INFORMED INVESTOR

August 2023

threePILLARS
wealth management

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Welcome to the August edition of our quarterly newsletter, Informed Investor.

ECONOMIC UPDATE

July was a relatively uneventful month in financial markets and volatility remained low.

Generally speaking, risk assets continued to perform well despite a sharp increase in the oil price. In fact July was the best month for oil since January 2022.

Inflation seems to be coming off the boil in most key regions, reducing the likelihood of significant further increases in interest rates.

Bond yields did not move meaningfully against this background, resulting in a quiet month for fixed income markets.

Continued over...

FURTHER INFORMATION

Julian Payne
Three Pillars Wealth Management
P: 02 4969 8402
E: julian@threepillarswealth.com.au

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Capstone
FINANCIAL PLANNING

ECONOMIC UPDATE CONTINUED

AUSTRALIA

As anticipated, the Reserve Bank of Australia left official interest rates on hold at 4.10% at its meeting in early July (and again when policymakers convened on 1 August).

Investors increasingly believe that this will be the peak in interest rates in this cycle. The policy tightening that has already occurred is filtering through the economy and dampening pricing pressures.

Inflation fell to an annual rate of 6.0% in the June quarter, down from 7.0% in the first three months of the year. This moderation likely affected policymakers' deliberations at August's meeting.

Moreover, the monthly reading for June showed prices rising by 5.4% from a year earlier, affirming that a downtrend in inflation is firmly in place.

This is feeding through to both consumer and business confidence, both of which improved in the most recent surveys.

NEW ZEALAND

Similarly in New Zealand, there are hopes that interest rates might have peaked (at 5.50%).

Inflation data for the June quarter showed prices rising at an annual rate of 6.0% – the same as in Australia – and policymakers have indicated a willingness to pause their policy tightening program.

US

Inflation in the world's largest economy has fallen to its lowest level in more than two years. Headline CPI fell to an annual rate of 3.0% in June.

The 'core' measure – favoured by policymakers and which strips out food and energy prices – rose at an annual rate of 4.8%, although this was the smallest increase since 2021.

The Federal Reserve is still aiming to bring inflation down to 2%, although it seems clear that aggressive policy tightening over the past year or so is having its desired effect. In June 2022 the headline inflation rate was 9.0%, so progress has been made.

Officials raised the Federal Funds rate by a further quarter percentage point during July, taking borrowing costs to their highest level since 2001. Forecasters are suggesting this might be the final hike before interest rates start to come down again in 2024.

For now the US labour market remains resilient. More than 200,000 new jobs were created in June and wages continue to rise quite strongly.

EUROPE

According to preliminary forecasts, the annual inflation rate in the Eurozone slowed for third consecutive month in July, to 5.3%. This was the lowest level since the start of 2022 and reflected a moderation in energy prices.

Less positively, the rate of inflation in services sectors continued to increase. This remains a concern for the European Central Bank and prompted policymakers to increase official interest rates by a further quarter of a percentage point in July.

While interest rate hikes are having their desired effect on the inflation front, they appear to be acting as a strong headwind for overall economic activity levels. The International Monetary Fund (IMF) is now forecasting that GDP in Germany – the biggest economy in the region – will contract by 3.0% this year.

More broadly, a gauge of conditions in the manufacturing sector in the Eurozone fell to its weakest level in more than three years.

The outlook in the UK is a little brighter, with the IMF now expecting the economy to grow 0.4% in 2023.

Following widespread industrial action in recent months, the UK Government announced pay increases of 6%+ for public sector workers. This is feeding through to overall wage growth, which is running at the fastest rate on record.

ASIA

Chinese export data continues to deteriorate, clouding the outlook for overall economic growth. The value of exports fell 12.4% in June from the same month a year ago, which was the biggest drop since the COVID period in 2020.

There was a fair amount of scrutiny on Chinese news during the month owing to a meeting of the Politburo, the ruling Communist Party's decision making committee.

According to the official Xinhua News Agency, China will pursue a number of "counter-cyclical" policy measures to support domestic activity levels and help offset faltering export demand.

An easing of restrictions in the property sector is also anticipated. This area of the economy has been struggling for more than two years, following the introduction of more stringent lending standards.

Geopolitical tensions in China remain elevated too. Officials announced that exports of two materials used in the semiconductor industry will cease in August, after the US, Japan and Netherlands imposed curbs on chip exports to China.

AUSTRALIAN DOLLAR

The Australian dollar fared well in the first half of July, but lost ground towards month end.

In the month as a whole the AUD gained 0.8% against the US dollar – closing at just over US67c – but depreciated by 0.7% against a trade-weighted basket of international currencies.

AUSTRALIAN EQUITIES

'Confession season' for ASX-listed companies commenced in July, with a number of firms testing investor expectations with fourth quarter and full year guidance updates ahead of August's reporting season.

In aggregate, earnings expectations for the next 12 months declined over the month, but the market was supported by improving inflation-related data and better than expected earnings results from large cap companies in the US.

Nine out of 11 sectors in the S&P/ASX 200 Accumulation Index generated positive returns, helping the Index rise 2.9% over the month. This extended gains in the calendar year to date to 7.5%.

Energy stocks such as Beach Energy (+19.6%), Karoon Energy (+13.2%) and Woodside Energy Group (+10.3%) were bolstered by stronger oil prices. WTI crude oil prices rose more than 15% over the month, to more than US$81/barrel, reflecting an improving demand outlook as inflationary pressures ease. Production cuts from OPEC+ member countries are also limiting supply and helping support prices. The Energy sector was the standout performer in July, ending the month 8.8% higher.

The strength of Block (+21.4%), along with the major banks ANZ (+8.6%), NAB (+7.8%), Commonwealth Bank (+5.4%) and Westpac (+4.7%), underpinned a 4.9% rise in the Financials sector. That said, Perpetual (-4.7%), Steadfast (-2.8%) and ASX (-1.4%) performed less well.

The Health Care sector (-1.5%) was a notable lagged, reflecting disappointing returns from Healius (-9.7%), Ansell (-9.7%) and CSL (-3.2%). Ansell called out a number of earnings headwinds, including rising interest costs and excess inventory as demand from distributors falters. These issues led to a lower than expected earnings guidance range for FY24.

Consumer Staples (-1.1%) stocks also tended to underperform the broader market. Endeavour Group was the worst performer in this area of the market, falling 3.6% following the Victorian Government's announcement of a number of regulatory reforms for venues with electronic gaming machines.

Small Caps outperformed their larger peers in July, with the S&P/ASX Small Ordinaries Index adding 3.5%.

The Consumer Discretionary, Consumer Staples and IT sectors all added more than 8%. The Materials sector (-0.4%) was the only sector to finish the month in the red.

GLOBAL EQUITIES

Suggestions that interest rates might be close to peaking in key regions boosted sentiment towards risk assets and helped equity markets generate pleasing returns. The MSCI World Index added 2.1% in AUD terms.

The encouraging tone of profit announcements in the US helped the S&P 500 Index rise 3.2%. This was the fifth consecutive month of gains for the Index; the longest winning run for around two years. The S&P 500 Index has now returned more than 20% in the calendar year to date.

Technology stocks continued to outperform, enabling the NASDAQ to rise 3.8% and extend gains in 2023 to more than 37%.

European markets fared well too, particularly Italy where the MIB Index closed the month more than 5% higher. It was a similar story in the UK, where the FTSE 100 Index returned 2.2%.

Hong Kong's Hang Seng (+6.2%) led gains in Asia, on optimism that the Chinese Government will introduce various stimulus measures and provide support to beleaguered property developers. China's CSI 300 and Singapore's Straits Times also performed well, adding 4.5% and 5.2%, respectively.

The MSCI Emerging Markets Index returned 6.3% in July and closed the month close to its highest level in more than a year.

LISTED PROPERTY

Global property securities fared well in July, consistent with gains in broader equity markets.

The Federal Reserve raised US interest rates again during the month, but lower than expected inflation prints and generally resilient economic data in the US helped support sentiment towards real estate markets.

The FTSE EPRA/NAREIT Developed Index returned 3.2% in AUD terms.

The best performing regions in local currency terms included Germany (+17.5%), Sweden (+12.5%) and Spain (+8.8%).

Laggards included Hong Kong (+1.3%), Japan (+1.6%) and Canada (+1.8%), although it was pleasing to see returns from all countries close the month in positive territory.

A-REITs added 3.8%, with stocks in the Industrial and Retail sub-sectors generating particularly favourable returns.

GLOBAL AND AUSTRALIAN FIXED INCOME

Yields on 10-year Treasuries in the US traded in a 30+ bps range in July, but closed the month just 9 bps higher.

Similar moves were seen in Europe, with yields on 10-year German bunds closing July 10 bps higher.

The receipt of higher bond coupons helped support returns, but the upward move in yields in the US and Europe unfortunately resulted in a small negative return from the Bloomberg Global Aggregate Index in AUD terms.

The Bank of Japan relaxed its yield curve control mechanism, announcing that yields on 10-year Japanese Government Bonds would be allowed to rise above the previous 0.50% ceiling. This resulted in a sharp sell-off in the local bond market and required the Bank of Japan to intervene and buy bonds on the open market to arrest the weakness.

Locally, yields on 10-year Australian Commonwealth Government Bonds rose 4 bps and remained slightly above the 4% level. This was a modest headwind, but the receipt of higher coupons helped the Bloomberg AusBond Composite 0+ Year Index return 0.5%.

GLOBAL CREDIT

A further narrowing in credit spreads in both the investment grade and high yield sub-sectors provided a healthy tailwind for credit and enabled corporate bonds to generate pleasing returns.

The release of generally favourable earnings announcements in the US and Europe helped support sentiment.

European names fared particularly well over the month and outperformed peers in the US.

Less positively, sentiment towards Asian credit continued to be affected by ongoing financial issues in the Chinese property development sector.

Source: First Sentier Investors

SOME RECENT QUESTIONS ON AUSTRALIAN INFLATION

KEY POINTS

- The Australian inflation rate peaked in the December quarter but has been slower to decline than some global peers. While interest rate rises are helping to reduce inflation (especially as discretionary consumer spending slows), rises in domestic energy prices, a tight rental market and a lagged pick up in wages have contributed to higher than expected inflation outcomes.
- The main policy available in the RBA's toolkit to manage inflation is interest rates, which is a blunt tool because of its unequal impact on households with debt.
- The burden of interest rate increases falls on households with mortgage debt. Businesses and investors are also impacted but the deductibility of interest provides some offset.
- Some countries in Europe have opted to use price controls for essential items to reduce inflation, with mixed results. Price controls tend to add distortions to the market and rent controls are not helpful while housing supply is limited (like in Australia).
- But the government still has a role to play in helping the RBA achieve its 2-3% inflation target through keeping fiscal policy neutral/contractionary if inflation is high, ensuring a well functioning energy market, maintaining sustainable wage increases, regulating businesses to discourage price gouging and monopolistic behaviour and calibrating appropriate migration targets to match housing supply.

INTRODUCTION

Australian inflation is very high. Consumer prices were up by 7% over the year to March, around a 33-year high but this was a decline from a cyclical peak of 7.8% in December 2022. The Reserve Bank of Australia (RBA) has been focusing on reducing inflation through the main policy tool available in the central bank's toolkit – interest rates. The cash rate has risen from 0.1% in April 2022 to 4.1% in June – a 4% lift in just over a year. But, the impact on inflation so far has been lower than expected. As a result, we are often asked whether interest rates are actually having an impact on inflation or whether there are better tools available to policymakers, especially as interest rate hikes are having an unequal impact across household groups. We go through some of these issues in this article.

ARE INTEREST RATE HIKES WORKING TO REDUCE INFLATION?

Interest rate hikes have led to a slowing in consumer demand which is helping to reduce inflation. Discretionary spending fell in the March quarter and the volumes of retail spending was negative over the December-March quarter. Without the lift in interest rates, inflation may have increased further and consumer and market-based medium-long term inflation expectations could have kept rising well above the RBA's 2-3% inflation target.

Some might say that rate hikes should have worked faster or better by now to reduce inflation. The problem has been that there have been numerous supply driven elements of the inflation story that have been less sensitive to interest rate changes. COVID driven supply chain disruptions led to big increases in shipping costs, commodity prices like energy, metals and agriculture increased significantly in 2021-22 (mostly from supply disruptions), domestic energy supply issues led to an Australian energy crisis and multiple domestic floods led to higher food prices. While these issues may not be directly influenced by the level of change in interest rates, it is the responsibility of the RBA to ensure that supply driven price changes do not leak into consumer prices. A lot of these supply related issues are now resolved but it takes time for it to be reflected in the final inflation figures.

Evidence of excessive price gouging by businesses is not obvious. Profit margins have expanded (increasing from 10% in 2020 to a recent high of ~16%) but have generally moved in proportion to the rise in inflation (see the first chart) and are now declining. The profit share (ex mining) of GDP has also been fairly stable. And slowing consumer discretionary spending means that continued profit margin expansion will be unlikely.

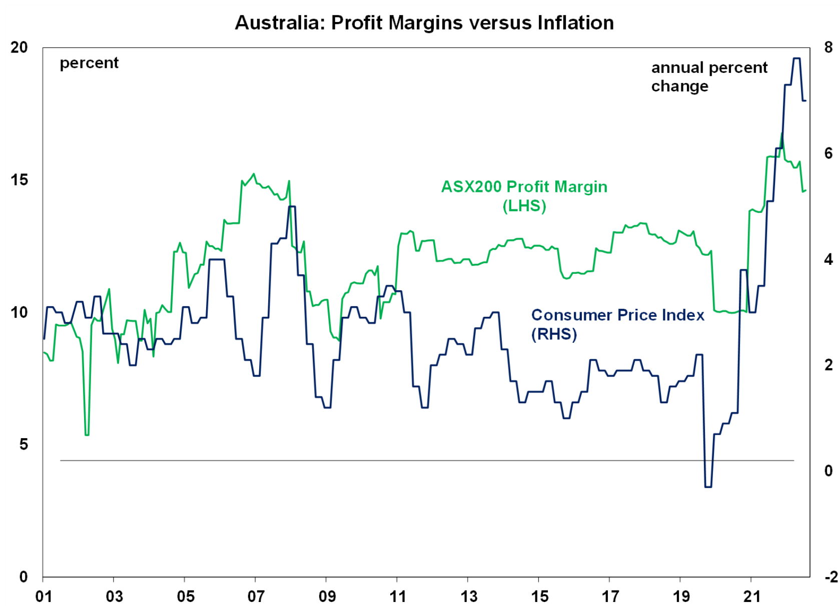
The peak of Australian inflation (in December 2022) also occurred later compared to some global peers which means that the slowing in inflation appears like it's taking longer. US inflation peaked at 9.1% in June 2022 and in the Eurozone at 10.6% in October 2022 (see the second chart).

Australia's energy crisis occurred later relative to the Northern hemisphere, because of a raft of our own domestic issues like supply challenges with coal, a poor national plan for the energy transition and higher global prices. This meant that both the US and Europe were more impacted by an energy price surge in early 2022 from the war in Ukraine and the winter weather.

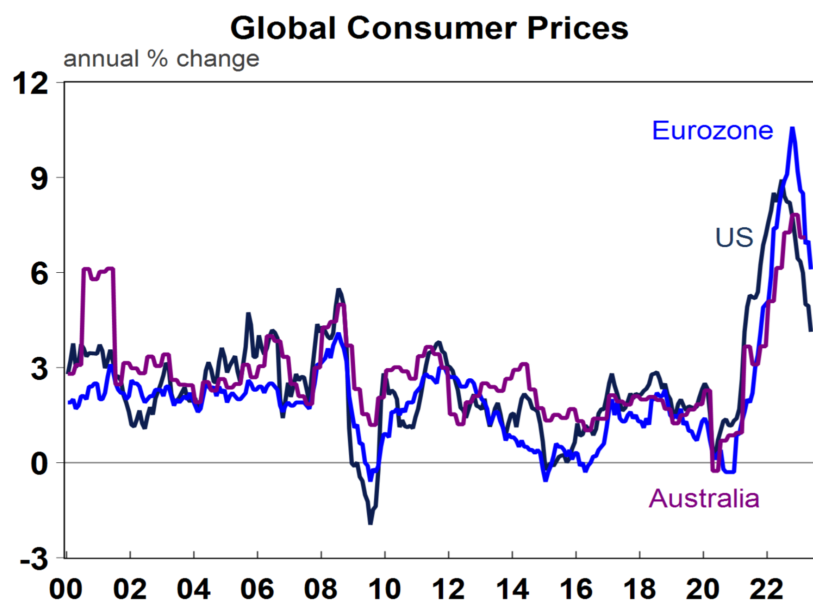
Australia's rental market also tightened significantly over the past year as net migration rebounded to record highs after the pandemic, pushing vacancy rates to ultra low levels in the capital cities and lifted rents, although recent vacancy rates across the capital cities have ticked up and newly advertised rental growth is slowing.

Australia's wage setting system also seems to have more "inertia", with the minimum wage decision occurring once a year and many other wages like awards also based off this annual decision or driven by changes to headline inflation, which only peaked in December 2022.

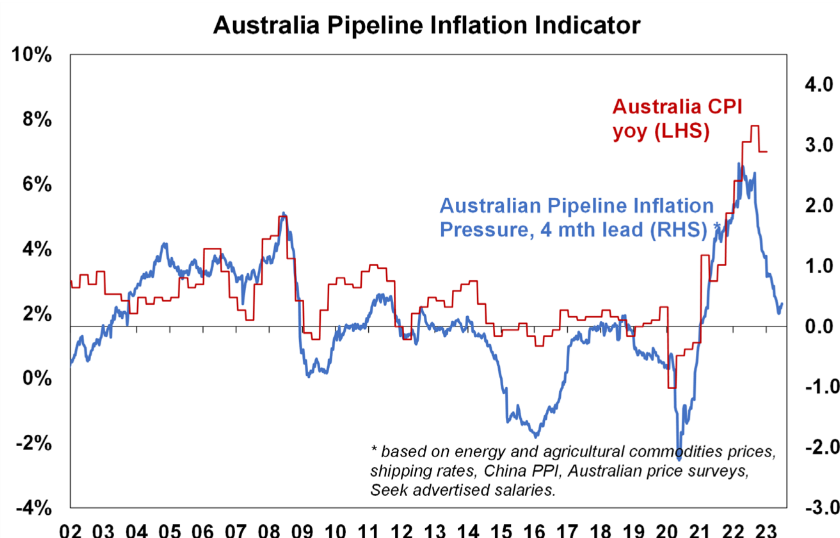
While these factors all suggest that inflation in Australia could remain higher for longer for now, the good news is that our Pipeline Inflation Indicator (see the third chart) still suggests significant downside to Australian inflation over the next six months and we expect headline consumer prices to be at the top end of the RBA's target band by early 2024 (on a 6-month annualised basis).



Source: Bloomberg, AMP



Source: Macrobond, AMP



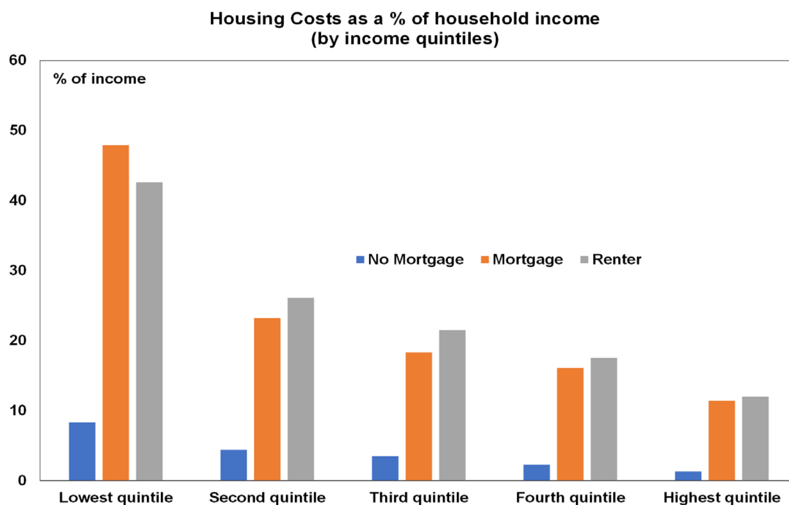
Source: Bloomberg, AMP

ARE INTEREST RATE HIKES INCREASING INEQUALITY?

The impact of monetary policy works primarily through the lending channel because borrowing rates are priced off the cash rate. Households with a mortgage are the most impacted by interest rate changes. Businesses and individual investors are arguably less impacted because they can deduct the debt interest expenses. There are also other financial market channels that monetary policy works through, mostly through the exchange rate.

The high level of household debt now means that mortgage holders will bear the brunt of monetary policy changes. Renters can also be affected from higher interest rates if landlords are able to pass on the higher cost of debt servicing through higher rents. This is only usually an option in a tight rental market (which the current situation is allowing for).

In Australia, 37% of households have a mortgage (using data from 2019-20), 29% rent and 30% own their own outright. Detailed ABS data on housing costs shows that households with a mortgage spend close to 16% of their gross household income on "housing costs" (mortgage or rent and rate payments) as at 2019-20, owners without a mortgage spend 3% of their income on housing costs and the average renter spends close to 20% of their income on housing. And there are divergences across income quintiles (see the chart) with the lowest income quintiles spending a very large share of income on housing costs.



Source: Bloomberg, AMP

ARE THERE OTHER OPTIONS TO COMBAT HIGH INFLATION?

The high degree of supply related factors that have increased inflation, the slow reduction in prices despite aggressive interest rate hikes and the high burden placed on households with a mortgage has led to questions about whether there are other options available to reduce the level of inflation.

The RBA has been tasked with the responsibility for the 2-3% inflation target but the only tool at its disposal is monetary policy. While the range of options within the toolkit has expanded beyond interest rates (including yield targets and quantitative easing) all of these measures ultimately influence the money supply and therefore the cost of borrowing.

The government has more tools at its disposal compared to the RBA through its spending and taxation decisions as well as regulation. However, these tools are slow moving and do not have as much of a direct impact on inflation. Some have argued that price controls need to be considered in Australia. Food price caps have recently been tried in Europe for some essential items, including in France, Croatia and Hungary with mixed impacts as measured inflation went down but there were reports of some food shortages.

Usually, economists do not advocate for price controls or caps because it's a distortion in the market and leads to problems like supply shortages. However, the Federal government did impose energy price caps domestically, so it is already being utilised in some capacity. Talk of rent controls would likely add to supply constraints across Australia at a time when housing supply needs to lift.

But, the government does have a role to play in many components that impact inflation, such as by ensuring a well regulated electricity market, sustainable outcomes for minimum award and public sector wages which set the tone for the rest of the market, ensuring that fiscal policy (both state and federal) is appropriate for the state of the economy (we think the impact of the May Federal budget is more or less neutral but with the addition of some state cost of living benefits it could be marginally inflationary and the government could consider raising taxes to help get inflation down), regulation of retailers to ensure adequate competition and ensuring adequate housing for the migration targets.

IMPLICATIONS FOR INVESTORS

For investors, the good news is that inflation is expected to decline through the rest of the year which should mean that central banks are close to the top of their tightening cycles. This is generally positive for sharemarkets however, the further interest rates increase, the higher the risk of recession which is a risk for sharemarkets. The RBA's recent hawkish stance means that further increases to the cash rate are likely in Australia. We expect another two interest rate increases from here, taking the cash rate to 4.6% which risks a recession in the next 12 months because of the heightened sensitivity of households to interest rate hikes in Australia.

Source: AMP

HOW TO MONITOR CARRIED FORWARD CONCESSIONAL CONTRIBUTIONS

You may be eligible to make concessional contributions that are greater than the annual cap if you haven't fully used your concessional cap in an earlier year.

WHAT ARE CONCESSIONAL CONTRIBUTIONS?

There are a number of ways you can contribute to superannuation. Depending on certain factors, contributions may be categorised as concessional or non-concessional. There are also other types of contributions that are not considered to be either concessional or non-concessional. Concessional contributions (CCs) commonly include:

- Contributions made for you by your employer
- Salary sacrifice contributions, and
- Personal contributions that you claim as a personal tax deduction.

CCs (within your cap – see below) are taxed at the concessional rate of up to 15% (or up to 30% if your income[1] from certain sources exceeds $250,000) within your super fund. However, additional tax and penalties may apply for contributions made in excess of your cap. Non-concessional contributions include those made with after-tax money, such as your take home pay, or funds in your bank account. A different cap applies to non-concessional contributions. See ato.gov.au.

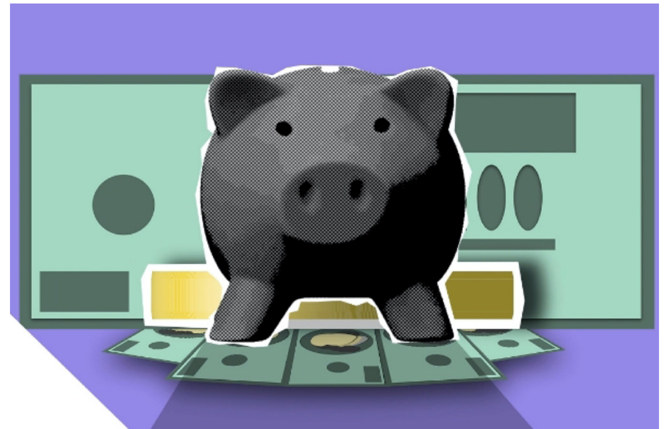
WHAT ARE CATCH-UP CONTRIBUTIONS?

Caps apply to limit the contributions you can make to superannuation without having to pay additional tax and other penalties. The cap that applies depends on the type of contribution made. Contributions that are considered to be 'concessional contributions' count towards the annual CC cap. From 2018/19 to 2020/21, this annual cap was $25,000[2], which then increased to $27,500 in 2021/22 and remains unchanged in 2022/23 and 2023/24. If you don't fully utilise your CC cap in an income year (from 2018/19 onwards), you're able to 'carry forward' the unused cap amount, and you may be eligible to make 'catch up' concessional contributions in a subsequent year.

WHAT ELIGIBILITY RULES APPLY?

To be eligible to make catch up CCs you need to:

- have a total 'total super balance'[3] at the 30 June prior less than $500,000, and



- be eligible to make super contributions. You are eligible if under age 67. If you're 67 or older, you need to have met the work test in the financial year you're making the contribution or be eligible for the work test exemption.

Remember that you can only carry forward unused CCs for 5 income years, after which they expire.

HOW TO ACCESS CARRIED FORWARD CC DETAILS ON MYGOV

There are a few ways you can monitor your available carried forward CCs. This includes:

- keeping detailed records of all the contributions you and others (such as your employer) have made to your super accounts for the last 5 income years
- contacting your super funds to check what contributions have been received to your account in the past (including the accounts you may have closed), and
- checking your details on MyGov.

It is recommended that detailed records also be maintained and that you refer to your own records rather than relying only on the information in MyGov. This is because there may be a delay before your super fund reports details about your contributions to the ATO. Remember, additional tax applies for excess contributions.

Source: MLC

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[1] Income for this purpose includes taxable income, reportable fringe benefits, total net investment losses and low tax contributions (concessional contributions that are within your concessional cap).

[2] Cap may be indexed in future years.

[3] Total super balance includes the total of all amounts you hold in super accumulation and pension accounts, in-transit rollovers, and if you have a self-managed super fund, it may also include the outstanding balance of a limited recourse borrowing arrangement. The total is reduced by personal injury or structured settlement contributions made to super.

GRANNY FLAT ARRANGEMENTS WITHIN THE CONTEXT OF THE GIFTING RULES

There are special rules for granny flat arrangements that may prevent the deprivation rules from applying. However they must satisfy a range of requirements.

Retirees wanting to downsize their home may consider the option of living in a granny flat or an extension to / spare room of a relative or friend's home. Money, the transfer of an asset or a combination of both, may be given as consideration for the right of accommodation or a life interest in a property. For social security (including DVA) purposes this is called a 'granny flat arrangement'.

Under social security rules, a person can give away assets or money of up to the harsher of $10,000 per financial year or $30,000 over a five year rolling period. However, Centrelink may allow a greater amount to be given away where the person pays for a granny flat arrangement. Any amount exceeding specified limits as allowed by social security will fall under the deprivation rules, commonly referred to as 'gifting.'

Where an amount is 'gifted' it is assessed for the social security means test for five years.

PAYMENTS THAT DO NOT FALL UNDER 'GIFTING'

Centrelink recognises that granny flat arrangements are usually family arrangements. Payment for construction costs to provide accommodation for the person or the transfer of property (such as the family home to the grantor of the right), is not considered 'gifting'. However if the amount paid exceeds the construction costs or is in addition to the property which has been transferred, Centrelink will apply the reasonableness test.

THE REASONABLENESS TEST

Where the reasonableness test applies, amounts up to the value of the granny flat interest do not fall under gifting. The value of the granny flat interest is the greater of the reasonableness test amount, and the:

- value of the property that was transferred, or
- value of property purchased for the grantor, or
- construction costs incurred.

The reasonableness test is a quasi-actuarial calculation to value the granny flat interest for social security purposes.

It uses a conversion factor that is based on the person's age next birthday and the maximum partnered pension rate at the time the granny flat arrangement is entered into:

- ## THE ANNUAL COMBINED MAXIMUM PARTNERED RATE X CONVERSION FACTOR

The calculation is the same whether the person is single or partnered. For couples, the conversion factor is based on the younger spouse's age next birthday.

Example 1

Janice, aged 69, pays her son Justin $800,000 for the right to live in a granny flat to be built in Justin's backyard. Construction will cost $150,000. As the amount paid for the granny flat arrangement exceeds $150,000 the reasonableness test will apply. The conversion factor based on 70 years is 17.36 and the annual combined maximum partnered rate at that time is $41,704.

The reasonableness test is calculated as: $41,704 x 17.36 = $723,981.44

The value of the granny flat interest is calculated as $723,981.44, being the greater of the reasonableness test amount and construction costs. The amount of $76,018.56* (i.e. $800,000 less $723,981.44) will be considered a 'gift.'

Example 2

James, aged 80 and Anna, aged 78, transfer the title of their home valued at $600,000, plus $100,000 to Katy, who agrees to grant the couple a life interest in the home. As money was paid in addition to the transfer of property, the reasonableness test will apply. The value of the granny flat interest is $600,000, as this is the greater of the value of the property transferred and the reasonableness test amount calculated at $446,232.80 ($41,704 X 10.70). The $100,000* will be assessed as a gift.

*Deduct $10,000 per financial year that is allowed to be gifted (once per amount), up to a maximum of $30,000 over a five year rolling period.

- ## TERMINATING A GRANNY FLAT ARRANGEMENT WITHIN FIVE YEARS

'Gifting' may apply where a pensioner terminates a granny flat arrangement if it was expected at the time of commencement, that the pensioner would leave the accommodation within five years. For example, where the pensioner needs aged care. The value of the granny flat arrangement will be assessed by Centrelink for the remainder of the five year period.

Example 3

If Janice from the first example, left after three years, Centrelink may include $723,981.44 for the next two years in Janice's means test calculations.

When advising a client with respect to a granny flat arrangement, it's important to investigate all details of the arrangement before it's entered into and to determine whether the reasonableness test will apply.

Pensioners who 'gift' to gain or retain more Age Pension may actually receive less than what they give away. 'Gifting' may be an option for self-funded retirees who have financial resources to spare, however pensioners who depend on social security should think carefully before 'gifting' large amounts of cash or other assets.

Source: BT

HOW TO HELP GROW YOUR MONEY THROUGH COMPOUND INTEREST

Earning interest on interest: learn how the power of compounding can send your savings rocketing.

Einstein has repeatedly said that compound interest is the eighth wonder of the world. While it may appear complicated, it's actually a relatively simple concept that can accomplish extraordinary things over time.

WHAT IS COMPOUND INTEREST?

Compound interest enables you to earn interest on interest which is accumulated over time.

Metaphorically speaking, it's like planting a tree. When that tree grows, it produces seeds that allows you to plant other trees. Those trees will also grow and produce seeds of their own. So with enough time, you could turn one tree into an entire forest.

THE DIFFERENCE BETWEEN COMPOUND AND SIMPLE INTEREST

When it comes to earning interest, or a return on your money there are two types of interest you could earn.

Compound interest enables you to earn interest when you invest a sum of money; but in addition to this interest, you'll also earn interest on the interest you've earned.

With simple interest however, you'll only earn interest on your original sum of money invested. For instance, if you invest $10,000 into a savings account and earn 5% interest compounded annually, in the first year your interest earnings will be $500 (5% x $10,000).

However, in the second year, your interest will be calculated based on the original amount you invested, plus the interest you earned in the first year - $10,500. In total over 3 years, you would have earned $1,576.25 in interest.

With simple interest, your interest earnings won't increase year on year so you'll continue earning just $500 over the 3 year period leaving you with $1500 in interest earnings.

COMPOUND INTEREST IS A LONG TERM INVESTING STRATEGY

The effect of compound interest becomes extremely powerful over a long timeframe as the amount of interest earned grows.

Warren Buffett is the epitome of someone who values long term investing. He attributes the majority of his success to identifying good businesses and companies with strong fundamentals to buy and hold for the long-term[1]. He then let the magic of compound interest work for him.

One thing that is important to remember is that investing in the beginning doesn't reap many rewards. It isn't until years later that you feel the true power of compound interest working for you.

GET STARTED EARLY

Because compound interest is generally most effective over a long timeframe, in order to truly see its potential, the earlier you start investing your money, the better. So it's generally really not about how much you're investing but more about how much time you're allowing your money to grow.

HOW YOU CAN EARN COMPOUND INTEREST

Bank account

One way to earn compound interest is through a bank account. While this approach carries very little risk, it's generally unlikely that your returns will be enough to outpace inflation so this is something to keep in mind.

Super

Investing in your super is one of the most effective ways to potentially maximise the benefits of compound interest.

Why? Time is on your side. The more you contribute to your super early on in life, the higher potential for that money to grow by the time you need it as a result of compound interest.

Of course though, you need to bear in mind that you cannot access your super until you meet a condition of release. This includes reaching the legal age for retirement, among other things.

Dividends

When you're paid dividends from shares, you can withdraw that dividend as cash or you can reinvest it back into the issuing stock. This means you're earning dividends on dividends, also known as compound interest.

The bottom line: When it comes to investing, compound interest and time are truly your best friends.

Source: MLC

[1] http://www.arborinvestmentplanner.com/warren-buffett-strategy-long-term-value-investing/