

Topic 1: Introduction to Financial Planning

The life cycle hypothesis		
Keynesian's Consumption Function	Equation	$C = \alpha + cY_D$ $S = Y_D - C$
	Intuition	Consumption expenditure comprises <u>both variable and fixed portions</u> <ul style="list-style-type: none"> As income increase, so will consumption, but on less than a 1:1 basis There is a specific amount that an individual will consume, regardless of the level of income (implies that negative saving is possible)
	Downside	Not supported by empirical evidence
	Alternative Theories	<ul style="list-style-type: none"> Permanent income hypothesis Life-cycle hypothesis Both theories draw on the notion that consumption is related to a broader income measure than current income
Life Cycle hypothesis	Notion	Savings and Consumption decision preference links with the stage of our life-cycle.
	Hypothesis	<ol style="list-style-type: none"> Individual prefers a higher standard of living, i.e. they want to maximize current consumption. Individuals want a relatively constant standard of living throughout their lives. → Before retirement, we will keep saving and avoid a sharp drop utility.
Objective of Financial planning	The basic objective of financial planning is to ensure that there is adequate lifetime income to meet lifetime consumption and achieve the life-cycle model.	
Life cycle Phases	There are 3 major phases in terms of saving and investment strategies: <u>Accumulation phase</u> (Growth oriented), <u>Consolidation phase</u> (consolidation) as well as <u>Spending phases</u> (income oriented) which would be adopted through different life cycle phases: <ol style="list-style-type: none"> Young, single, no commitments. Younger couple, two incomes, no children. One-income family, young children, tight budget. One- or two-income family, older children. Retired, living off private income and/or government pension 	
	<ul style="list-style-type: none"> In the context of the life cycle model, collectively phases (i)-(iv) represent the accumulation phase, where a capital sum is built up (v) is the retirement phase, where that sum is converted to a RIS for consumption over remaining lifetime. 	

Topic 4: Asset Allocation and Investment Choice I&II

Asset Classes	From conservative to the most risky asset classes there are: <ul style="list-style-type: none"> • Debt/ bonds (approximately 6-8%, zero coupon/coupon paying) • Properties(8-10%) • Equity/ shares (10-12%, Fundamental vs technical analysis) • Other investments : derivatives (options, futures), collectible (art, vintage cars), bullions (gold), cryptocurrency, even education 	
Investment portfolio construction	<ol style="list-style-type: none"> 1. <u>Asset allocation</u> (macro decision, accounts for 90% return) Percentage of funds in the different asset classes 2. <u>Security selection</u> (micro decision, accounts for 10% of returns) Selection of individual securities within each asset class. <p>Although statistically, the second category doesn't contribute much to the return thus has little value, however, theoretical diversification principle does hold in reality.</p>	
Investment Strategy & Management Style		
Investment Strategy	Strategic asset allocation (SAA)	<p>Find efficient(%) allocations amongst asset classes</p> <p>This method is relatively passive and is based on a target (%) allocations amongst asset classes. Assets are allocated to achieve investors' desired rate of return and the portfolios are periodically rebalanced back to the targets as investment return skew the original asset allocation.</p>
	Tactical asset allocation (TAA)	<p>This method is relatively aggressive and include a market timing component. Managers would choose if they believed that certain asset classes are mispriced and trying to take advantage of that arbitrage. Trying to outperform the market. Empirical evidence suggests that most managers are poor at market timing. Require much more researching about the market.</p>
	Dynamic asset allocation (DAA)	<p>This method typically is used differently by different investors. Mostly this method is a mix of both strategic and tactic methods. It involves periodically rebalancing of the portfolio, however, not to keep a constant return like strategic asset allocation, instead it but those that are increasing and sell those that are declining.</p>
Management Style	<ol style="list-style-type: none"> 1. <u>Active management style</u> → trade frequently, managers react to the updated market sector forecasts, attempt to profit from arbitrages and market timing 2. <u>Passive management style</u> → buy and hold, the initial asset allocation will remain the same over the investment horizon (subject to minor re-balancing alternations) 	
Four broad strategies	<p>The foregoing implies that there are at least four broad strategies, ranging from fully passive management to fully active.</p> <ul style="list-style-type: none"> – SAA and stock selection - buy & hold [passive] – SAA - buy & hold; stock selection – trade – TAA - active; stock selection - buy & hold – TAA - active; stock selection - trade [active] 	

Equity Investment	<p>\$100,000). With CMT collecting money to a pool of fund, small investors can hold a diversified portfolio of debt investments.</p> <p>Shares are at the riskier portion of the investment pyramid. An equity investment representing an ownership interest in a corporation.</p> <p>Long-term returns on equities typically been stable and higher than other assets, while short-term investment in equities can lead to losses due to volatility in markets.</p>	
Equity Selection Methods		
Fundamental analysis	<p>Fundamental analysts study anything that can affect the security's value, from macroeconomic factors such as the state of the economy and industry conditions to microeconomic factors like the effectiveness of the company's management. Efficient Markets Hypothesis (EMH) assumes that information has already been reflected through share prices.</p>	
Technical analysis	<p>Technical analysis is a trading discipline employed to evaluate investments and identify trading opportunities by analysing statistical trends gathered from trading activity, such as price movement and volume. It is a hit or miss. There is no evidence show that technical analysis is effective in terms of predicting market movement especially in the long term. However, a lot of professional investors still use it frequently because once they successfully predicted some movement, they want to give themselves credit for it and prove they are better investors. Refresher on EMH, it is weak because prices fully reflect market data. Past prices have no predicted power about future prices.</p>	
Ransom selection	<p>This method has been favoured by historical data, that about 90% of return is contributed by this method. This is due to the diversification effect from random selection.</p>	
Efficient Markets Hypothesis (EMH)	<p>Below are the relevance of the EMH to daily share price movements. The efficient market hypothesis (EMH) states that share prices reflect all information which means stocks trade at their fair market value on exchanges. Proponents of EMH posit that investors benefit from investing in a low-cost, passive portfolio. Opponents of EMH believe it is possible to beat the market and that stocks can deviate from their fair market values.</p>	
Equity vs Bond		
Comparison	Stocks	Bonds
Meaning	An equity instrument representing an ownership interest in a corporation	A debt instrument with a promise to pay back the principal amount with interest
Issuers	Corporates	Government institutions, financial institutions and companies
Holders	Shareholders are the owner of the company	Bondholders are the lenders to the company
Returns	Profits earned by the company are paid in the form of dividends	Interest payments are made in the form of coupon payments
Risk level	High risk level since it depends upon performance, no guaranteed returns	Relatively low since bondholders are prioritized for repayments
Risks	Market Risks, Business Risk	Interest rate risk, inflation risk
Benefits	Shareholders have the right to vote	preference in repayment

Topic 7: Self-managed Superannuation Fund

Basic requirements to qualify as a SMSF.

SMSF stands for self-managed superannuation fund. It is set up as a trust and must have fewer than five members, generally all members are trustees, and all trustees are members, although it is possible to have a corporate trustee. It is regulated by ATO.

Crucial requirements are:

- it must comply with the 'Sole Purpose Test', i.e. its prime purpose is provision of retirement benefits, and
- it has a written investment strategy that takes into account the needs of its members.

Differences between SMSF and SAF

An SAF is a small APRA fund, i.e. it is regulated by APRA and has an approved trustee. Advantages of a SAF over SMSF: access to the Superannuation Complaints Tribunal (SCT), more flexible membership structure possible, with fewer restrictions on relationships between members. For SAFs some financial redress is possible if trustee or administrators prove fraudulent. Disadvantages: Approved trustees may be costly; trustees still need to manage investments

Requirements associated with use of a corporate trustee

Trustee duties are onerous, and penalties apply to breach of duties

- a corporate trustee has limited liability, as opposed to individual trustees who carry personal liability for breaches (and would each pay individual fines)
- change of membership is easier with a corporate trustee
- change of title to fund assets is easier with a corporate trustee
- corporate trustees can automatically pay lump sums, avoiding additional attention to more rigorous compliance obligations under the sole purpose test
- litigation against the trustee will not usually involve fund members

Six benefits related to the use of an SMSF

1. allows personal control of investments / RIS generation (this is the main attraction)
2. can result in cost savings, e.g. not paying investment fees
3. enables provision of flexible pensions; need only draw a minimum amount in order to obtain tax-free income
4. represents a means to provide secure income in retirement for all fund members
5. allows trustees to look after present and future family
6. allows for tax efficiency, especially CGT by matching CGT gains with CGT losses

Four disadvantages related to the use of an SMSF

1. each member is a trustee and responsible for fund compliance
2. trustees must take responsibility for meeting the sole purpose test, which has implications in relation to investments
3. trustees must keep and retain accurate records (for up to ten years)
4. trustees must keep abreast of legislation, and if necessary, alter the trust deed to serve the members best interests.

General recommendation on the amount of assets before starting up a SMSF

Whilst there is no hard and fast rule on this, the suggested minimum start-up value is about \$150,000-200,000. The basic criterion is having enough in assets to generate sufficient income to offset the extra costs of running as SMSF. However, there are also the non-cash costs of running a SMSF that need to be carefully considered. In practice, many people who would like to take control of their superannuation by way of setting up a SMSF wait until their accumulation is well in excess of \$200,000. Evidence indicates that people who start an SMSF with \$150,000 or less tend to make losses relative to leaving their super in an industry / retail / corporate fund

Question 8: Tax on Dividends & Capital gains

- Transaction costs are tax deductible
- Capital losses may be used to offset a capital gain but are not deductible outright
- Non-capital losses can be carried forward to future tax years
- Withholding taxes will apply to foreign distributions

Taxation on capital gains

If gains are classified as long-term (asset held > 1 year), a discount applies to the **amount that is subject to tax** (*generally 50%*)

example: you purchased 1,000 KGN shares @ \$4.10 in March 2020

- in August 2020, you observe that KGN was trading at ~\$22 per share and decide to 'take some profit', selling 500 shares at \$21.90
- your assessable income in FY 2020/21 would include $500 * (\$21.90 - 4.10) - (\$19.95 * 2) = \$8,860$
- if you were to sell at the same price in 2022, the taxable gain would be \$4,430

The 19.95 is brokage fees (1 buying, 1 selling)

Taxation on dividends

Dividends are subject to taxation under the *dividend imputation system*. → Ensure that the tax rate applicable to dividends will be the MTR of the recipient shareholder.

	Classical system	Imputation system
Company Level		
Net operating income	\$1,000,000	\$1,000,000
Interest expense	(\$400,000)	(\$400,000)
Taxable income	\$600,000	\$600,000
Tax ($t_c = 30\%$)	(\$180,000)	(\$180,000)
Net distributable income	\$420,000	\$420,000
Shareholder Level (owns 1% share, 45% MTR)		
Dividend received	\$4,200	\$4,200
Imputed income [= $t_c \times D / (1 - t_c)$]	---	\$1,800
Total (taxable) dividend	---	\$6,000
Tax payable ($t_p = 45\%$)	(\$1890)	(\$2,700)
Imputation Credit	---	\$1800
Net Tax Liability	---	(\$900)
Net(after tax) Income	\$2310	\$3,300
Effective Tax rate	$\frac{1890 + 1800}{6000} = 61.5\%$	$\frac{900 + 1800}{6000} = 45\%$