Long-Term Investing Report

Comparing 10 and 20 year performance of various investments to December 2005

ASX
AUSTRALIAN STOCK EXCHANGE

An annual research study by Russell and the ASX

Russell

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^ According to the Morgan Stanley Capital International global index (MSCI®)

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Summary

This report investigates the performance of various types of investments over the past 10 and 20 years. As part of the performance comparison, the report considers the real-life impact of tax and borrowing on ultimate investment returns. The aim is to provide individual investors with a reasonable insight into how different investments have performed over the medium to long-term – in real terms. This report is a continuation of the annual ASX Investment Performance Report, historically prepared by Russell[#]. This is the 9th year it has been published.

Results: Before-tax but after-costs

» Global listed property achieved the highest return of 14.6% p.a. for the ten year period.

» Australian listed property achieved the highest return of 13.2% p.a. for the twenty year period.

» Overseas shares (unhedged) underperformed Australian fixed interest for the ten year period.

» Cash achieved the lowest return of any asset class over the ten and twenty year periods.

Results: After-tax and after-costs

» Australian listed property outperformed all other asset classes at both the lowest and highest marginal tax rate for the ten year period.

» Australian shares achieved the highest return of 12.4% and 10.4% at the lowest and highest marginal tax rates, respectively, for the twenty year period.

» When taking gearing into account (i.e. borrowing money to invest), Australian shares underperformed residential investment property at the lowest marginal tax rate, but matched the return at the highest marginal tax rate.

» Global property and global shares are not included on an after-tax basis due to the differential tax treatment for Australian investors in different contries.

Diversified Managed Funds

» The sample managed funds will naturally always lie in between the lowest and highest performing asset classes.

» The managed funds exhibited less volatility than shares and property, providing a more consistent return for investors.

Tax Implications for Investors

» The results of this study show that tax makes a significant difference to the end outcome for various investments.

» Personal taxation has a greater impact on fixed interest and cash investments.

» The impact of personal taxation on Australian shares returns has been less significant, due to franking credits.

» At the lowest marginal tax rate, the tax credits from dividend imputation resulted in the after-tax return being slightly greater than the before-tax return for the twenty year period.

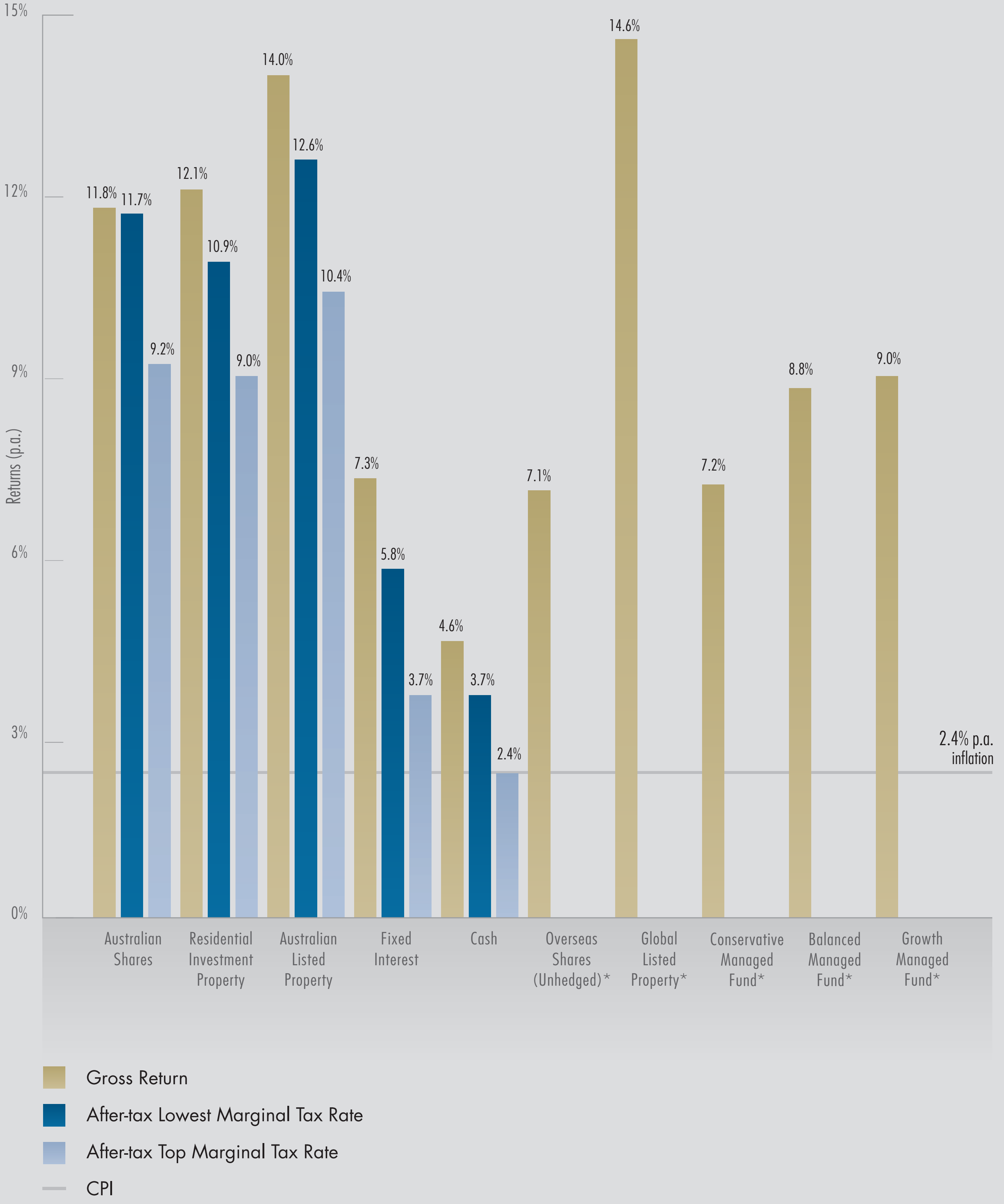
Effect of Gearing

» Borrowing money to invest (i.e leverage) over the past ten years has effectively increased the after tax return of both Australian shares and residential investment property.

» The increase in performance of the two asset classes has more than offset the borrowing costs over the ten year period.

Chart 1

Comparison of various investments,
at different tax rates.
10 Years to 31 December 2005.



* Only before-tax return has been calculated
Note: all returns are net of costs

Long-Term Investing Report

All investment markets move in cycles. While this report presents a review of medium-long investment performance, it is not indicative of how asset classes might perform in the next 10 or 20 years. For a variety of reasons, Australian listed property, Australian shares and residential investment property have all experienced unprecedented booms at various points in the last ten years, strongly influencing results.

Fair Comparison of Investment Performance

This report is designed to investigate the performance of various investments over the medium and long term. The results are provided on a consistent net basis (i.e. after all costs and taxation) over ten and twenty year periods ended 31 December 2005. Performance is calculated over these two periods for two reasons: (i) to assist those individual investors who invest for the medium and longer term; and (ii) to provide a reasonable comparison between investment sectors. The report also considers the tax impact for investors at both the lowest marginal rate and highest marginal rate, to provide a more accurate indication of performance for investors at different tax thresholds.

Seven major sectors are included in this report:

» Australian shares

» Residential investment property

» Listed property*

» Global listed property

» Overseas shares (unhedged)

» Domestic fixed interest

» Domestic cash

In addition to these seven sectors, the report includes net of costs returns for three sample diversified indexed managed funds for the ten year period ended 31 December 2005:

» Conservative (25%–35% allocation to equities and property)

» Balanced (65%–75% allocation to equities and property)

» Growth (75%–85% allocation to equities and property)

Performance Comparison – Before Tax

10 Year Performance

Chart 1 shows that global listed property outperformed all other investments in the past ten years followed by Australian listed property. Returns have been particularly strong for global and Australian listed property, Australian shares, and residential investment property over this period, even after taking inflation into account.

Australian investors can gain exposure to global property markets by investing in Australian domiciled listed property trusts with assets offshore. The sector has approximately 40% of its assets offshore – US, Europe and Japan and this trend has continued as the availability of investment grade assets has reduced in Australia.

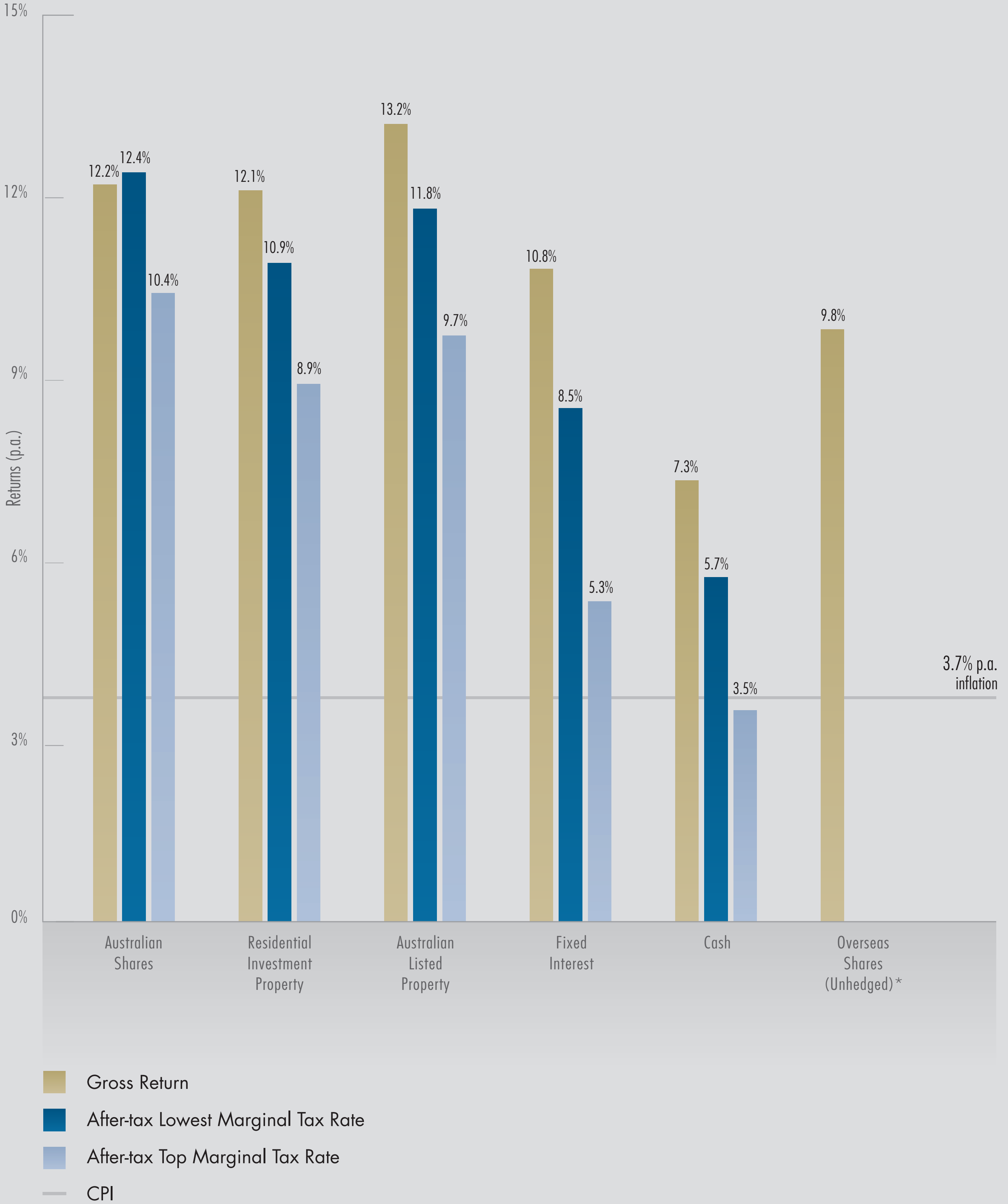
The sample managed funds are made up of a diversified selection of investments across a range of asset sectors. As a result, the performance of these sample funds will naturally always lie in between the lowest and highest performing asset classes. In this study, the balanced and growth funds returned less than Australian shares, Australian and global listed property, and residential investment property – but higher than overseas shares (unhedged), fixed interest and cash. The managed funds exhibited lower volatility (less variability in returns, year to year), providing a

“Global listed property outperformed all other investments in the past ten years followed by Australian listed property.”

* Although listed property is considered a separate sector in this report, it is also a sub-sector of Australian shares.

Chart 2

Comparison of various investments, at different tax rates.
20 Years to 31 December 2005.



* Only before-tax return has been calculated
Note: all returns are net of costs

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more consistent yearly return for investors as a result of diversification effects.

Although Australian listed property has exhibited very strong returns over the last ten years, the listed property market looks a lot different now, compared to ten years ago. There has been major consolidation among listed property trusts particularly within the S&P/ASX 200 Property index – approximately 25 listed property trusts. Within this index, Westfield alone accounts for about 35% while the five largest trusts comprise 65% of the index.

This raises the issue of concentration and lack of diversity within the Australian listed property trust sector. As for residential investment property, the returns from this sector have resulted from the biggest, longest and most geographically widespread property boom we've experienced, with house prices nationwide more than doubling in six years. Similarly, the Australian sharemarket has enjoyed a spectacular boom. It is important here to point out that past performance is by no means an indication of future performance.

20 Year Performance

Chart 2 shows that in the past twenty years, the Australian listed property sector (13.2% p.a.) has outperformed all other investment sectors before taxation but after costs. Australian shares (12.2% p.a.), residential investment property (12.1% p.a.) were also strong performers over the period. Fixed interest (10.8% p.a.) outperformed global shares (9.8% p.a.) and cash 7.3% p.a. before tax. All investments performed well above average inflation (3.7% p.a.).

Performance Comparison – After Tax

The results of this study show that tax makes a significant difference to the end outcome for various investments. Overall, for the ten year period, at the top marginal tax rate, the effective tax rate for Australian shares is around 22%, residential investment property and listed property is around 26%, fixed interest and cash is around 49%.

The relatively low effective tax rate for Australian shares can be attributed mainly to the benefits of dividend imputation. Dividend imputation allows investors to offset tax already paid by a company on profits it earns (currently at 30%) against the tax on their dividends.

10 Year Performance

Taking tax into account, chart 1 shows that in the past ten years, Australian listed property has outperformed all other investment sectors.

At the lowest marginal tax rate, the after-tax returns of Australian listed property (12.6% p.a.), Australian shares (11.7% p.a.), residential investment property (10.9% p.a.), fixed interest (5.8% p.a.) and cash (3.7% p.a.) were well above the average rate of inflation (2.4% p.a.) over the ten year period. Global property and global shares are not included on an after tax basis due to the differential tax treatment for Australian investors in different countries.

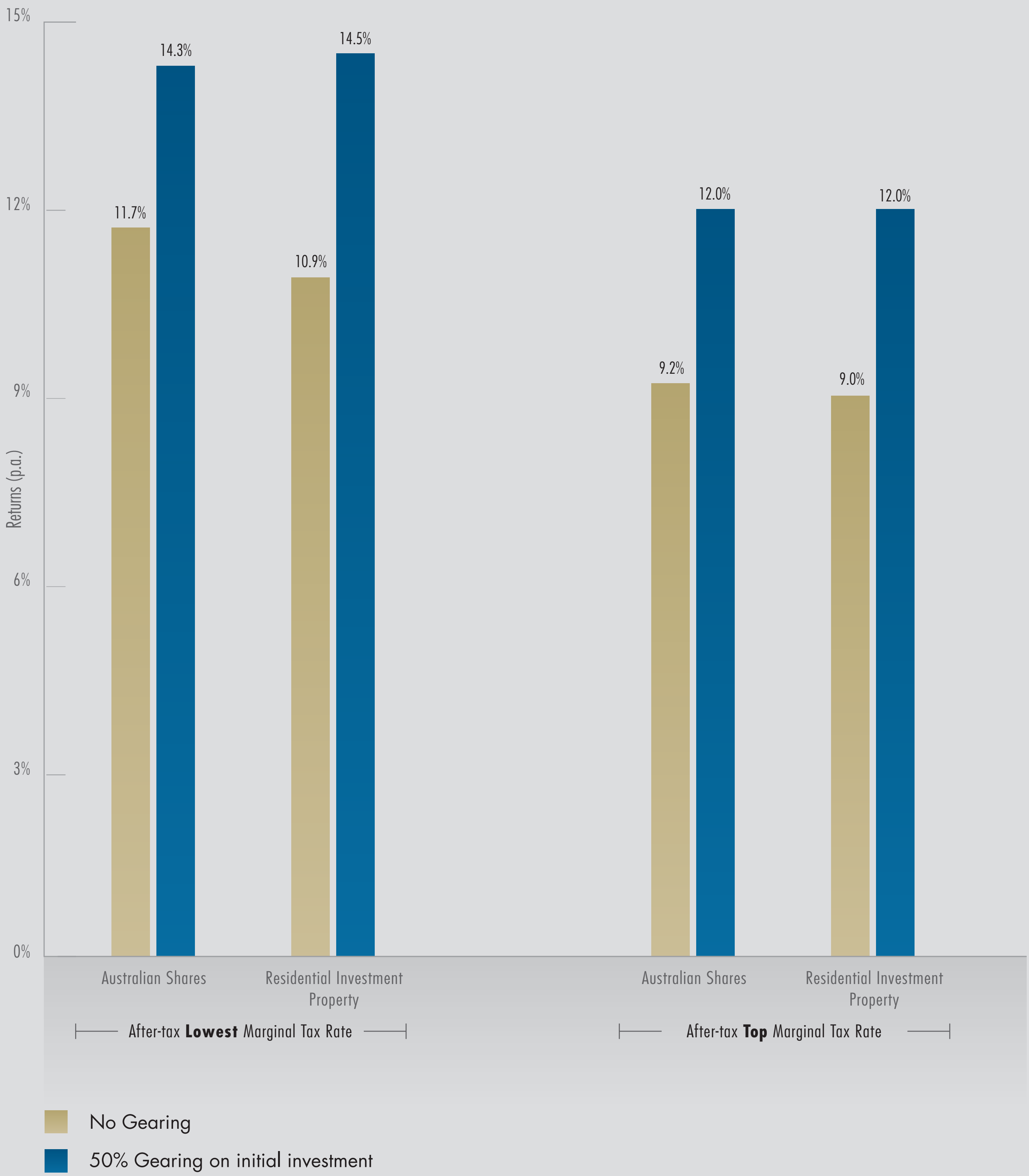
At the top marginal tax rate, the after-tax returns from Australian listed

> "Focusing on the after-tax analysis, the chart shows that in the past ten years, Australian listed property has outperformed all other investment sectors."

Chart 3

Comparison of Australian shares and residential investment property,
on an after-tax basis, with and without gearing.

10 Years to 31 December 2005.



* Only before-tax return has been calculated

Note: all returns are net of costs

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property, Australian shares, residential investment property and fixed interest assets have exceeded inflation. The cash return (after-tax), has matched the average rate of inflation.

20 Year Performance

Excluding overseas shares (unhedged) from the after-tax analysis, chart 2 shows that in the past twenty years, the Australian shares sector has outperformed all other investment sectors after allowing for taxation and expenses. On a before-tax basis, the real returns (ie, after inflation) of Australian shares, Australian listed property, overseas shares (unhedged), residential investment property and fixed interest, have been strong.

At the lower marginal tax rate, the after-tax returns of Australian shares (12.4% p.a.), residential investment property (10.9% p.a.), listed property (11.8% p.a.), fixed interest (8.5% p.a.) and cash (5.7% p.a.) were well above the average rate of inflation (3.7% p.a.). At the top marginal tax rate, the after-tax returns from Australian shares, residential investment property and Australian listed property have exceeded inflation. Returns from fixed interest assets were more moderate, but cash returns fell slightly short of average inflation.

The results highlight the greater impact of personal taxation on fixed interest and cash investments. The impact of personal taxation on Australian shares returns has been less significant, due to the introduction of dividend imputation in July 1987. At the lower marginal tax rate, the tax credits from dividend imputation resulted in the after-tax return being slightly greater than the before-tax return.

Effects of Gearing

We will now consider the effect of borrowing on investment performance. Of the asset classes under analysis, gearing (borrowing money to invest) is most common amongst investments in Australian shares and residential investment property.

In calculating the after-tax returns with gearing, the following assumptions have been applied:

- 50% of initial investment is borrowed (i.e. initial gearing ratio of 0.5)
- Gearing arrangements involve interest-only loans
- Indicative home loan interest rates (for residential property) are on average 1.0% p.a. lower than margin lending rates (for Australian shares)

In calculating the after-tax returns, allowance has been made for the tax deductibility of interest costs. The chart shows that the use of leverage over the past ten years has magnified the after tax return of both Australian shares and residential investment property. The results reflect that the performance of the two asset classes have more than offset the borrowing costs over the ten year period.

> "The use of leverage over the past ten years has magnified the after tax return of both Australian shares and residential investment property."

Chart 3 compares the ten year investment return of Australian shares and residential investment property, on an after-tax basis, with and without gearing.

Performance Calculations

The investment performance comparisons in this report took into account real life tax implications, investment costs and changes as they occurred over the last ten and twenty years.

This analysis has been conducted on the following basis:

Investment Comparison

- All investment returns are determined after taking into account expenses relating to the acquisition, management and disposal of the asset. **Gross returns** are calculated before-tax but after-expenses. **Net returns** allow for the taxation treatment of each investment over the period of analysis. This aims to represent a realistic method of comparing the different asset classes for an investor.
- **Compound returns** are calculated over a ten year period from 1 January 1996 to 31 December 2005, and over a twenty year period from 1 January 1986 to 31 December 2005. The returns are equivalent to the per annum compound returns that investors would have received for an investment in the particular asset class if they invested in an equivalent portfolio over the two periods.

Income Tax

- The lowest and highest **marginal tax rate** are currently 16.5% and 48.5%, respectively. These rates have varied slightly over the ten and twenty years due to changes in **taxation policy** and the **Medicare levy**. These variations have been taken into account in the calculation of after-tax returns. Both bottom and top marginal rates include the **Medicare levy** of 1.5%.
- The **corporate tax** rate was reduced from 34% to 30% from July 2001. The **corporate tax** rate has varied slightly over the past ten years due to changes in taxation policy. These variations have been taken into account, including the impact on the calculation of franking credits, which have an impact on after-tax returns for Australian shares.

> "Investment returns are determined after taking into account expenses relating to the acquisition, management and disposal of the asset."

Capital Gains

- Generally, assets acquired on or after 20 September 1985 are subject to the **capital gains tax** provisions. For the calculation of ten year and twenty year returns, **capital gains tax** is calculated on both the initial investment and any subsequent reinvestment of income. Cash and fixed interest are not subject to **capital gains tax** as all gains are taxed as income and are therefore subject to marginal rates.
- The **Government's Tax Reform Plan** has included changes to the capital gains tax regime applying from 21 September 1999. Assets acquired prior to this date and held for a minimum of twelve months can be assessed for **capital gains tax** in one of two ways. Private investors can choose to pay **capital gains tax** (at their marginal tax rate) on either 100% of the capital gain (with indexation) or 50% of their capital gain (with no indexation). In this report, we have presented sector returns based upon the calculation method that provides the higher after-tax returns. The discounted capital gain method (as opposed to indexation) has provided the higher after-tax returns in all cases.

Performance Calculations // Continued

Capital Losses

» **Capital losses** may be carried forward indefinitely and offset against other **capital gains** in future periods. We have assumed the investor has other investments, either today or in the future that have, or will, produce capital gains to which capital losses may be offset.

Gearing

» After tax returns with **gearing** have also been calculated for Australian shares and residential investment property over the ten year period from 1 January 1996 to 31 December 2005. Half of the initial investment is assumed to be borrowed and gearing arrangements are assumed to involve interest-only loans (i.e. periodic payments do not include any repayment of principal). In addition, allowance is made for the deductibility of interest costs.

» **Borrowing costs** are based on data from the Reserve Bank of Australia ("RBA") bulletin. For residential investment property the **standard variable rate** for housing loans is used, while for Australian shares the margin loans rate is used.

Investment Measures

» The **residential property** measure is a population weighted average return across major capital cities. Increases in value are based on median house prices obtained from the Real Estate Institute of Australia. Data from the Australian Bureau of Statistics is used to make adjustments for capital improvements. Net rental income allows for vacancy rates, maintenance expenses, management fees, government charges, land tax and insurance. Acquisition and disposal costs include conveyancing, stamp duty and agents' fees.

» The **cash** measure assumes an investment in cash management trusts, with data sourced from the RBA Bulletin.

» The **Australian shares** measure is based on investment in listed shares with price movements and dividend reinvestment consistent with the S&P / ASX All Ordinaries Accumulation Index. Allowance is made for brokerage and stamp duty (where applicable) on acquisition and disposal. Stamp duty ceased to apply from 1 July 2001 to transfers of marketable securities quoted on the Australian Stock Exchange. Dividend franking is taken into account in determining the impact of tax on dividends.

» The **fixed interest** measure is based on investment in Australian Government and corporate bonds. Returns are derived from the Commonwealth Bank All Series All Maturities Index to September 1989 and then the UBS Warburg Australia Composite Bond Index thereafter. Price movements and coupon payments are both taxed as income.

» The **listed property** measure is based on the returns implied by the S&P / ASX Property Trust Accumulation Index. Acquisition and disposal costs, such as brokerage and stamp duty (where applicable), have been factored into the return calculations. Assumptions have been made with respect to the tax treatment of listed property

"Variations in marginal tax rates have been taken into account in the calculation of after-tax returns."

income, including the component of tax-free (abolished in July 2002) and tax-deferred income.

» The **overseas shares (unhedged)** measure is based on investment in listed shares with price movements and dividend reinvestment consistent with the MSCI World ex Australia Gross Dividends Accumulation Index (Unhedged) in AUD. Allowance is made for brokerage on acquisition and disposal. After-tax returns are not calculated due to the differential tax treatment of overseas shares investments by an Australian investor in different countries.

» The **global listed property** measure is based on investment in listed property securities with price movements and dividend reinvestment consistent with the UBS Global Investors Index (Unhedged) in AUD. Allowance is made for brokerage on acquisition and disposal. After-tax returns are not calculated due to the differential tax treatment of overseas investments by an Australian investor in different countries.

» The **conservative managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 25–35% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to the differential tax treatment of overseas shares investments (which forms part of the allocation) by an Australian investor in different countries.

» The **balanced managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 65–75% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to the differential tax treatment of overseas shares investments (which forms part of the allocation) by an Australian investor in different countries.

» The **growth managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 75–85% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to the differential tax treatment of overseas shares investments (which forms part of the allocation) by an Australian investor in different countries.

“After-tax returns are not calculated for overseas shares and global property due to the differential tax treatment of overseas investments by an Australian investor.”

A PDF of this report is available from the Russell and ASX websites:

» www.russell.com.au
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