



Compiled by
Michael Lannon

Investing in Australia's **TOP 20** companies made easy

Last month's column highlighted separately managed accounts (SMA's) and their characteristics and advantages. The major benefit of SMA's is the investor directly owns the underlying shares and the administration costs are very low. This month, I am pleased to announce the launch of a new SMA service that is now available to ADA members – the 2020 DIRECTINVEST *BlueChip20*.

This new product in association with the ADA's Membership Services allows members to invest directly in a portfolio of Australia's top 20 companies with an initial investment as low as \$5,000 and very low brokerage costs with the option of using 50% gearing. 2020 DIRECTINVEST has teamed up with Blackrock Investment Management (formerly Merrill Lynch Investment Management) to bring you this innovative product. In the future it is hoped to add more portfolio options but initially it was decided to offer members a simple solution facilitating investment in Australia's top 20 companies.

MAKING THE MOST OF YOUR INVESTMENT CHOICES

These days investors are confronted with a myriad of options for investing: wrap accounts, managed funds, direct shares, property and interest bearing investment products such as cash management accounts and online bank accounts. Many people are confused by the use of industry jargon and as a result do nothing. Put simply investors have two choices when it comes to investing – either invest in real assets such as property or shares or lend their money by purchasing interest bearing investments. Let's look at these two options.

As a savings vehicle interest bearing investments for high income earners are not ideal. I often refer to purchasing interest bearing investment options as 'going broke safely' (Table 1).

Table 1.

| Going Broke Safely | |
|----------------------|----------------|
| Amount invested | \$10,000 |
| Interest rate | 5.50% |
| Gross income | \$550 |
| Income tax (\$46.5%) | \$255.75 |
| Net Income after tax | \$294.25 |
| After inflation (3%) | -\$5.75 |

If you were to put \$10,000 into a cash management account that paid interest of 5.50% per annum then you would earn \$550 in interest. However, you need to look at the effect of inflation and income tax on your return. If you are in the top tax bracket (46.5%) then you would need to pay \$255.75 in tax leaving you with \$294.25 after tax. If you assume inflation is approximately 3% then you would need \$10,300 to buy the same amount of goods after one year. Yet after tax you only have \$10,294.25 which in real terms is \$5.75 less than the inflation adjusted amount required. Therefore, whilst it may appear that your money is growing you are in fact going broke safely.

Rather than using interest bearing investments as a savings vehicle investors should consider purchasing real assets such as property or shares in quality companies that historically have grown well in excess of the inflation rate. An added bonus is that dividends on Australian shares often have franking credits which means you pay lower tax on dividends than you do on interest. As well capital gains tax on investments held for more than 12 months is half the rate of tax on interest income.

The 14 year strong run in property prices have made property unaffordable for many young professionals and often the complexity and administration involved with investing directly in the share market can seem daunting. Questions arise such as:

- What should I buy?
- When should I buy?
- How do I do it?

TAKING THE INVESTMENT PLUNGE

The Australian Stock market is made up of hundreds of companies with a combined market value in excess of \$1 trillion dollars. Investors starting out can be restricted to buying shares in a small selection of companies because of the size of their initial investment and the barrier of large brokerage fees. As a result their portfolio can lack the diversity, and may not perform as well, as the wider market.

The 2020 DIRECTINVEST *BlueChip20* allows investing in Australia's leading companies easier and cost effective. With an initial investment of as little as \$5,000, investors could own a direct, blue chip share portfolio of Australia's top 20 companies ➤

including names such as: BHP, Commonwealth Bank, National Australia Bank, RIO Tinto, Woolworths, Westfield, AMP, Westpac Bank, ANZ, Macquarie Bank, Telstra and Fosters.

By adding to investments monthly through a regular payment of as little as \$500, portfolios will grow as more shares are accumulated in these blue chip Australian companies. By choosing to invest a set amount each month benefits from 'dollar cost averaging' means that if markets are weak more shares are obtained and the lower the risk of getting the timing of investments wrong.

The 2020 DIRECTINVEST *BlueChip20* utilises the separately managed account technology of Blackrock Investment Management (formerly Merrill Lynch Investment Managers) and offers the following advantages:

- Low brokerage rates of 0.05% - \$5 per \$10,000 invested.
- A low annual administration fee of 0.80% + GST (less than half the cost of a managed fund).
- Direct access eliminating costly adviser service fees.
- 24/7 online access to portfolios.
- The ability to download portfolio and tax positions to a spreadsheet making accounting easier and cost effective.
- Direct ownership of the underlying shares which allows tax positions to be optimised and eliminates inherited capital gains often prevalent in managed funds.
- Optional one to one gearing facility (50%) at competitive interest rates through Merrill Lynch Equity Margins Limited.

The 2020 DIRECTINVEST *BlueChip20* is an introduction to share market investing. It could not be easier.

The initial investment can be added to through monthly instalments, debited directly from a nominated bank account. These instalments can be as little as \$500. If you choose to gear then an equal loan amount of \$500 is added each month. Each new instalment is then used to purchase additional shares. It's called instalment gearing.

A COMPARISON

If \$5,000 was invested ten years ago in the ASX Top 20 shares, you'd now have \$16,464. However, by investing \$5,000 and then adding \$500 each month, you would now have \$130,736.

The average annual return [^] of the S&P/ASX Top 20 Accumulation Index (dividends are reinvested) are as follows:

- 10 Years - 22.92%
- 5 Years - 15.79%
- 3 Years - 26.95%

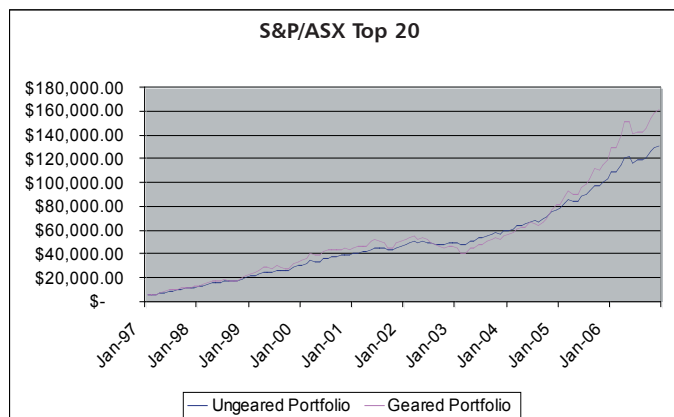
Additionally, as Table 2 illustrates, if the initial contribution was matched with a loan of \$5,000 and then each monthly \$500 contribution matched with a \$500 loan, you would now have \$161,094.*

[^]Based on the performance of the S&P/ASX Top 20 Accumulation Index for the relevant period ending 31/12/06. Source IRESS

*Based on initial contribution of \$5,000 and subsequent contributions of \$500. Geared portfolio assumes initial loan of \$5,000 and \$500 borrowed per month.

Based on the performance of the S&P/ASX Top 20 Accumulation Index from 31/12/96 to 31/12/06. Interest cost of 2.5% over RBA Cash Rate. Source IRESS.

Table 2



LOW BROKERAGE COSTS

The 2020 DIRECTINVEST *BlueChip20* gives you the advantage of removing this brokerage hurdle. Shares can be purchased in 20 separate companies with minimal brokerage costs. The maximum brokerage cost applied to any contribution is 0.05%. For an initial investment of \$5,000, this represents total brokerage costs of no more than \$2.50 (+GST). For a subsequent monthly instalment of \$500, brokerage costs would be no more than \$0.25.

TAX REPORTING AND PAPERWORK IS SIMPLIFIED

Normally, buying direct shares in 20 companies on a regular basis would generate significant paperwork. The 2020 DIRECTINVEST *BlueChip20* takes care of this for you. The tax cost base of shares is automatically adjusted with each trade and dividend payments are recorded and paid into a nominated account. Corporate actions are automatically recorded. Complete and concise records are available on-line at any time to help simplify the preparation of the annual tax return.

The 2020 DIRECTINVEST *BlueChip20* delivers full web-based reporting allowing all investment activity to be monitored daily.

TAKING THE FIRST STEPS

Investors should read the Product Disclosure Statement available from www.2020DIRECTINVEST.com.au/BlueChip20

- Decide on an initial investment size (minimum \$5,000)
- Calculate an amount that you can comfortably afford as a monthly contribution (minimum \$500).
- Decide if you want the optional gearing facility for both the initial investment and monthly contribution.

You will receive nothing in the mail, unless you request an annual hard copy report.

UNNECESSARY ADVISER SERVICE FEES ELIMINATED

2020 DIRECTINVEST *BlueChip20* is available on a direct basis and allows investors to choose to pay a separate professional fee for advice if they wish to do so. Many advisers will add up to 1.0 % per annum adviser service fee to separately managed account products like to *BlueChip20* which effectively eliminates the low cost advantage. If you have read my past articles you will be familiar with my mantra 'Pay a professional hourly based fee for advice and execute your transactions through a discounter like 2020 DIRECTINVEST'.

THE BLUECHIP20 INVESTMENT PROCESS USING OPTIONAL GEARING

The investment process begins with an initial contribution (minimum \$5,000). Upon receipt of this initial contribution, if you choose to gear, the first loan draw down occurs. These funds are also placed in your *BlueChip20* investment cash account.

The combined funds will then be used to purchase shares in the S&P/ASX Top 20, in the approximate ratio of their market capitalisation.

For example, if your initial investment is \$10,000 and BHP represents 15% of the S&P/ASX Top 20 Index, you will buy BHP shares to the value of \$1,500. If Commonwealth Bank represents 10%, you will buy CBA shares to the value of \$1,000.

A cash balance of approximately 2% of your total investment will be retained to cover fees. Interest is paid on any cash that is retained in your *BlueChip20* cash account.

From time to time, the share portfolio may be rebalanced to reflect the changing values of the companies owned, or to retain the 2% cash position.

Monthly Instalments

Subsequent monthly investment contributions will be debited directly from a nominated bank account on the 15th of each month. This also occurs for the gearing option when regular monthly loan draw down will also occur on the 15th and the combined funds used to purchase additional shares.

The monthly contribution will be used to buy those shares that your portfolio is the most underweight in at the time. This process occurs automatically and ensures that your portfolio reflects, as closely as possible, the performance of the S&P/ASX Top 20 Index.

THE POWER OF DIVIDENDS

Under the 2020 DIRECTINVEST *BlueChip20* separately managed account structure, you are the beneficial owner of your shares. Dividends are directed to your interest-bearing deposit account linked to your portfolio or to a nominated bank account. The funds can then be reinvested across your share portfolio.

USING DIVIDENDS TO PAY BORROWING COSTS

If the dollar for dollar gearing option is chosen then the investor receives twice the amount of dividends and franking credits that would ordinarily be received without gearing. These dividends could pay the majority of the borrowing costs (interest) on the loan.

Depending on personal circumstances, the interest on the investment loan may also be tax deductible. The combined impact of dividends, franking credits and tax deductions can create an attractive cash flow situation.

An example

You have \$5,000 and borrow an additional \$5,000 and invest the full \$10,000 in *BlueChip20*. The Top 20 shares pay a combined dividend yield of four per cent franked at 85%.* You receive \$400 in dividends and \$159 in franking credits over the course of one year.

Your borrowing costs on a loan of \$5,000 for one year are \$450.**

Your personal marginal tax rate is 40% and you are eligible to claim your interest expense as a tax deduction.***

Table 3 illustrates the cash flow effect of this scenario.

In this case, the cash flow impact of gearing is positive, which

Table 3.

| | Income | Expenses |
|-----------------------------|--------|----------|
| Dividends | \$400 | |
| Franking Credits | \$159 | |
| Tax on grossed up dividends | | \$224 |
| Tax deduction on interest | \$180 | |
| Interest on loan | | \$450 |
| | | |
| Net inflow | \$65 | |

means that the cost of borrowing has been more than offset by the dividend income, franking credits and tax deduction.

If you choose the geared option for the *BlueChip20* there are no loan establishment charges for individual borrowers and the loan is provided by Merrill Lynch Equity Margins Limited. In deciding to borrow to invest, you need to appreciate that while gearing can increase returns through capital growth and greater dividends, it can also have a similar negative impact when markets fall.

Whilst historical returns are never an indication of future returns, Table 2 demonstrates the out performance of a geared investment in the S&P/ASX Top 20 shares over the 10 years to 31 December 2006.

I am really excited about this product because it represents what I believe is the future of investing in Australia. Choosing a passive investment approach such as the *BlueChip20* as the core of your investment strategy is a simple, highly effective and easy to understand path to savings and investment. In the future it is hoped to add more investment options that incorporate the tax efficiencies and low administration costs of the separately managed account technology but allow members to retain ownership of the underlying shares.

Through our relationship with multiple professional associations such as the ADA we are able to negotiate better deals for members than they could access themselves. This year marks our 10th anniversary of helping our members increase their returns through reduced fees. We are looking forward to serving you with innovative investment ideas over the next 10 years.

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*Assumption based on the average yield and franking rate of the S&P/ASX Top 20 Index as at 31/12/06.

**Calculated on an annual interest rate of 9%. (Please note that interest rates are subject to change as determined by the RBA Cash Rate)

***You should seek independent advice from your tax adviser to determine if you are able to claim interest costs as a tax deduction.