income, retirees should have a solid grasp of the income tax that applies to them. The below table shows the rates of tax for varying levels of income earned.

PERSONAL INCOME TAX RATES
1 July 2017 - 30 June 2018

Taxable income	Tax payable* - residents	Tax payable - non-residents
Up to $18,200	Nil	
$18,201 - $37,000	Nil + 19%	32.5%
$37,001 - $87,000	$3,572 + 32.5%	
$87,001 - $180,000	$19,822 + 37%	$28,275 + 37%
Above $180,000	$54,232 + 45%	$62,685 + 45%

A low income rebate of up to $445 also applies to those whose income is below $37,000, which means that the normal effective tax free threshold for Australians is $20,542pa. (First $18,200 free of tax, $2,342 @ 19% = $445 tax less a $445 rebate results in no tax payable).

For those over age pension age, a Seniors Tax Offset may be available which can further reduce tax for retirees and works in a similar manner as the low income rebate. This rebate is not well understood, but results in the effective tax free threshold for eligible retirees to be approximately $32,300 (single) and around $29,000 for each member of a couple ($58,000 combined).

Commonwealth Seniors Health Card

Those who have reached Age Pension age, are an Australian resident, but are not entitled to any Age Pension due to means testing may still qualify for the Commonwealth Seniors Health Card.

The principal benefit of this card is lower cost pharmaceuticals, however there can also be some additional discounts on some utilities, council rates and motor registration.

To qualify, 'adjusted taxable income', plus deemed income from allocated pensions purchased after 1st January 2015, must be below $51,500 for a single person, and $82,400 (combined) for a couple.

Age Pension entitlements

AGE PENSION AGES[1]			
Date of birth from	To	Qualification age	
		Female	Male
	31 December 1948	Already Qualified	
1 January 1949	30 June 1952	65.0	65.0
1 July 1952	31 December 1953	65.5	65.5
1 January 1954	30 June 1955	66.0	66.0
1 July 1955	31 December 1956	66.5	66.5
1 January 1957 or later		67.0	67.0

[1] The Government has announced it will progressively increase the Age Pension age to age 70 from 1 July 2025. Not yet law at the time of writing.

Accessing Age Pension benefits is a very personal issue. Some clients wish to pursue it, and some don't. For many retirees, age pension can form a useful boost to retirement income. Age criteria is set out in the table to the left.

A means test (both Assets and Income) is then applied, and the test that results in the lowest amount of Age Pension is the one that is used by Centrelink.

A summary of the means test thresholds are provided below. The significant changes to the assets test that came into effect on 1st January 2017 are represented in this table. It is important to note that under the assets test – Pension cut out will be $830,000 for a Homeowner couple, and $552,000 for a Single Homeowner.

The table to the right shows the current Assets and Income Test thresholds.

It is important that some common assets are exempt from means testing. These assets include:

1. Principal place of residence
2. Superannuation for a partner who is below age pension age
3. Pre-paid Funeral Bonds
4. Gifts made that are below the allowable limit ($10,000 per year up to a maximum of $30,000 over a 5 year time period)

We also highlight to retirees that it is only the market value (not the insured value) of motor vehicles and personal effects that should be advised to Centrelink. A good reference point for motor vehicle valuation is carsales.com.au.

ASSET TEST THRESHOLDS
20 September 2017 – 19 March 2018

	Homeowner		Non-Homeowner	
	Full pension	Pension cut out	Full pension	Pension cut out
Single	$253,750	$552,000	$456,750	$755,000
Couple	$380,500	$830,000	$583,500	$1,033,000
Reduction rate	Pension reduced by $78 pa per $1,000 of assets over full pension thresholds			
Indexation	▪ full pension thresholds are indexed each 1 July in line with CPI ▪ cut out thresholds applicable 20 September 2017 to 19 March 2018. Adjusted 20 March, 1 July and 20 September			

INCOME TEST THRESHOLDS

	Full pension	Pension cut out
Single	$4,368.00 pa	$50,876.80 pa
Couple	$7,800.00 pa	$77,916.80 pa
Reduction rate	Pension is reduced by $0.50 (singles) and $0.25 (each member of a couple) per $1.00 of income over full pension thresholds	
Indexation	▪ full pension thresholds indexed each 1 July in line with CPI ▪ cut out thresholds applicable 20 September 2017 to 19 March 2018. Adjusted 20 March, 1 July and 20 September	

Allocated Pensions and Annuities

Allocated Pensions

It seems that 'every man and their dog' want to recommend an allocated pension as the only solution to retirement income. Allocated Pensions have their place, but we are of the view that they have been overused.

An allocated pension is simply an investment that pays regular income, and must be purchased using superannuation monies. For those over the age of 60, the income is tax free, but retirees must withdraw a minimum amount of income from their pension each year. No maximum income limit applies. The chart to the right outlines the minimum income limits that must be taken each year.

Age	Annual payment as a % of account balance
55-64	4%
65-74	5%
75-79	6%
80-84	7%
85-89	9%
90-94	11%
95+	14%

The income stream will continue until there is no money left in the investment. How long the pension lasts depends on how much income is drawn, and the investment returns earned by the fund. Upon death of the pension owner, the residual account balance can be distributed to beneficiaries.

For those allocated pensions purchased before 1st January 2015, there may be some advantages to retirees under the Age Pension Income Test or eligibility to receive the Commonwealth Seniors Health Card. For new allocated pensions, the main advantage is the tax free income paid to investors.

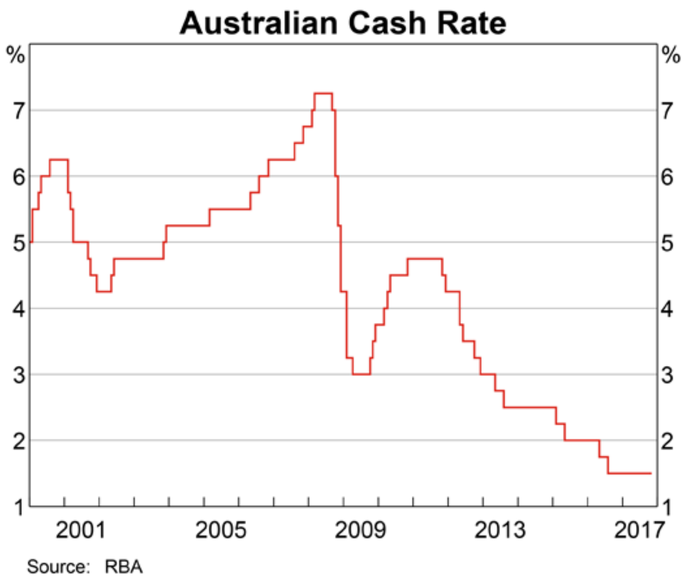
We would simply flag though that retirees are able to generate a reasonable level of tax free income without using an allocated pension structure, and therefore generally encourage retirees not to hold all their assets within the superannuation system mainly due to the risk of government rule changes.

Annuities

An Annuity is "A fixed sum of money paid to someone each year typically for the rest of their life". It is a long term, fixed term, fixed rate investment. We are not totally opposed to annuities however given the low interest rate environment we would recommend caution. In particular we suggest retirees consider the following questions:

1. Counterparty risk of the annuity provider. If I invest in a lifetime annuity, will the provider continue to exist over the course of my life?
2. Are the rates on offer from annuity providers superior to guaranteed bank deposits?
3. Am I comfortable investing into something that can not be altered at any stage?

Role of Cash and Fixed Interest



There are essentially two types of investments available to retirees:

1. Those where money is loaned out and an interest coupon received in return (ie term deposit).

2. Those that involve taking an ownership stake in an asset such as property or shares.

Logically an investor owning assets should earn a superior return than those lending money, generally unless recessionary conditions prevail.

The key reason for retirees to hold funds in cash and fixed interest is to provide security of cash flow, irrespective of fluctuations in financial markets. Retirees who hold 3-5 years worth of required cash from their investments in fixed interest can then afford to take a long term view of their other investments during periods of market turbulence.

The other key objective of holding cash and fixed interest is to minimise the risk of investors becoming forced sellers in falling markets in order to raise cash to provide for income.

There are many types of fixed interest investments on offer to investors including:

Bank Deposits/Cash Accounts – offered by approved deposit taking institutions (eg banks) and investors receive a government guarantee up to a dollar limit.

Debentures – not government guaranteed but have the look and feel of a term deposit – investors must ensure they are confident of the financial strength of the debenture issuer before proceeding.

Hybrids – can be listed on the ASX, and is generally an unsecured loan to a company offering an interest rate margin above the bank bill rate. Hybrids offer the upside characteristics of fixed interest, but can also exhibit the downside risks of shares. We recommend extreme caution if investing in hybrids.

Fixed Interest Managed Funds – sometimes also known as Capital Stable and Conservative funds which invest largely in Government Bonds. Many investors believe Government Bonds to be a safe and secure method of investment, but in times of rising interest rates the capital value of Government Bonds that are held inside managed funds can fall as they are revalued each day. Great care should be taken at the present time investing in this area.

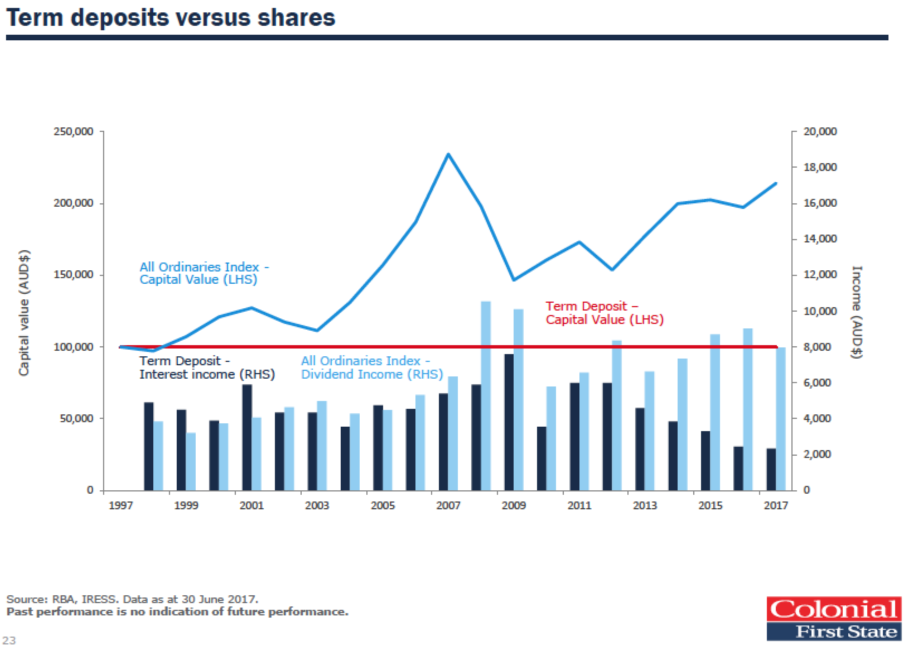
Value of Shares to Retirees

There are several reasons why retirees should consider investing part of their investments into shares:

1. Growing income stream over time as company profits grow to offset impact of inflation
2. Tax free or better than tax free income resulting from franked dividends.
3. Capital Growth over time

The chart to the right shows the capital and income value of $100,000 invested in a term deposit over the past 20 years versus being invested in the Australian Share market (ASX200). The term deposit is still valued at $100,000 after 20 years (red line left axis) which compares poorly with the capital value of over $200,000 from shares (light blue line).

The other interesting aspect is that the value of income paid from shares (light blue bars) over the past 20 years is far superior to that from term deposit (dark blue bars), particularly as interest rates have fallen.



We encourage investors, when buying shares to consider themselves as part owners of the company that they are buying shares in.

Business owners would normally find the following attributes attractive when considering buying a business:

- Market leader in their segment
- High quality management (measured by feedback from institutional investors)
- Reasonable debt levels
- High levels of recurring income & consistency of earnings

These characteristics are designed to result in investing in only high quality companies and would usually screen out resources companies, biotechs and start up businesses.

The power of franked dividends

A franked dividend is simply a dividend paid to an investor where tax has already been paid by the company (at the company tax rate which is currently 30%).

This means that a retiree receiving the dividend will be entitled to receive the amount of tax the company has already paid, back as a tax credit. This avoids double taxation that would otherwise occur.

Consider a company earns a profit of $1,000 and then pays tax of $300 before paying $700 to investors as a dividend. The investor declares the $700 dividend plus the $300 credit (called an imputation credit) on their tax return as income, making a total income of $1,000. If the investor was in a position where they did not pay tax such as a single retiree with taxable income less than $32,200, then they could receive a tax refund of $300 which represents the amount of tax originally paid by the company.

For retirees who do not pay tax, imputation credits are refunded to them. Fully franked dividends can be better than tax free income for retirees and can enhance retirement income.

For a simple rule of thumb, a 5% fully franked dividend equates to a 7.1% after tax rate of income from cash and term deposits when imputation credits are considered.

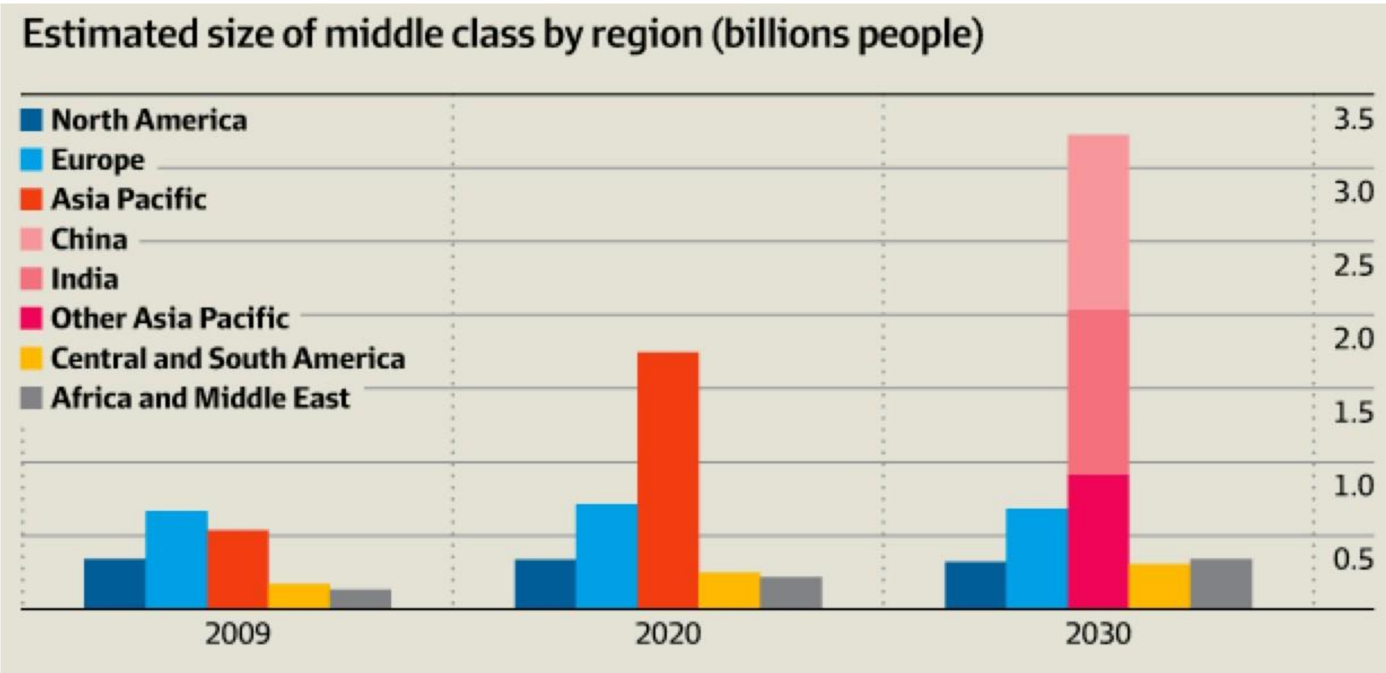
Example:

Age Pension (Single Person) $22,365
Fully Franked Dividends $6,000
Tax Payable on income is $0 as below tax free threshold
Refund of Imputation Credits (Tax refund) $2,571

Why Invest Overseas?

Australians tend to be parochial not only with respect to sporting achievements, but also when it comes to investing. Confining investments within Australia can limit investment returns as the Australian share market tends to be dominated by banks and resources companies. Australia represents less than 2% of global economic output and population. There are many industries that are simply not well represented on the Australian financial markets. Pharmaceuticals, Automobiles and Technology companies readily come to mind.

One of the other trends of our generation is the emerging middle class of Asia. The graph below shows the estimated growth of the Asian middle class. Families whose income surpasses basic needs of food and shelter usually results in them spending on health, technology and leisure, just to name a few industries that are likely to witness explosive growth from this demographic change. Growth of this magnitude is hard to find in Australia.



To further illustrate this point, did you know that in China in 2014:

1. 32 million passengers flying per month
2. 640 million internet users
3. 25 million motor vehicles sold
4. 14 billion e-commerce parcels delivered
5. $5bn in box office revenue at the movies.

We encourage investors to think beyond Australia's shores when making their investment decisions.
GEM Capital invests in well managed Global Share funds and listed investment companies to achieve the International exposure.

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Case Study - Single

Peter is turning 65 shortly and has $400,000 of investments, owns his own house and wishes to spend around $30,000 per year in retirement preferring not to run down his capital.

He has superannuation of $120,000 as part of his current investments. Based on the asset test Peter should receive around $11,300 of Age Pension (under new asset test rules of 1/1/2017).

This means that Peter requires around $15,000 per year from his own investments with the balance received from Age Pension. In order to provide 5 years worth of income, Peter will hold $80,000 in Fixed Interest, with an assumed interest rate of 3%pa.

His superannuation is rolled into an allocated pension (invested largely in International Shares) and Peter draws an income of 6%pa from this. This helps Peter reduce his tax liability.

The balance of Peter's investments are held in quality Australian Shares paying franked dividends (we assume at the rate of 5% fully franked for this example).

Investment	Amount	Taxable Income	Tax Free Income
Age Pension		$11,300	
Fixed Interest	$80,000	$2,400	
Aust Shares	$200,000	$10,000	(Imputation Credit $4,285)
Allocated Pension	$120,000		$7,200
Sub Total	**$400,000**	**$23,700**	**$7,200**
Less Tax		- $1,045	
Add Seniors Rebate (part)		+ $2,060	
Add Low Income Rebate		+ $445	
Net Tax Payable		$0	
ADD Refund of Imputation Credits		+ $4,285	
Total After Tax Income		**$35,185**	

Case Study – Married Couple

Bob and Marg are both 65 and own their house. They have investments of $500,000 and wish to spend $50,000 per year in retirement and prefer to keep their capital in tact. They have $200,000 in superannuation.

They should receive Age Pension of around $25,000pa combined. This means that they require around $25,000 per year from their investments with the balance received from Age Pension. In order to provide 5 years worth of income, they will hold $120,000 in Fixed Interest, with an assumed interest rate of 3%pa.

Their superannuation is rolled into an allocated pension (invested largely in International Shares) and they draw an income of 6%pa from this. This helps Bob and Marg reduce their tax liability.

The balance of Bob and Marg's investments are held in quality Australian Shares paying franked dividends (we assume at the rate of 5% fully franked for this example).

Investment	Amount	Taxable Income	Tax Free Income
Age Pension		$25,000	
Fixed Interest	$120,000	$3,600	
Aust Shares	$180,000	$9,000	(Imputation Credit $3,857)
Allocated Pension	$200,000		$12,000
Sub Total	**$500,000**	**$37,600**	**$12,000**
Less Tax		- $960	
Add Seniors Rebate (part)		+ $70	
Add Low Income Rebate		+ $890	
Net Tax Payable		$0	
ADD Refund of Imputation Credits		+ $3,857	
Total After Tax Income		**$53,457**	

About Us

GEM Capital Financial Advice is a boutique financial advice business which is privately owned and aims to deliver highly researched and considered financial advice, that is backed up with friendly personal service.

The owners of GEM Capital have been advising clients since the 1980's and it is our experience plus the fact that we are not owned by a financial services product provider, which should bring peace of mind to our investors. Usually we are co-investors alongside our clients and every quarter we disclose all investments owned by GEM Capital advisers.

We take the responsibility of managing our clients money very seriously, but aim to have fun at the same time.

Our team has been together for many years with every one of our team members having over 10 years experience with GEM Capital Financial Advice. This doesn't happen by accident as we not only aim to carefully look after our clients, but also our team.

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