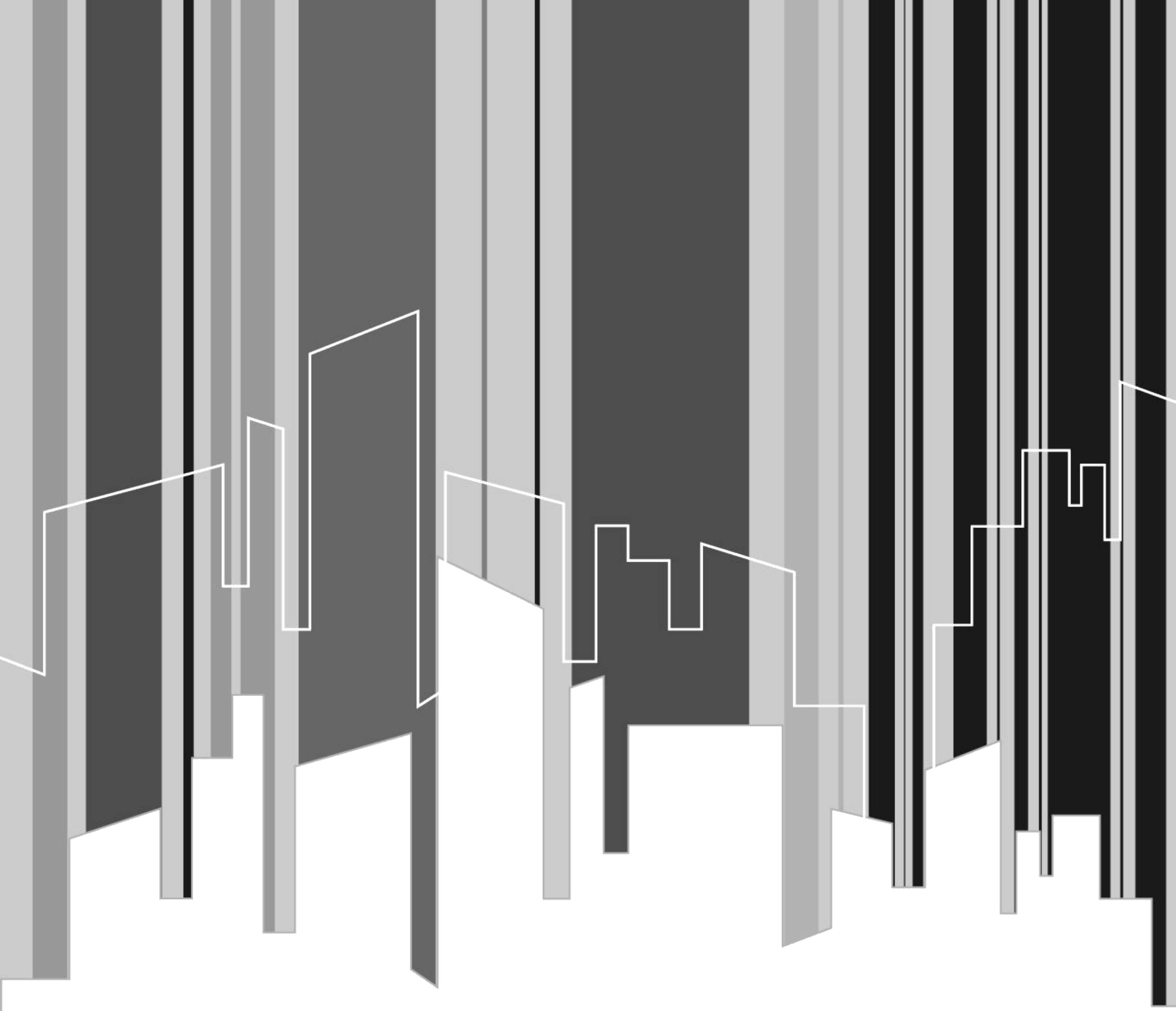


NEWSLETTER

March 2020

HUTTON

FINANCIAL

Introduction

Well, February proved to be quite the month.

In this edition of our newsletter, we take a sober look at the current state of the share market and, in particular, the impact that fears around the Coronavirus are having on the market. The virus is obviously a very serious thing and we sincerely hope that neither you nor any of your loved ones are affected by it.

Our analysis does point to ways that you can minimise the risk of events such as the virus negatively affecting your portfolio. If you would like to know more about these techniques, please do not hesitate to get in touch.

We hope that the month of March treats you well.

Shane Neaves

1800 488 866

shane@huttonfinancial.com.au

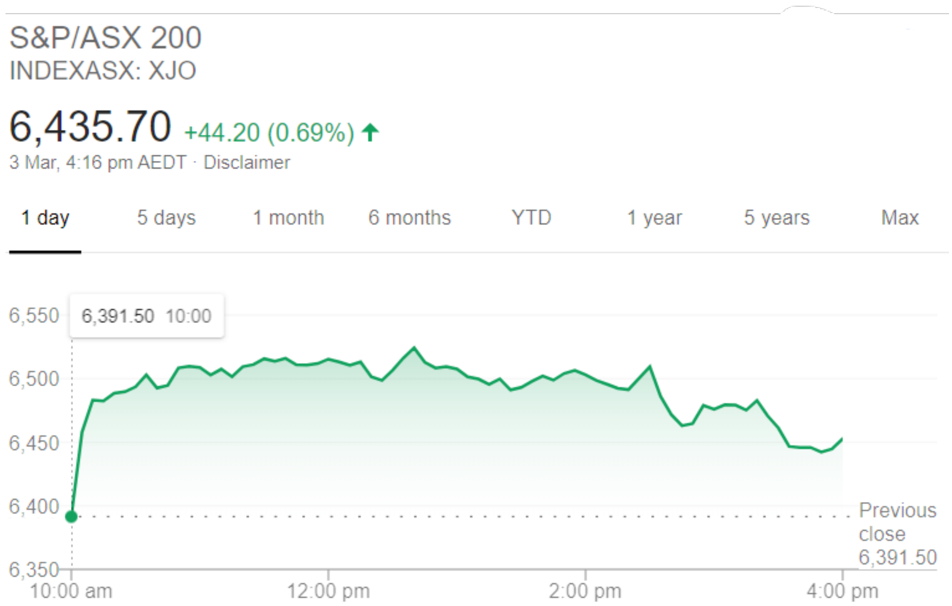
www.huttonfinancial.com.au

The Share Market

The Australian share market has been very volatile these last few weeks. It is important that we spend this month's newsletter letting you know our thoughts on the market and the factors impacting on it.

Last month we reported that the Australian market had reached an all time high. Prices have dropped significantly since then. From its monthly high of 7,162 points at the end of trading on February 20, the ASX 200 had fallen by 10.7% by the end of trading on Monday March 2 – the last complete business day before this newsletter was prepared. Here is how it looks, with thanks to Alphabet:

There is no secret as to the cause of the downturn. Concern about the Coronavirus, and especially its impact on world economies, triggered significant selling in all major markets across the last week of February. The selling continued on the first day of this week, although it was then corrected somewhat on Tuesday. The following graph shows the movement in value of the ASX for Tuesday March 3:

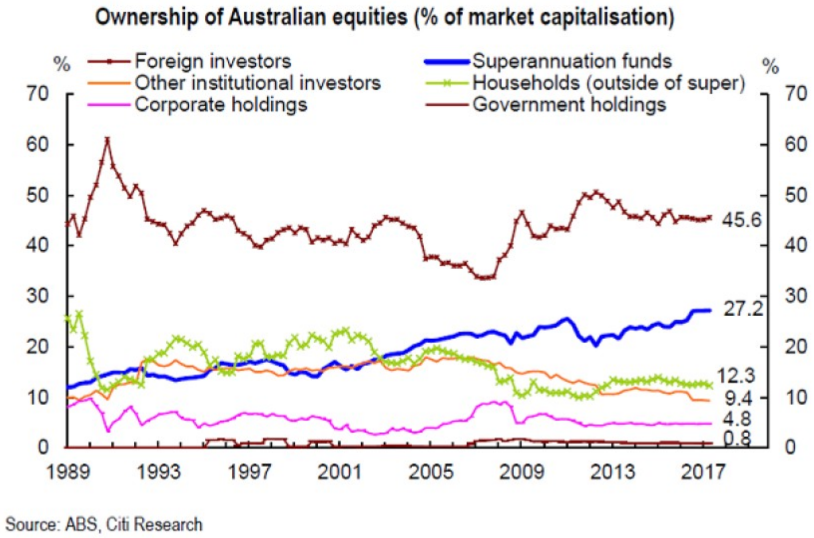


On Tuesday, at least, the market was rebounding (Tuesday is the day we need to go to press, for internal administrative reasons. We apologise that this is now three days ago).

So, what is going on? In this newsletter, we want to thoroughly examine many of the factors that have driven these price fluctuations and use this latest 'black swan event' to further educate our readers about some of the factors that impact on share market prices.

The Effect of Managed Investments - Selling

In understanding the recent price movements on the ASX, it pays first to understand who owns what on the Australian share market. In 2018, the ABS and Citibank produced the following research on share ownership:



As the graph shows, in 2018, more than 45.6% of shares traded on the ASX were owned by overseas investors. Just 12.3% were owned directly by Australian households (which is another name for private people). By far the main way in which Australians invest in the ASX is through their super fund, which account for 27.2% of all investments on the exchange.

Amongst other things, these figures tell us that most shares held on the ASX are held through managed investments, which include super funds. This makes sense and is generally a good thing: managed investments are usually a good way to cheaply access a diversified range of share market investments (more on diversification later). But the presence of managed investments that hold a diverse portfolio of shares can mean that the whole market is affected by selling that results from a market scare such as we have had recently.

To illustrate, let's look at a simplified version of managed investing. Let's say an investor holds interests in the shares of 50 companies via an exchange traded fund (a form of managed fund commonly abbreviated as an 'ETF'). These 50 companies are diversified across different sectors of the economy (finance, minerals, retail, etc). If the investor decides to exit the market, he or she (or it) needs to sell shares in the ETF. The fund will, in turn, sell some of the shares of each of the 50 companies. So, the investor's decision to convert their investment to cash means that the investment manager sells shares across the portfolio – regardless of whether those individual companies warrant being sold.

This means that, when investors in managed investments sell as a result of something specific, like the Coronavirus, the fund manager ends up selling shares in companies that will either (i) not be affected by the Coronavirus; or (ii) might even *do well* out of the Coronavirus. Strange as it may seem, natural 'disasters' such as pandemics often create more economic activity than they inhibit, especially over the long term. Think, for example, of the recent bushfires. Many houses have been destroyed. Emotionally, this is horrible, but economically it means that there will be greater demand for the services of builders, landscapers, etc, in the years to come.

Historically, we have an even larger precedent than this. The Economic Depression of the 1930s did not really end in Australia until 1939, when Australia entered the Second World War. The war effort meant that everybody was put to work, and this created a spike in economic activity that continued well into the early 1970s.

So, natural disasters can give a boost to some sectors of the economy. In the case of the Coronavirus, as a more recent example, there have been various media reports of supermarkets selling out of particular groceries. Here is a picture that was run in the Fairfax Press on Tuesday of this week:

As you can see, the supermarket in question had all but run out of toilet paper and rice – although no one seems to be stocking up on rabbit-shaped chocolate just yet. Think about this picture: people who make and sell toilet paper products have seen a boost to their sales, as have the people who distribute them and, of course, the supermarket that sells them to the public. This should mean that these companies' profits take a boost as well. But have a look at this graph, showing the share price movements for Woolworths, Australia's largest supermarket chain, in the month to March 2:

Woolies shares closed at $43.60 per share on February 20. By the close of March 2, shares had fallen to $38.63. This is a fall of more than 11% - which is actually higher than the market average. (Please do not interpret this graph as a recommendation to buy shares in Woolies; it is neither a recommendation against or for that particular company. The graph is shown simply to demonstrate that the sell-off in shares has not been particularly targeted). What this shows is that, in this case, a company that has actually benefited from the likely impact of Coronavirus has nevertheless seen its share price fall.

Interestingly, by the close of trade on Monday, March 2, the share price of Australia's *second* largest supermarket chain seem to be reflecting this particular nuance. Coles 'bucked the trend' on Monday March 2 and actually rose on the day. Have a look at this graph of the price for the Coles Group for the month prior to March 2:

On 20 February, shares were trading at $16.15. Shares fell to a low of $14.21 at the close on Friday, February 28. But by the close of trading the following Monday, prices had rebounded to $14.67. Perhaps investors who could not buy toilet paper had decided to buy shares in Coles instead.

(As an interesting aside, one of Australia's largest toilet paper manufacturers, ABC Tissue Products Pty Ltd, has been up for sale since mid-2019. As a private company, it shares are not traded on the Australian Stock Exchange. However, media reports in the second half of 2019 state that national sales were already almost half $1 billion. If the sale price is still being negotiated, then photos like the one above will be very good news for the vendor!)

The point of all this is that the presence of managed investing can sometimes mean that 'sell-offs' of shares are more widespread than they need to be – especially in the short term. This certainly seems to be case recently in our market.

The Effect of Managed Investments - Buying

As we saw above, when investors sell units in a managed fund, that decision tends to trigger selling across a wide range of shares. However, investment managers are in the business of buying shares, as well. So, the money that remains within the fund can be put to use buying shares that the manager now thinks will boost the portfolio.

Put very broadly, the methods of investment managers divide into two very broad categories. The first category is *passive* investment, whereby the investment manager does not pick and choose which particular shares to hold within its portfolio. Passive investment is sometimes called *index* investing, because many passive investors simply try to mimic a particular index.

The second category is *active* investment. Active investment is where the investment manager does pick and choose the particular shares to purchase for its portfolio. It is looking to make qualitative decisions about which companies are currently under-priced.

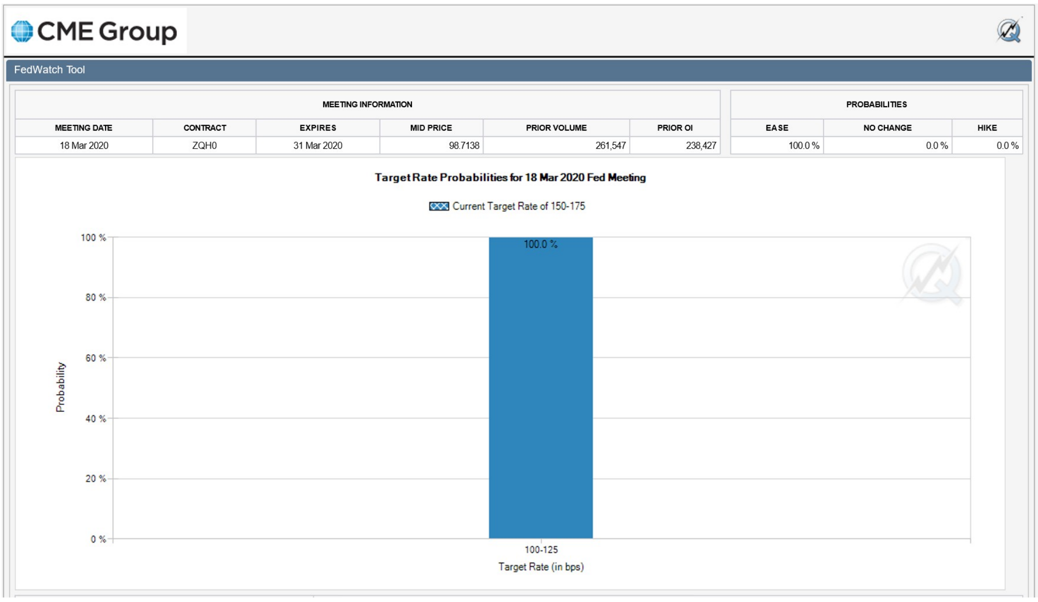
This second type of investment manager is always therefore looking to reallocate holdings within its portfolio. Put very simply, active investment managers are looking to sell shares in companies they expect not to do well and buy shares in companies they expect will do well. For example, if the observation above regarding Coles is correct, and its share price rose because it was selling more product, then we would expect that it was active investment managers who made this happen. Profit seeking investment managers saw the empty shelves in their local supermarket and realised that this must mean increased sales for the retailer.

There will often be a timing difference, however, between the negative effect of selling and any positive impact of buying. Panic selling has an immediate effect. One of these effects is to depress prices across the board. Astute buying takes longer, as investors evaluate which companies have been oversold. Given that prices have fallen, these buyers do not have to work as quickly in order to take advantage of what is going on. So, after a general sell-off, it can take some time for investors to return to the market to do some strategic buying.

What Else is Driving Markets? – Central Bank Responses

The Coronavirus has not occurred in isolation. There are other factors that are also impacting on global share markets. Some of these are tangentially related to the Coronavirus. One of these factors is the expectation that central banks around the world will respond to the economic threat of Coronavirus by reducing interest rates. This has already happened in Australia. The Reserve Bank Board met this week and dropped the target cash rate to a record low of 0.5%.

This decision follows announcements of intent on other world markets, especially the US market. The US Federal Reserve will meet later this month, but the markets that speculate on the moves in interest rates are almost unanimous in their expectation that rates will be cut. This is shown in the following graph of the CME Fedwatch Tool:



(In case the writing is too small: the graph shows a 100% probability that rates will be cut by 0.5% when the fed meets on March 18. People think a rate cut is a certainty).

What Else is Driving Markets? – Normal Market Movements

There is no doubt that the big recent falls are caused by concern over Coronavirus. But the Coronavirus has not occurred in a vacuum. It has become just one influence on market prices – albeit a major influence.

The Coronavirus has had a large, short term impact on the market. But the sharemarket is not just a short-term pricing system. The market also adapts to longer term influences on its prices. These adaptations are part of a normal market cycle.

In our newsletter for December 2019, published in the first week of that month, we reported that the Australian sharemarket had provided a positive return of 23% in the 11 months since the start of 2019. Markets do not provide 20%+ annual returns very often. When they do, there is every chance that the market has become overly optimistic and prices have risen too far. We said as much in our November newsletter:

> *According to Bloomberg.com, the current PE ratio for the ASX 200 (as at the end of November 2019) is 20.23. This suggests that a company earning one dollar per share will have shares trading for more than*

$20 each. This is significantly higher than the long-term average of 15. That tells us the prices have risen to a greater extent than the underlying earnings in the companies that comprise the ASX 200.

In case you missed it, that is a slightly formal way of saying that share prices were higher than expected given the profits being generated by the underlying companies. That is, they were over-priced. Looked at from this angle, at least some of the recent reduction in share prices is part of a normal cycle of change and correction. Prices had risen a bit too high and they are now falling back to more normal levels. While the Coronavirus has undoubtedly triggered some selling of shares, standard economics tells us that at least some of that selling was going to happen anyway. Underneath the Coronavirus confusion, the market is going through a normal period of correction.

What This Means for You

We think this last point is really important. Even without a potential pandemic, markets rise and markets fall. No one should invest in the sharemarket if they do not understand that reality. That is why you should never put money into a market if you know you will need that money in the short to medium term. There is just too much risk that you will lose money by doing so.

Happily, there are ways that investors can protect themselves from at least some of the risks that those rises and falls create. The best way to manage risk is through **diversification**. For most people, diversification means spreading a total investment among shares in several companies. This is done to reduce the impact on the overall investment of a negative performance by one or two companies. We can illustrate the benefits of diversification using a simple exemplary (that is, made up) model:

> Let's assume that, of all the companies trading on the Australian Stock Exchange, one third of them will record a financial loss in any given year. The other two thirds record a gain. If an investor buys shares in just one company, then he or she has a 1/3 probability of losing money in any given year. However, if the investor divides his or her investment between two companies, then the probability of losing money falls to 1/9. That is because the chances of the investor choosing *two* companies from the same third of the market is one in nine. If the investor divides his or her investment between three companies, then the probability of losing money falls to 1/27th. And so on.

Please remember, though, that diversification reduces the potential for positive returns as well. Using the same theoretical example as above, if an investor buys shares in just one company, then he or she has a two thirds probability of making money in any given year. However, if the investor divides his or her investment between two companies, it becomes more likely that their portfolio will also include at least one company that loses money.

So, diversification between companies reduces the size of potential returns within the portfolio – be they positive or negative. This reduces the risk of losing money but also places an upper limit on the amount of money that can be made. Generally speaking this trade-off is worth it: over the medium to long-term share markets do very well. As we also wrote in December: *the average Australian sharemarket return over the past 119 years is 13.1% per year (source: marketindex.com.au).* The general idea, then, is to invest in such a way that an average such as this (or whatever the future average will be) is within your reach. To do this, the number one goal is to not lose money. Stay in the market long enough and in such a way that you do at least as well as average.

MarketIndex.com.au
ASX Share Prices, Charts & Analysis

This is one of the chief virtues of managed investing. The investor (that is, you) only needs to make one investment into a specific fund. That fund then pools your money with a lot of other people's money and buys a diversified portfolio of shares. The investor only has to manage one thing, but the investment is diversified.

I am Average and I am Proud

As the past 119 years have shown, an average share market investor has been a good thing to be. The more diversified your portfolio, the more you are likely to achieve the market average. But diversification *within* your portfolio is not the only way to use diversification.

Buying or selling the right shares is critical to successful share investment. But buying or selling the right shares at the right time is even more critical. The problem is, just as no one really knows how a particular company will perform, no one really knows what direction the market is about to go in – which means no one really knows beforehand what the exact right time to buy and sell is.

To manage this risk (known as timing risk), you can use a form of **diversification over time**. The idea is very similar to diversifying between companies. Instead of buying or selling a lot of shares (or units in a managed fund) at a single point in time, you can buy or sell smaller portions at different points of time. If you buy or sell at the 'wrong' time, this won't have as much of an effect if you are only trading a portion of your investment. You make any particular point in time far less critical than if you did everything all at once.

Quite happily, people who commit to regularly investing even a small amount at a regular time (such as each month through their super) can actually benefit when prices fall. They will enjoy a larger investment than they otherwise would have purchased. If you are a regular investor, then we really encourage you to keep on investing. The current low prices are definitely not the time to stop making those regular investments.

On a very similar note, the longer you hold an investment, the more likely you are to achieve the market average. The more time you have your money in the market, the greater the likelihood that all those points in time will combine to give you an average return.

Summary

In summary, while the market moves of the past fortnight have certainly been stunning, in many ways they should have been expected by anyone investing in a volatile market like the share market. Yes, right now everybody is looking back at the market and wishing they had sold everything on February 19. But no one knew then what we know now. Successful investors rely on something more useful than wishes and regret. They do the following:

1. diversify their investments across time;
2. diversify the assets they hold; and
3. invest for the long term, understanding that the short term will always be volatile.

No one knows which direction the market will take tomorrow. Or the day after that. We can confidently say that the period of heightened volatility will continue for a while yet. The key is to look beyond the noise of today and keep your focus on your long-term objectives. So, investing regularly and holding for the long term is still our preferred way for clients to invest in the share market.

Our Final Wish for you and your Loved Ones

The experts all seem to agree that Coronavirus will become more widespread here in Australia and across the world. We sincerely hope that you and your loved ones, wherever they may be, stay safe from harm.

We came across the following link, from the NSW government, that has a comprehensive list of FAQs for the Coronavirus. We hope this might be of help to you. Click here to open the page.

NSW GOVERNMENT | Health

Black Swans

(First Published February 28 2020 on our website)

If you have been following the financial news lately, you will probably have heard people talking about a potential 'black swan event.' They are usually referring to the Coronavirus. But, what's all this about black swans?

The phrase 'black swan event' became popular in the 2000s when option trader Nassim Nicholas Taleb wrote a book called *The Black Swan*. Taleb's book sold three million copies and spent almost a year on the New York Times bestseller list. It remains a great read – and not just when it comes to economics.

In the world of finance, a black swan event gets its name from the fact that, before Europeans arrived in Australia, no one in Europe had ever seen a black swan. Because no one in Europe had ever seen one, black swans were simply thought not to exist. This became a firm belief – "I have never seen a black swan, which proves that black swans do not exist" - rather than a more accurate and humble observation – "I have never seen a black swan, but that does not prove anything, because I know there are a lot of things I have not seen."

In investing, the term refers to something that people believe will never happen just because it has not happened so far… until it does happen, at which point it looks obvious. Perhaps the most famous black swan event was the Global Financial Crisis, which essentially stemmed from a collapse in domestic American house prices in the late 2000s. Because house prices had traditionally risen, many people came to believe that house prices simply could not fall. People took on larger mortgages and lenders lent money to people who could not afford the long-term repayments. Basically, everyone was banking on prices continuing to rise so that the loans could be refinanced. Financial engineers even started packaging up what were known as 'sub-prime loans' as AAA-grade investments, again based on the belief that borrowers never defaulted on their loans and so these packages were "as safe as houses."

And then… the black swan flew into view. People *did* start defaulting on their home loans. One thing led to another and world economies took up to a decade to recover. In hindsight, it all looked very logical – if people can't afford their loan repayments they won't repay their loans. Just because many people had never seen house prices fall did not mean that they *could not* fall.

So, why are people talking about black swans again? Well, some people are wondering whether the Coronavirus might become another black swan event. When you stop and think about it (ie, in hindsight), the idea that in this age of globalisation a virus will spread quickly around the world makes complete sense. But there is a concern that world financial markets have not 'priced in' the risk of a health event that makes it harder for people and things to move around the world. People have therefore been too optimistic and that optimism might mean that share markets are overpriced.

Only time will tell if this is the case. Basically, everything will depend on the extent to which the virus affects world economies. And no one has ever proven themselves very good at predicting things like that (except in hindsight!)

What we do know is that share prices go down quite often. In fact, about a third of price movements tend to be negative, as a long-term average. Last year, and in the first weeks of 2020, the market soared. This can lead people to forget that prices fall sometimes, as well.

As professional advisers, this is something we never forget: markets move in both directions, up *and* down. Our advice is always to accept the key lesson of the black swan: rare things happen. More formally, this is known as 'risk management' and it is the key element of any successful investment plan.

If you would like to discuss how to effectively manage your own financial risk, please do not hesitate to get in touch. We will gladly help you arrange things so that you do everything you can to avoid mistakenly thinking that there is no such thing as a black swan.

Sleeping Easy in Retirement

(First Published February 21 2020 on our website)

If your plan is to sleep easy in retirement, then a piece of research recently came across should be front and centre in your thinking. The Australian Bureau of Statistics looked at average household wealth in the 2017/2018 financial year all around Australia. This kind of comparison is always interesting and provides much food for thought for anyone interested in their financial management. But in this particular piece of research, one finding stood out above all others.

For households with at least one person aged 65 or over, the ABS compared the average household wealth between those that owned their own home and those that did not. The difference was enormous: people who owned their own home outright had average household wealth of $960,000. For households who do not own a home, the average household wealth was just $40,000.

Average household wealth obviously includes the value of any home that you own. People who own homes have much more wealth.

The non-home owning households necessarily include the very poorest Australians. Obviously, really poor people do not own homes. They don't own very much at all so they will lower the average wealth of any group that includes them. But even allowing for this group, the difference that owning a home makes to the wealth of older Australians is pretty staggering. And if this particular piece of research is any sort of guide, the message is clear: owning a property – or a similar kind of asset - is critical in a comfortable retirement. If you want to sleep easy, it is easiest to do so if you own valuable assets.

There are various reasons why people might not want to buy a property. Most people only ever own one property at a time – the home they live in. So, people who do not yet want to settle down and live in the same place for an extended period might defer buying any property at all. Often, a life event such as a health incident, the loss of a job or a marital separation might mean a home is sold and not replaced. Or a business might lose money and take personal assets with it. Life happens.

The good news is that there is almost always a way available to make things better. Even if buying a property is not on your radar, there are things that you can do to increase your wealth both now and in the future. You might have noted above how we cast the message from the ABS data: owning a property – <u>or a similar kind of asset</u> - is critical in creating wealth.

Property has a lot to recommend it in terms of asset ownership. Usually, it is purchased using some form of debt, and the interest payable on property loans is typically lower than the interest payable on other sorts of loans. This gives buyers the benefit of leverage, where they only need to possess a portion of the purchase price in order to 'buy' a home. What they are actually buying is the right to any increase in value in that home. So, if property prices rise, the buyer gets to keep 100% of that rise. As we have seen over the last two decades – and we are already seeing again in 2020 – property prices have tended to rise over time.

This rise tends to be quite general. In fact, 'successful' property investment is often not so much about buying the *right* property as avoiding the *wrong* property. Most properties have done at least OK over the medium to long term. But some have not. People who avoided the houses that have not done well have, therefore, done well. They have kept all of the general gain in property prices.

But the same logic can be applied to other assets that tend to perform similarly to property over the medium to long-term. These tend to be share-based investments and can either be owned directly or indirectly through a managed fund or – often – a super fund. Indeed, 'beefing up' your super can be a great way of managing whatever assets you might have following something like a marital separation. Some people even use the tax benefits of super to save the money they will need to buy a home once they retire.

The important point is not to be discouraged if you or someone you know cannot afford a home. There are many different ways to get to where you want to go, and our experience is that almost everyone can benefit from making some adjustments to their financial management. So, if you are at all worried about your future wealth, please give us a call and get together with us.

If you already have a home, but are worried about losing it, then there are things you can do to minimize that risk as well. What you do depends on where the risk is coming from, so we will not go into too much detail here. But assets like homes can often be protected. Once again, if this is you, then please give us a call to see how we can help. We love to see our clients sleeping easily.

Asset Rich, Cash Poor

(First Published February 14 2020 on our website)

You may have heard the phrase, 'asset rich, cash poor.' No one likes to hear anything with the word 'poor' in it, but if you have to be poor, this is the best way!

Assets are the wealth you own. Cash is the wealth you have available to spend. They are not always the same thing, which is how people can be 'rich' in one and 'poor' in the other.

In an economy like ours, there are three broad ways in which people generate cash (or, to give it the more technical term, earn *income*). The first is through their labour. The second is by owning land. And the third is by owning capital. Technically, 'capital' is every other type of asset other than land. But in this context, we tend to see capital as either money or ownership interests in a business – shares, as they are more typically known.

Each type of income has its pros and cons. Especially when we are young, labour is often the easiest way to earn income. From the age of about 15, we can exchange our time for a wage or, if the job is a little more formal, for a salary. The amount of income we receive in exchange for our time depends on a whole range of things, but generally it is a function of supply and demand. Higher demand and lower supply tends to drive the price of our labour up (think qualified people such as tradespeople or professionals); high supply and low demand keep the price of labour low (think jobs with few barriers to entry that lots of people can do, such as working in a supermarket).

So, the relative ease with which labour can create income is one of its strengths. But labour also has a lot of limitations. In terms of generating wealth, the main drawback is that the amount of income that can be generated from labour is limited. This is especially evident if you are paid an hourly wage: the number of hours you can work is limited by various things, including the law. (While people occasionally look at the large salaries of people like bank CEO's as evidence of high labour income, in reality those 'jobs' have more in common with owning an asset – with the 'asset' being the right to be the CEO for a particular period of time.)

Which brings us to the other two ways to earn income in the modern economy: by owning land or by owning other assets. People who own land or assets can often use those assets to generate income (or avoid a cost, which can have the same impact on daily living. A residential property can be used to create rental income, for example. Or, if the owner lives in it, the property allows the owner to save on expenses such as rent).

Often, it is easier to generate income from assets than it is from labour. Capital assets do not become unwell, for example, and they do not grow old. Capital assets, especially financial assets, do not need to be re-trained if the underlying economy changes. Financial assets can simply be re-directed to that part of the economy that is growing. Capital assets can be given to professional asset managers to manage on our behalf. They can also be divided up and 'diversified' across different forms of investment, so that we can reduce the risk of losing that capital. Try diversifying your job and see what your boss thinks!

Different types of financial asset produce different types and levels of income. A family home, for example, is very definitely an asset. But, as we say above, if you use the home to live in, you cannot receive rent as well. The only 'cash benefit' of living in the home is that you do not have to pay rent.

Generally, the family home is the type of asset people refer to when they use the term 'asset-rich, cash poor.' The value of most family homes has risen markedly in value in recent decades. As we saw last week, this is having a huge impact on wealth distribution in Australia: in 2017/2018, people aged 65 or over who owned their own home outright had average household wealth of $960,000. For households who did not own a home, the average household wealth was just $40,000.

The family home makes $920,000 worth of difference to the average 65+ household. And when you look at the median house prices in Australian cities, you see that most of this difference is the value of the house itself. In December 2019, the overall Australian average house prices was just under $810,000. In Sydney, the average was $1.14 million. In Melbourne, it was $900,000. These are the two biggest populations, so it is these cities that affect the national average household wealth the most.

What the figures show is that, for many people, most of their wealth is held in the family home. This is where the phenomenon of people being asset rich and cash poor comes from: people own houses that are worth a lot of money. But they cannot use that house to generate cash.

If this is you, please do not fret! The first part of your description is 'asset-rich.' Being rich in anything is a good thing! Happily, there are various ways that you can use this household wealth to improve your financial situation. And, no, we are not encouraging you to rent your place out on AirBnB - we are talking about low-risk, common sense steps you can take.

So, if you want to tweak things to give yourself more cash to live on, please don't hesitate to get in touch. This is one problem we especially love to solve.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances.All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

Contact Details

Address	L1, 115 Upper Heidelberg Road Ivanhoe VIC 3079
Phone	1800 488 866
Website	www.huttonfinancial.com.au
Email	nick@huttonfinancial.com.au

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