Case Study

What You Really Need to Focus on in Retirement

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This is a case study regarding a potential new client that was referred to us in the early months of 2008, just before the GFC really set in.

Let me give you the background.

John and Betty (not their real names), were fully retired, ages 67 and 65, and had a successful Self Managed Superannuation Fund with us, for more than five years at the time, with a balance in July 2008 of $1,003,000.

They had a well diversified, high quality investment portfolio, holding many of our favourite investment options, and even though their portfolio was down in value over the preceding 8 months (the first stage of the GFC), they were comfortable with their position and comfortable with the quality of investments that they owned within their SMSF.

Anne (not her real name) was recommended to us by John and Betty, in the early months of 2008. Anne had an SMSF, which had been set up by her late husband 4 years previously, and sadly her husband died 2 years after the SMSF had been set up at age 69. Apparently the SMSF had been set up on the recommendation of her husband's tax accountant, who in turn recommended a financial advisor who helped them organise the investments for their super fund. As it turns out, Anne didn't like the financial advisor, and after her husband passed away she disengaged his services and basically left the portfolio untouched until she saw us in 2008.

When we reviewed the portfolio, we came to the conclusion that it was of fairly poor quality, with too many complex and speculative investments for someone in the retirement phase of their life. There wasn't enough focus on income generation, and the portfolio was poorly diversified.

One year earlier Anne's superannuation fund was worth $1,100,000 and rounding to the nearest $1000, transactions over the 2007/08 FY were:

-$55,000	Minimum Pension drawn by Anne
-$13,000	Investment Management, Accounting & Audit Fees
-$144,000	Net Investment loss for the year
+$9,000	Franking credits refunded to the SMSF
$897,000	Closing balance of the 30th June 2008

There were only 11 investments across the fund, and the 3 poorest investments had lost a combined $100,000 over the 12 months.

In the early stages of the GFC, and having experienced some very poor results in the previous 12 months, Anne was naturally concerned, and wanted us to review her SMSF portfolio and potentially take over the management of the fund. As a result of our review, we realised there was a lot of poor investments in the portfolio and our initial recommendation was to get rid of 8 out of the 11 investments, keep only 3, and rebuild the portfolio from there.

Our proposed new portfolio recommended many of our favourite investments, and we put this proposal to Anne in July 2008, but the news about the GFC distressed her and she decided to put everything into Term Deposits, the whole $897,000, and decided that she didn't need to use our services.

Well, in the next 6 months, I think Anne was quite pleased with herself, she had secured average Term Deposit rates above 7%, at a time when the GFC was going through its toughest period, and all other superannuation funds were losing money.

The GFC is now basically history, investment markets around the world have recovered, and the last two years in particular have been very strong.

So after 6 years of "going it alone", Anne decided to come back and discuss her SMSF with us, because of the poor returns she's now getting on her term deposits.

In the table below, we show the results for both SMSF portfolios, John and Betty, who rode out the tough times and stuck with their portfolio, and Anne, who went to term deposits after July 2008 and has stayed there now for 6 years.

	John and Betty	Anne
Portfolio Value 1/7/08	$1,003,000	$897,000
Minimum Pensions Drawn Each Year[1]	$50,150 (2008/09)	$44,850 (2008/09)
Average Rate of Return Over 6 Years[2]	7.42% pa	5.21% pa
Balance as at 30th June 2014	$1,154,000	$880,940
2013/14 Cash Yield[3]	6.08%	3.70%
Prospective Cash Yield 2014/15[4]	$69,250	$32,597
Franking Credits and Costs[5]	+$12,000 Franking credits -$11,232 Inv Mgt, Accounting & Audit Fees (Estimated)	-$3,300 Accounting & Audit Costs (Estimated)
Estimated Net Income 2014/15	$70,013	$29,297
Estimated Minimum Pension 2014/15[6]	$57,700	$44,047

Special notes:

1. *Both John and Betty and Anne have continued to draw the minimum pension of 5% of their account balance over the last 6 years.*
2. *This is the average gross rate of return over the 6 year period.*
3. *This is the total cash yield, dividends, interest and distributions received over the 2013/14 FY.*
4. *We are estimating that prospective cash yield in the coming financial year, and for John and Betty, that's based on an assumed cash yield of 6%. For Anne, it is based on interest earnings on her term deposits, assuming rates don't change in the next 12 months.*
5. *John and Betty have a good exposure to Australian Equities that pay fully franked dividends and hence will receive a refund of franking credits from the ATO. Anne has no franking credits, and her costs are simply the Accounting, Audit and Compliance costs.*
6. *This is the estimated minimum pension drawings that each of them have to take for the 2014/15 FY.*

Anne now realises that she is in a difficult predicament. Whereas John and Betty's SMSF balance has funded their pension payments and increased quite a bit over the last 6 years, Anne's balance has dropped below the 2008 figure, and basically can't increase, because it's all held in cash and term deposits. And the minimum pension that Anne has to draw this year, is about $15,000 more than the estimated net income for the 2014/15 FY, which means that her balance will continue to decrease.

Anne is certainly in a comfortable position, it's highly unlikely that she'll ever run out of money (now age 72), but her SMSF is now substantially under-performing, John and Betty's portfolio, and of course the critical difference is the estimated net income for the 2014/15 FY which is:

- $70,018 for John and Betty
- $29,297 for Anne

John and Betty's fund is generating more income than they necessarily require, but Anne's SMSF isn't generating enough income to cover her minimum pension payment and not only is the capital value of the fund certain to decrease over the next few years, there's also no protection against future inflation.

Anne now wants us to take over the management of her SMSF, effective from 1 July 2014, but the predicament that she's facing, is that many of our most popular investments (which were also recommended in 2008) are now substantially more expensive. The table below highlights how they have changed over the last 6 years:

Investment	Current Price (Shares Only)	Performance Since July 2008
CBA	$78	up 100%
Ramsay Health	$50	up five fold
Westpac	$33	up 83%
Woolworths	$35	up 49%
Ironbark Karara		up 86%
Magellan Global		up 123%
Platinum Asia		up 59.3%

And all of the above figures are price growth only, and dividend payments are on top of that.

The moral of the story:

Buy quality investments, and hold them for the long term.

Focus your attention on income generation, and don't worry about capital movements, up or down, it's only on paper, and you only lose money if you sell at a price lower than your purchase price.

We have estimated John and Betty's net income for the current financial year from the portfolio at $70,018, and it's almost certain that we will be within $2000 of that figure, and it's more than they need to draw as their pension payment for the year.

Footnote: John, Betty and Anne (not their real names) have all consented to the use of this detailed, factual information, and we respect their privacy.

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