



Financially Speaking

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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 share markets. Past experiences, preconceived 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.¹

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 (ie 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

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



What is the benefit of investing in shares?

Quality shares (and managed share funds) are expected to generate higher returns than most other asset classes over the long term. The return from quality shares comprises a growing income stream as well as capital growth.

How do shares generate a growing income stream – and capital growth?

Quality shares (and managed share funds) generate a growing dividend stream for investors. As you can see in Chart 1, the

annual income generated by a \$100,000 investment in shares since 1983 (with income not re-invested) started off low, but then gradually built up.

In fact, last year's income was \$50,917, or 51% on the initial \$100,000 investment. The reason for the increasing dividends from shares is that quality businesses do not distribute all of their profits to shareholders. They retain some of their profit each year and use it to invest in the business – to help it grow.

If this is done well, it means they'll have more profit the next year – from which they can afford to pay shareholders a higher dividend than they did the previous year. Plus they will again retain some profit for re-investment. So the next year their profits will hopefully be higher again, allowing the company to distribute an even higher dividend while still retaining more profit for re-investment. And even more the next year. And so on.

Of course, the more the value of the company grows as a result of the re-investment of the retained profits, the more the market will recognise this and people will pay more to buy their shares. Hence the capital growth.

Compare the income stream from shares to a well known income producing investment – the term deposit. As shown in Chart 1, a \$100,000 investment in term deposits since 1983 did well while interest rates were at historical highs, but then income dropped away to just \$3,750 or 3.7% in 2009. Compare that to the \$50,917 income from shares last year.

In fact, since 1983, the \$100,000 investment in term deposits generated a total income of just \$208,350 compared to \$837,772 from shares. Add to that the \$882,204 in capital growth from shares – as at 1 January 2010 – and you have a total return of \$1,719,976 from shares, compared to \$208,350 from term deposits, as shown in Table 1.

What is the risk of investing in shares?

All shares and managed share funds experience volatility. Their values all go up and down – on a daily basis. That's because shares are easily traded on the stock exchange. You can buy and sell shares almost whenever you want. The trade-off for that liquidity and convenience is a bumpy share price.

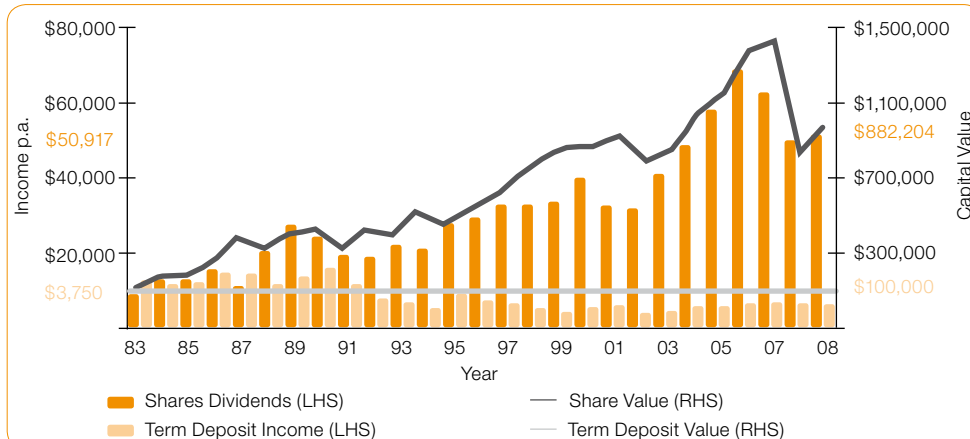
However, with quality shares (and managed share funds) you'll notice that over time their prices go up more than they go down. And the magnitude of the price rises are generally greater than the price falls, as shown in Chart 2 of annual sharemarket returns.

As a result, over time your shares should generate solid capital growth. In fact the longer you hold your shares or managed funds the less likely you will have a negative return, as you can see in Chart 3.

These graphs are for illustrative purposes only. Past performance is not an indicator of future performance.

Source: Australian Unity

Chart 1. Shares Generate a Growing Income* (\$100,000 invested from 1 Jan 1983 -1 Jan 2010. Income not re-invested).



* Assumptions and sources: Assumes \$100,000 was invested in the relevant index at 1 January 1983 and income was not re-invested. Shares: These figures are derived from the All Industrials price and accumulation indices to 31/12/2001, and then the S&P/ASX XNJ and XNJAI price and accumulation indices. On an annual basis the percentage increase in the accumulation index less the increase in the price index reflects the dividend generated. Franking credits have been ignored. Term Deposits: 1 year Bank Fixed Deposits – Reserve Bank Australia. Term Deposit is rolled over every year. Past performance is not an indicator of future performance.

Table 1: Shares ahead by \$1,511,626 since 1983*

1 Jan 83 – 1 Jan 10	Shares	Term Deposits
Total Income	\$837,772	\$208,350
Growth	\$882,204	NIL
Total	\$1,719,976	\$208,350

Chart 2: The prices of quality shares go up more than down S&P/ASX All Industrials Accumulation Index (1 Year Annual Returns)

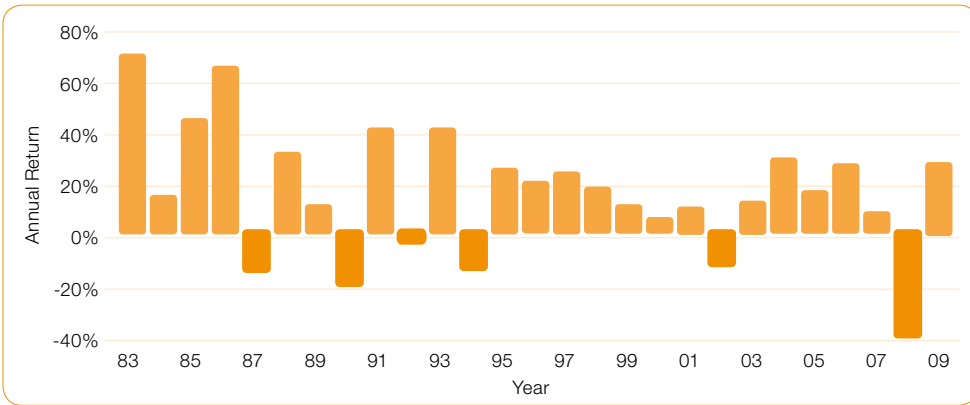
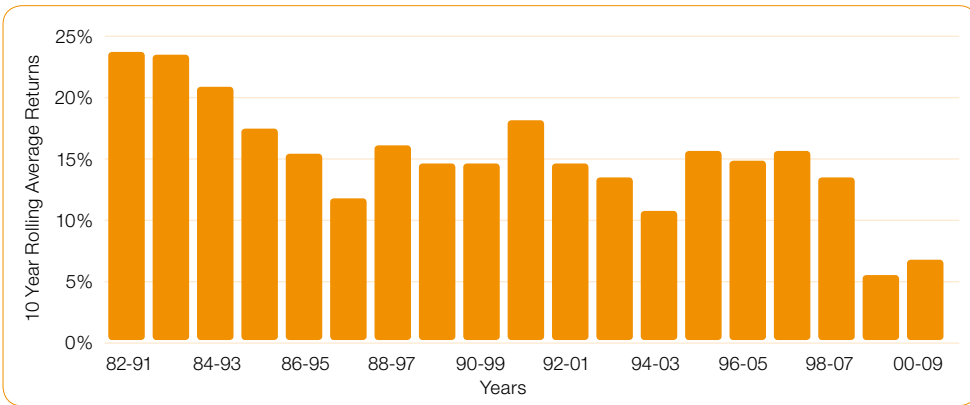


Chart 3: Shares perform consistently over the longer term 10 Year Rolling Average – S&P/ASX All Industrials Accumulation Index



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.

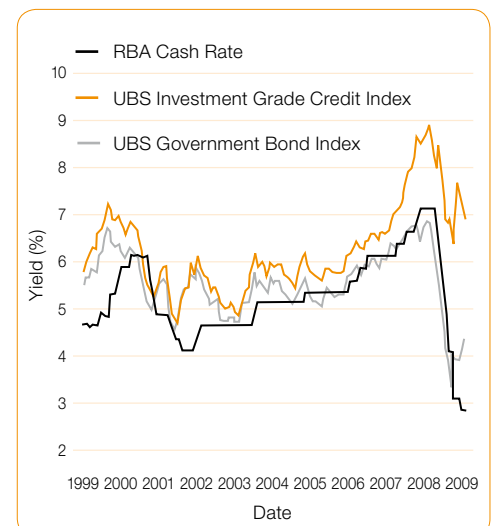
Term deposits pay a fixed rate of interest, but they are not tradeable, they must be held to maturity, that is, they are illiquid. While this means that depositors receive their full value back on maturity, it also means that there is no potential for any capital growth on a term deposit. If you break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



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.

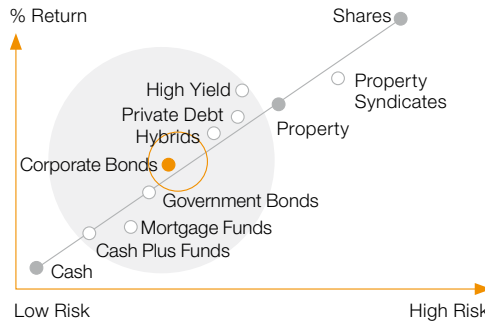
There are other risks in bond portfolios. These include liquidity risk, equity risk, sovereign risk, currency risk and event risk. To compensate for these higher risks bond investors require higher returns than cash.

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

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

Table 1: Bond funds and term deposits compared

Features	Bond Funds	Term Deposits
Income based on	Portfolio return based on bond yields – coupon payments plus any appreciation in bond values	Fixed rate of interest paid by issuer, usually a bank
Management style	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
Value can appreciate or depreciate	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
Backed by	Credit of underlying bonds – mix of government, bank and corporate issuers	Individual bank issuer balance sheet
Credit risk	A mix of ratings based on the blend of underlying bonds	Generally the same credit risk as the issuing financial institution
Other risks	Liquidity risk, equity risk, sovereign risk, event risk, and currency risk	Sovereign risk, and event risk

Real Estate Investment Trusts versus Residential Property

This article explores a number of myths regarding residential investment property; a long term favourite for many Australians. By drawing comparisons with alternative property investments this article highlights a number of compelling reasons that may prompt many direct property investors to rethink their strategies.

At first glance, the investment characteristics of a residential investment property don't paint a particularly attractive proposition:

- short term leases (typically one year);

- tenant risk (reliance on a tenant's regular salary/income to support payment of rent and maintenance of the property);
- low yields (residential property is currently averaging less than half that available from a Real Estate Investment Trust (REIT) fund);
- concentration risk (one property, one tenant, one location);
- one sided tenant protection legislation which oversees the relationship between landlord and tenant in residential property; and

- highly taxed - Stamp Duty of around 5.5% on acquisition and ongoing State Land Taxes (highly progressive tax structures) apply to residential investments.

Many investors cite negative gearing tax benefits as a strong incentive to invest in residential property. However, making a loss on your day-to-day cash flows in order to achieve a tax advantage can be problematic. Negative gearing increases an investor's reliance on the erratic capital gain component of the total return. This can be a risky strategy. The heavy reliance

that residential property investors place on capital gain raises the interesting ‘income versus capital’ debate.

Income vs capital

Property is an income investment. Yield is the central component of the total return from property.

Commercial property is known for its higher yields and steadier long term capital growth. These high yields are usually backed by commercial rent agreements which are locked in for five or more years. Many leases have locked in rent reviews directly linked to CPI which means the relative benefit of property is even more pronounced in a period of elevated inflation.

Conversely, residential property is generally considered a high growth and low yielding asset. “Punting” on potential growth returns from property is a strategy that has been proven over many years to be fraught with danger. The low initial yield that Australian residential property investors accept presumes an inversely high level of capital growth.

Whilst the consensus view of market analysts is that commercial property has hit (or is close to) the bottom of the market with strong upside potential, residential on the other hand is generally looking overvalued.

A recurring theme that is currently emerging is the worrisome reliance on capital growth in residential property and the downside risk to values that currently exists.

- Citi Economics Research in a report dated September 2010 stated “... the return on investing in housing increasingly has become more of a function of the capital gain on the investment rather than the actual (or implied) rental income. Housing therefore has taken on the characteristic of a growth asset.”
- Morgan Stanley, in a report on residential property published in August 2010 said “Australian house prices are expensive on every value metric, they are expensive relative to history and expensive relative to houses in comparable countries.”
- Jeremy Grantham, of respected global investment management firm GMO said, in a report released in June 2010, that “... Australia had an unmistakable housing bubble and that prices would need to come down by 42 per cent to return to the long-term trend. The price of housing typically trades about 3.5 times the average family income and in a bubble it goes to 6 or...7.5 (times). Australia is having one now. You (Australia) are at near 7.5 times the average family income...which suggests you are twice the size that you should be.”

- Goldman Sachs JBW in a housing report (dated September 2010) commented that “Australian house price dynamics do not appear consistent with a speculative bubble. Nevertheless, they are between 25-35% overvalued.”

Accordingly, it should be no surprise then that the latest Housing Industry Association – residential property (HIA-RP) data (from the Residential Land Report) found the Australian weighted median residential land value fell 3.6% over the June quarter. On an annualised basis, this equates to a 14.4% fall. Whichever way you analyse it, Australian residential property is looking expensive.

The following chart shows the Investment Property Databank (IPD) total returns from commercial property assets over the last 24 years to 30 June 2010. The chart clearly shows the recovery in values currently underway in commercial property. This is a vastly different situation to the residential market.

Further, respected property researcher Jones Lang LaSalle (JLL) in the Real Estate Intelligence Service report - Q3 2010 review (released in October 2010) said “...the preconditions for a steady, but sustained, Australian commercial property market recovery is now largely in place.”

Barriers to entry

A fundamental investment criteria many investors apply when screening assets or asset classes is based on the concept of barriers to entry. A sector with high barriers to entry typically displays lower volatility and higher returns because relatively fewer assets are able to be built (ie: the demand/supply equation is tilted in favour of the landlord). Simply, commercial property has significantly higher barriers such as

town planning, site amalgamation, tenant precommitment, financing and construction than most residential projects.

Liquidity and divisibility

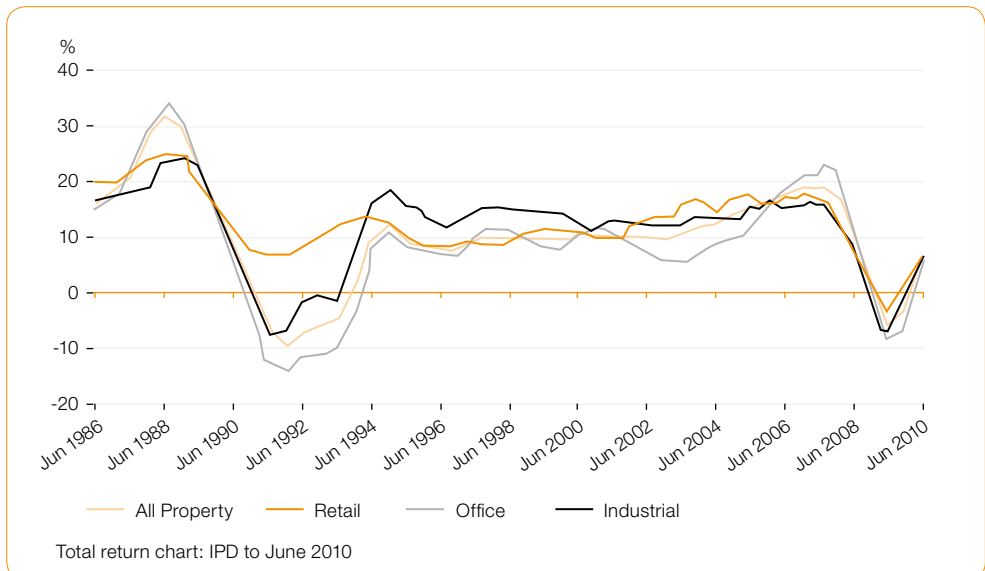
Liquidity is one of the most important features that investors look for in an investment. The key characteristic of an investment in a pure REIT fund is the ability to trade out and redeem your money within a few days. Of course, a long term perspective should always be applied but unforeseen circumstances sometimes dictate that liquidity is required. Practically, you can’t sell a bedroom in a residential investment property and conversely, nor can you purchase a bedroom. An investment in residential property is all or nothing. REITs or liquid property securities funds on the other hand offer liquidity and the ability to increase an investment even in very small parcels (typically the minimum additional investment size or regular investment plans are \$500-\$1,000).

Diversification

A balanced investment/super fund asset allocation typically has a 10-15% allocation to property. On this basis, assuming the minimum residential investment size is around \$500,000, this implies a minimum portfolio size of \$5 million is required if a balanced asset allocation is to be achieved. Investors rarely have a portfolio of this size. Even if they do, the risk of “putting all your eggs in one basket” by buying a single asset is significant.

The concentration risk that exists with a single residential investment (one asset, one tenant, one location) compares unfavourably with the diversification benefits of a well managed real estate securities fund. Multiple REITs holding numerous assets, in varied locations, each with a multitude of tenants,

Investment Property Databank (IPD), total returns rolling annual % per annum



(normally with very strong businesses supporting their ability to pay the rent) obviously offers far superior diversification.

Professionally managed property portfolio

REITs and property securities funds are managed by teams of dedicated professional investment managers who are highly skilled at managing property and property related investments. You can gain comfort from the knowledge that your investment is being managed by a full-time property specialist whose sole job is to maximise the return on your investment (both in terms of rental income and capital appreciation).

Whilst investors often engage the services of a real estate agent to assist with the buying/selling and management of residential property, landlords still face a serious commitment, spending valuable time and energy on successfully managing a property – dwellings flood, walls and foundations crack and there's no guarantee that tenants will be perfect. These issues are ultimately the owner's responsibility.

REITs present a compelling investment proposition

Different investment classes obviously offer different attributes including style of income, capital growth and risk. However, the inescapable conclusion is a well managed REIT portfolio offers superior diversification, lower ongoing costs and greater liquidity than the alternative direct residential property investment. Not only is the risk/reward trade-off inferior (due to the heavy reliance on capital growth rather than rental income stream), but the lack of liquidity and diversification in addition to the higher ongoing costs takes the gloss off residential property investing.

Over the long term, the greatest virtue of commercial property, as an asset class, is to provide sustainable and growing income. Underlying capital growth will follow properties with good income streams.

The all important lease covenant is what gives commercial property its unique characteristic. Even if underlying property values drop, rental income is still received. In the most devastating economic and financial market conditions, a relatively strong return can still be achieved. The income story for REITs and REIT managed funds remains compelling.

Source: APN Property Group



How can you ensure your Credit Rating?

Lenders, such as banks and credit card companies, are using credit scores to evaluate the potential risk posted by lending money to consumers and to mitigate losses due to bad debt.

Lenders use credit scores to determine who qualifies for a loan, at what interest rate and what credit limits should apply.

Credit scoring is not limited to banks. Other organisations, such as mobile phone companies, insurance companies, employers, landlords and government departments employ the same techniques.

In the current environment, a declined credit score result can severely affect your chances of obtaining the finance you are seeking.

Two years ago, it would have been rare for a customer's application for finance to have been rejected solely on the basis that you failed the credit score. Although many clients' initial applications were 'system declined', we were able to have this system-generated decision regularly overridden (where there were aspects of a client's application that warranted this).

Here are some legitimate fundamental steps that you can take to help maximise your credit score.

- Provide licence number when you have one
- Show all addresses for period required (2 years or 3 years)
- Show all employment details for required period including address, phone numbers etc
- Show bank account details (even if there is not much money in them as this can affect credit score if not listed)
- List all phone numbers even if you are not home during the day
- Include all assets including super and shares.

Excessive enquiries on a credit report can also affect your scoring.

Although this may sound simple, try not to leave any area on an application blank as they are included for a reason which can affect the score.

Speak with an expert if you have any queries about ensuring your Credit Rating.

Source: Lonsdale Finance Choice

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 any one. 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 diseases¹
- 50,000 Australians have a heart attack every year and a stroke occurs every 12 minutes¹
- one in three men and one in four women will be diagnosed with a malignant cancer before age 75²
- the average age of diagnosis of the most common chronic nervous system condition, Multiple Sclerosis is 30 (87% are of working age)³
- just under 50% of Australians with arthritis-associated disability are aged 15 to 54.⁴

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), 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.

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