

Topic 1: Return on investment	3
Evaluating an investment.....	3
Return on investment.....	3
Income	3
Frequency of income payments.....	4
Capital growth.....	4
Comparing risk and return	5
Topic 2: Transaction and investment costs	6
Transaction costs.....	6
Stamp duty and GST	6
Minimum investment.....	7
Topic 3: Liquidity and other issues	8
Ease of investment	9
Topic 4: Tax.....	10
Tax.....	10
Income tax and dividend imputation:	10
Tax deferred dividends	10
Capital gains tax (CGT):	11
Summary	12

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Topic 1: Return on investment

Evaluating an investment

Evaluating investment opportunities (e.g. shares, property, bonds) is easier if you use a standard set of criteria to measure and compare them.

While each investment must be evaluated in the context of your personal goals and objectives, in most cases the following characteristics may be considered:

- Return on investment (ROI)
- Capital and income security
- Risk
- Transaction costs
- Minimum investment amount
- Liquidity
- Ease of investment
- Taxation



Return on investment

Return on investment will usually be in the form of income (a payment you receive from your investment) or capital growth (where the value of your investment increases over time). Some investments, such as shares, may provide both.

Income

Investment income may include amounts such as interest on bank accounts, dividends from shares, rent from a property and distributions from a trust. As well as the amount of income you are likely to receive, you should consider the likely frequency and regularity of the income payments and the potential for any increases or bonuses. Does the investment pay distributions, weekly, fortnightly, monthly or yearly?



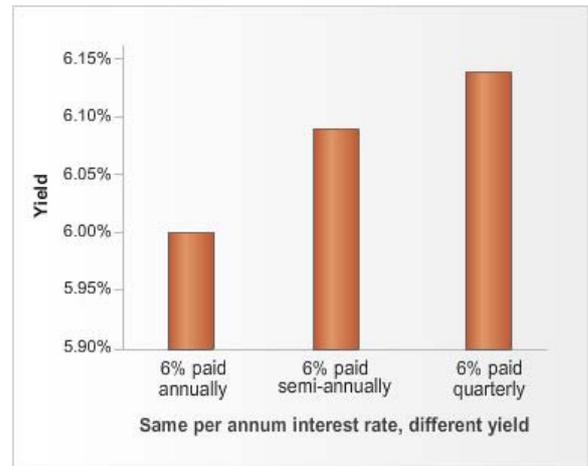
Income from investments is usually subject to income tax at your marginal tax rate.

Frequency of income payments

The frequency of income payments is a key factor in determining the yield for an investment. Compare three investments each with a 6% interest rate: the first paying annual coupons, the second paying semi-annual coupons and the third paying quarterly coupons. If you invested \$100,000 in each security you would receive coupons as shown in the table opposite.

Even though you receive coupons totalling \$6,000 over the year from each investment, when you take into account the timing of the coupon payments the yield can vary. This is because the sooner you receive your income payments the sooner you are able to reinvest that money. This means that the yield for an investment paying 6% quarterly may be higher than the yield for one paying 6% annually.

This relationship between coupon frequency and yields can be shown graphically.

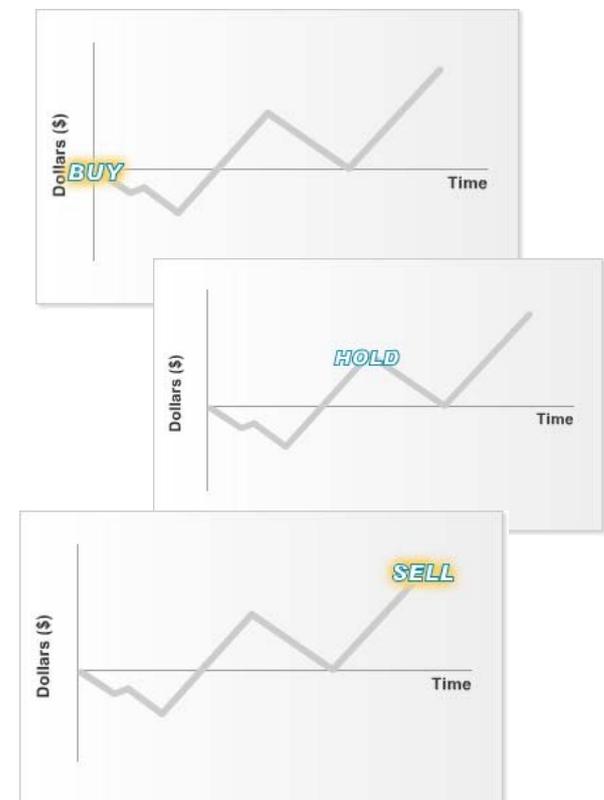


Capital growth

Capital growth generally refers to the increase in the value of the amount of money you have invested.

Returns from capital growth can only be realised when you sell an investment for more than its purchase price.

The main benefit of capital growth is that it protects you against inflation. This occurs when the value of your investment grows at a rate faster than the general rise in the price of goods and services. By keeping your capital growth ahead of inflation you are able to prevent inflation from eroding the spending power of your savings.



Capital growth may occur through rising share and unit trust prices on the sharemarket, increased values in the property market and profit on fixed-interest securities if sold before maturity. Realised capital growth from investments is usually subject to capital gains tax.

Comparing risk and return

Setting realistic expectations is important when determining what level of return you might expect from your investment.

When evaluating the return on investments you may wish to compare their rate against the return on government bonds. This rate of return is often called the 'risk free rate'. An investment in government bonds is generally very secure as there is little chance that the lender (the government) would default and fail to repay the investment.

The risk free rate may be a good guide to use when considering whether the risk is commensurate with the reward of an investment.

You can generally find the government bond rate in the business section of the newspaper.

Topic 2: Transaction and investment costs

Transaction costs

Investments often involve transaction costs when you buy or sell and may have ongoing costs of ownership. These costs can cover the use of the services of advisers, brokers, agents and other parties that help to facilitate your entry or exit from an investment. Calculating the entry, exit and any ongoing fees is a crucial step to determine the true level of return you can expect on your investment.

Transaction costs for direct sharemarket investments are the brokerage payable to your stockbroker. Brokerage is the cost associated with each transaction (either buy or sell) you make on the sharemarket.

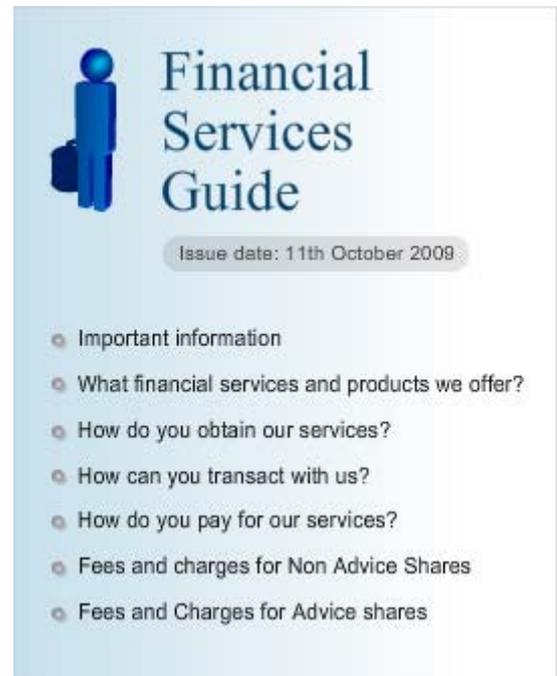
Brokerage rates vary between brokers to reflect the different services they provide. Brokers will provide clients with a Financial Services Guide (FSG) setting out services they offer, brokerage rates and other fees. There are no ongoing costs for direct sharemarket investments.

You can learn more about stockbrokers in the course "How to buy and sell shares".

Stamp duty and GST

Stamp duty on share transactions was abolished in July 2001. GST is incurred on brokerage fees associated with share transactions.

For investments other than share transactions, you may face additional government charges, real estate agent commissions, entry and exit fees for managed fund, bank charges, building maintenance, rates and letting agent fees.



Minimum investment

Cash investments and managed funds have low entry levels, you don't need much money to get started.

With investing in shares some stockbrokers will accept an initial investment of as little as \$500. However, a rough rule of thumb is a minimum investment amount of \$2,000 or more at any one time to spread your transaction costs over a greater value.

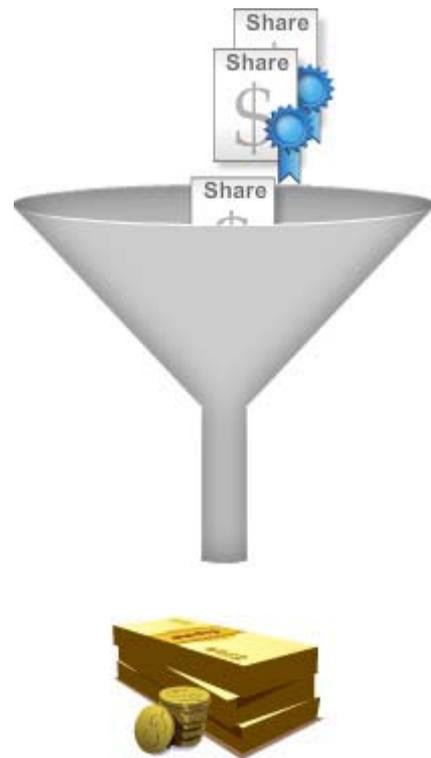
Direct property has a much higher minimum investment entry level than shares. However you can get exposure to property without the large capital requirement if you invest through a listed property trust.

Topic 3: Liquidity and other issues

Liquidity - the ability of an asset to be easily converted into cash.

An investment with high levels of liquidity provides you with greater access to your money should you need it. An example of a very liquid asset is cash at the bank. On the other hand a property investment has a low level of liquidity due to the length of time it takes to convert the property to cash following sale.

For shares in the major companies listed on ASX there are high levels of liquidity. That is, a large number of buyers and sellers lining up to buy or sell shares. Following the sale of shares on ASX you will receive your cash within three days. This is known as "T+3" (Trade day + 3 days).

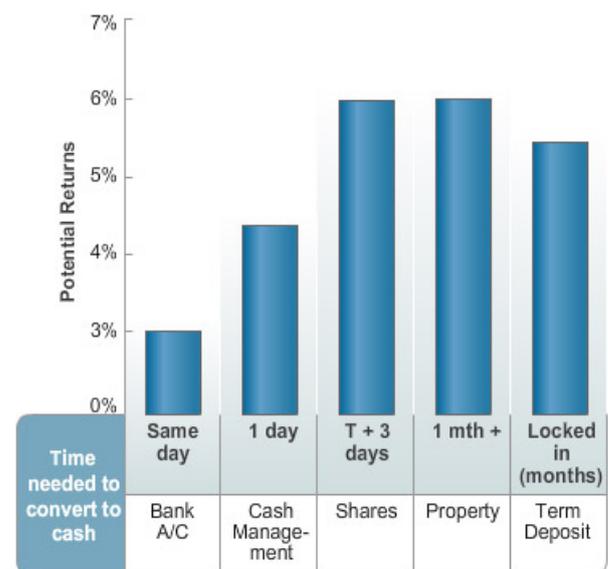


It is important to note that not all companies listed on ASX have high levels of liquidity. There are companies which have almost no market for their shares, so buying into or selling out of them can take time and getting a fair price may be difficult.

Liquidity is important for a number of reasons. For example unexpected expenses may require quick access to your investment capital. Or you may simply want to switch out of your current investments into a better opportunity.

Liquidity can be adversely affected by a number of factors including:

- A fixed term of investment such as for term deposits
- Lack of ready buyers or a slow sale process
- Exit fees
- Transaction costs, and
- Difficulty in dividing the investment into small parcels to sell.



Ease of investment

If you know how difficult it can be to find a suitable investment property, negotiate the price and arrange settlement, you will be pleased to hear that establishing an account with a stockbroker is as easy as opening a bank account. Having opened your account, you can buy and sell shares by giving instructions to your stockbroker over the internet, telephone or in person.

Share prices are listed daily in the major newspapers and may be accessed during the day through various telephone and electronic services. Shares can be bought and sold during ASX trading hours Monday to Friday, excluding [certain public holidays](#).

Normal Trading hours for ASX shares is from 10:00am until 4:00pm Sydney time. The trading day is broken into [distinct market phases](#) which allows certain trading activities to happen at different times throughout the day.



Topic 4: Tax

Tax

All investors want to optimise their after-tax returns. For this reason you should have at least a basic understanding of the tax treatment of different types of share investments.

As individual taxpayers, investors are liable for income tax on any income they receive from their investments in the form of dividends. Investors are also liable for Capital Gains Tax (CGT) on any net capital gains realised by selling their investments.

Income tax and dividend imputation:

Dividends from shares are often paid with franking credits attached in order to pass on the value of any tax that the company has already paid on its profits. Thus shareholders receive an 'imputed' credit with their dividends. Dividends can be fully franked to the extent of the company tax rate (currently 30%), partially franked or unfranked.

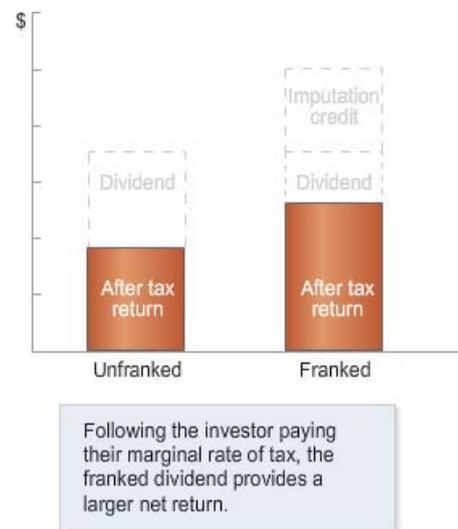
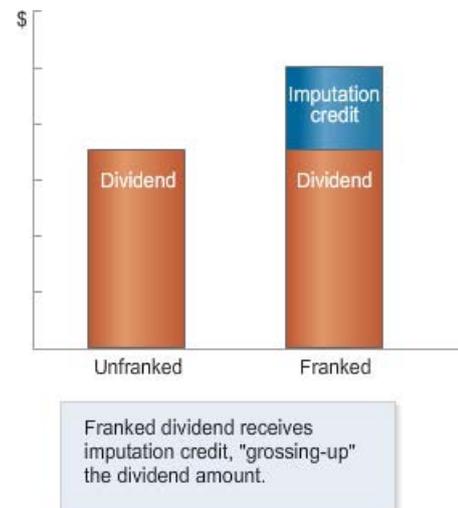
When you receive franked dividends, you must declare both the cash amount and any franking credits as assessable income in your tax return. Then you can apply the franking credit amount to offset (reduce) your income tax liability.

Tax deferred dividends

Returns from listed property trusts and infrastructure funds can come from distributions (dividends) paid to investors and changes in the value of the properties held in the trust.

The dividends from these listed funds can also offer a tax deferred component.

The tax deferred portion of the dividend reduces the investors' cost base, meaning investors do not pay tax on this portion of the dividend until they sell the trust and then at the concessional capital gains tax rate.



The tax deferred component is generally between 15% and 100% of the total dividend.

Capital gains tax (CGT):

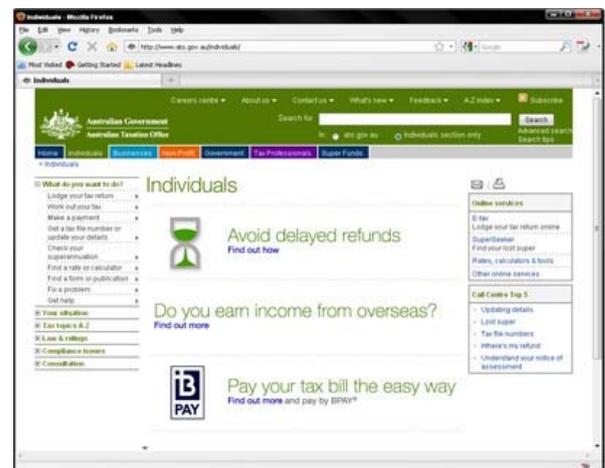
You realise a capital gain whenever you sell shares and the consideration received (sale price less related costs such as brokerage) is more than the cost base (purchase price plus related costs). If the shares were acquired on or after 20 September 1985, the capital gain must be included as assessable income in your tax return and is subject to CGT. CGT is payable at your marginal tax rate in the year in which you sell the shares.

For shares acquired on or after 21 September 1999 and sold 12 months or more after the date of acquisition, capital gains may be discounted by 50%; meaning only half of the capital gain must be included in your assessable income.

Many retirees need to draw down their capital as time goes by and therefore CGT is a concern. The fact that you can liquidate a portfolio of shares in stages means you can defer the CGT liability for as long as possible and take advantage of lower marginal tax rates in years when you do not have much other income.

ASX does not offer advice on taxation. Before entering into a transaction, you should ensure that you fully understand the legal, tax and accounting consequences. ASX advises that you always consult your accountant or other professional taxation adviser before making any investment decision.

The Australian Tax Office website provides a good source of tax related information: www.ato.gov.au



Summary

As an investor you have many options available to you.

The headline factor that generally drives people's investment decisions is the potential return on investment they may receive.

Gross return on investment can be affected by a range of factors.

These factors include, but are not limited to:

- Capital and income security
- Risk
- Transaction costs
- Minimum investment amount
- Liquidity
- Ease of investment
- Taxation