

Becoming Financially Literate



Many Australians delay taking control of their finances because they don't have the time, they find it too daunting or they may just not know where to start. The reality is though the sooner you take charge the sooner you can start working towards achieving better results, especially in the long term.

To assist you in this process CPA Australia has developed *30 Ways to Build Your Wealth* - a series of five fact sheets to get you on the path to good money management. This fact sheet provides helpful information to improve your financial literacy. The other fact sheets cover creating good money habits; spending money to make money; being tax savvy; and maximising your entitlements - all of which can be downloaded at www.cpaaustralia.com.au/links?30wayskit

While the information highlights some factors to consider and how these may impact your finances, it does not replace the need for ongoing financial planning advice that is tailored to your specific needs.

1. Value of compounding

Compounding means earning interest on interest, and is a more effective means to grow money than simple interest.

Compounding simply means that the amount you earn on your money is added back to the principal amount that you invested. The next time that the interest is calculated, interest is paid on the new amount, meaning each time the amount of interest you receive increases.

Even if you're investing the same amount, compounding can put you significantly ahead. For example, if you invested \$1,000 each year for 10 years at 5 per cent, compounded annually, you would have \$13,207 at the end of 10 years. If you waited five years, then invested \$2,000 each year for five years at the same rate (5 per cent compounding annually), you would only have \$11,604.

The following table shows the effect of compounding interest.

Year	Limited compounding Investing \$10,000 at five per cent over five years		Maximum compounding Investing \$10,000 at five per cent over ten years	
	Amt invested	Total	Amt invested	Total
1	-	-	\$1,000	\$1,050
2	-	-	\$1,000	\$2,152
3	-	-	\$1,000	\$3,310
4	-	-	\$1,000	\$4,526
5	-	-	\$1,000	\$5,802
6	\$2,000	\$2,100	\$1,000	\$7,142
7	\$2,000	\$4,305	\$1,000	\$8,549
8	\$2,000	\$6,620	\$1,000	\$10,027
9	\$2,000	\$9,052	\$1,000	\$11,578
10	\$2,000	\$11,604	\$1,000	\$13,207

If the interest is calculated monthly, or better still, daily, the impact will be greater.

2. Understand the advice you are receiving

A financial adviser has responsibilities to you as the client. But as the client, you should take some steps to increase your financial knowledge so you understand the advice you are being given.

The financial services industry has undergone some major regulatory changes in the past few years to improve the quality of advice provided to consumers. As the client, you must understand that the advice you will receive can only be as good as the information and instructions you give to your financial adviser. In addition, it is not the financial adviser who needs to make the decision, it is you.

Furthermore it is important that, as the client, you take the time to ensure you understand the advice you are given and are comfortable with that advice. This means it is essential that you read the financial plan that you are provided. You should never be afraid to ask your financial adviser to explain the recommendations in your plan, or to ask specific questions. There is no such thing as a stupid question. A good financial adviser will always be more than happy to take the time to answer your questions, as good financial planning is not only about providing good advice but also about assisting you so you understand the advice provided and can make a sound decision.

Numerous financial institutions have developed tools to assist consumers learn more about financial advice, including the process of financial planning, specific concepts and different types of investments. The CPA Australia web site, www.cpaaustralia.com.au, has a specific section for consumers, which includes information on selecting the right adviser and the process of financial planning.

3. How to select the right investments

Selecting the right investment is not as simple as choosing the one that has performed the best in the past. Just because it has performed well in the past, does not mean it will in the future.

Selecting the right investment is not as simple as checking its past performance. There are a number of factors that you must consider, including what amount of risk and volatility you are willing to be exposed to, the amount of time you want to spend on your investments, the quality of the manager and of course, the quality of the underlying investment.

You need to decide if you are comfortable taking a risk with your investments or if you would prefer an investment where the risk is reduced. Even if the investment you select is not risky, it may be more volatile. That is, its value may fluctuate a lot more in the short term. This is often the case with smaller emerging companies. These sorts of investments are not suitable if you are only investing for a short time.

In today's market, there are endless options when it comes to investing, so seeking the advice of a qualified financial planner is recommended.

Always remember that if an investment sounds too good to be true, then it probably is.

4. Dollar cost averaging

Dollar cost averaging is about investing money over a period of time, rather than in a lump sum, to avoid any market timing risks.

If we could work out the best time to invest in the share market to maximise our returns, we'd all be rich. But in reality the share market is highly volatile in the short term, meaning share values go up and down in value. It really is very difficult to predict which way the market is going to turn.

To overcome some of the short-term volatility of investing in the stock market, you should consider investing a lump sum over a period of time, say months, rather than all at the one time. This is often referred to as 'dollar cost averaging' as your initial investment price is averaged over a period of time.

By using dollar cost averaging, you are able to benefit from investing at the lows, while limiting investments at the peak. Dollar cost averaging will not always guarantee that you end up with more shares or units in a particular investment, such as when shares only increase over the period. However it does remove some of the guess work of trying to predict if shares are going to rise or fall in the short term.

5. The importance of investment diversification

Diversification means placing money into a variety of different types of investments so that you spread your risks, rather than putting 'all your eggs in one basket'.

Diversification involves spreading your risk across different investments and different asset classes. Investors talk about four main types of asset:

- cash
- fixed interest (bonds)
- property
- equities (shares)

There are variations on all of these, including specialist types of each and international variations. Each year, the top and bottom performing asset class tends to change, so trying to pick the winner each time means you may pick the loser and are likely to see enormous variations in returns from year to year.

Investing across different asset classes will certainly help smooth your returns from year to year. However, it's essential to spread your money across different individual investments to minimise the credit risk associated with investing in one company which could collapse (e.g. HIH). Managed funds already invest across a range of investments, so are a good way to diversify if you don't have the funds to do so yourself.

6. Focus on advice, not products

Good financial planning is not about getting the right product or the cheapest product.

Proper financial planning involves being asked a lot of questions such as:

- what you earn
- what you own
- what you spend
- what you owe
- where you are financially today
- where you want to get to

Only with the answers to these questions can the right financial strategies be identified. These strategies are what will differentiate good advice from bad advice. It is quite likely that an adviser will recommend that you invest in, or insure with one or more products – but it may not always be the case.

There is no doubt that if the adviser gets the strategy wrong then the product selection will not fix it. However, if the strategy is right – then your financial plan will probably survive one or two bad product choices and the likelihood of bad choices is minimised.

Make sure that your adviser asks lots of questions – and be prepared to discuss your current position in detail. If they don't ask lots of questions, they probably aren't the right adviser for you.

If the adviser talks a lot about products in the first meeting then they are possibly not focussed on giving you the best advice possible but rather trying to sell something to you. Remember if you are not comfortable with something, don't do it. And sometimes a second opinion helps.



7. Understanding fees & charges

Like anything in life, you get what you pay for – so the cheapest fee is not always the best.

Financial planning is a valuable service, which can significantly impact upon your financial security. Like anything else, you get what you pay for and there will be costs at all stages of the process. Be wary of financial planners who seem to offer their services ‘free of charge’ – you can be sure that you’re paying for them elsewhere through hidden commissions. There should also be a separation between how your fee is set and how you pay for it; this ensures that the fee is not based on any kind of product sale or purchase.

Legislation requires full disclosure of all fees, commissions and incentives by your financial adviser and other participants. The main methods of charging are:

- plan preparation fees
- implementation fees (including fee for service, entry fees, deferred entry fees, transaction fees, brokerage and legal, accounting & other fees)
- maintenance fees (including flat fees, asset based fees and commissions)

Some guidelines on what you can expect to pay for these services can be found on the CPA Australia web site at www.cpaaustralia.com.au.

The important thing to remember is that the cheapest is not always the best – they are probably doing a lot less for you.

To locate a CPA Financial Planning Specialist who can assist you with your financial planning needs, visit <http://www.cpaaustralia.com.au/links?findafp>

Note: Information is current as at 1 May 2006.

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