

Business Matters

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Borrowing Money and Negative Gearing

Should you borrow money to invest? That depends on your own personal needs and circumstances. Get advice from an adviser if you are not sure. An adviser is obliged under the law to look at your own personal situation. Real estate agents and salespeople just look after their clients, not you.

Speaking generally, plenty of people and businesses borrow to invest every day. So long as the investment itself is sound, borrowing can be sound.

Borrowing for bad investments will destroy your hopes and plans. If the investment loses value or even ends up worthless, you not only lose all your own capital but you also owe a debt as well.

Why do people get into negative gearing?

Firstly, negative gearing can offer tax benefits. With negative gearing, your borrowing costs exceed your investment income. The law allows you to deduct your borrowing costs from your total income provided that your investments are genuine.

For example, let's suppose Bruce buys an investment (it could be shares, managed funds, a rental property, etc) for \$100,000 and pays \$6,000 in interest and receives \$3,000 income from the investments. He has a loss before tax of \$3,000. Suppose Bruce has a well-paid job (more than \$150,000 per year) and pays tax on his salary at the top rate of 39%. He can now deduct this loss from his taxable income, and reduce his tax bill by \$1170 (39% of \$3000). The tax saving reduces Bruce's cost of borrowing.

You only get a tax benefit if you earn other taxable income in the first place. If Bruce earned nothing else apart from his investment, he's just left with a \$3,000 loss.

Can you afford negative gearing?

You can afford it only if you have money left over from your other expenses, and only if you can go on expecting reliable income from your job or other sources.

For example, Bruce won't be happy forking out money from his other income forever, just to feed a loss-making investment. He either expects to:

Turn around his yearly loss into a profit sometime in the future or sell his investment for a capital gain that's big enough to cover his past losses

Judge the investment first, not the tax benefit

A good investment must sooner or later show a profit, not a loss. A good investment should also give you a reliable and rising income. This will reduce your losses over time, and eventually you will expect to pay some tax. To choose a good investment takes time, knowledge and experience. Get independent advice if you do not want to research and manage investments yourself.

People selling you investments always look on the bright side. But let's check the dark side. Even experienced investors make mistakes and lose money sometimes, and the best, most honest advisers will sometimes give you a poor recommendation. Your experience and their skill and honesty do improve the odds of success. Inexperience and fast talking salespeople shift the odds towards failure.

What's the bottom line?

The longer you wait for your dollar, the more profit you need to earn to make up for lost time. A dollar today is worth more than a dollar tomorrow. If you earn a dollar today, you can invest it straightaway and earn income. Also, inflation makes tomorrow's dollar worth less than today's.

Remember that Bruce, using negative gearing, pays out today's dollars in interest in the hope of making a profit some time in the future. How long must Bruce wait to make a profit? Will his future profit compensate him for the past losses and the time he waited? Nobody knows for sure.

We suggest set a:

Realistic target by looking at rates of return from similar types of investments

Realistic time by when you aim to achieve your target that way you can check your progress.

What if interest rates go up?

You will obviously pay more money each

year in interest. Check what you will pay if rates go up, for example, to 10% or even

12% per year. Make sure you can afford to meet the payments, or else you could be forced to sell in a hurry at too low of a price.

There's also a hidden sting in higher interest rates that affects all investors. Higher interest rates generally reduce the capital value of your investments.

Remember how Bruce earned \$3,000 from his \$100,000 investment? That investment yields 3% per year. For example an interest rate at around 6% per year, investors like Bruce might be happy to earn 3% per year. That's why he is prepared to pay \$100,000 for an investment that yields \$3,000 in income.

Tomorrow, if rates go up, investors will have to pay more to their lender so they most likely will expect a better return than 3%. For example, if investors expect 5% per year, then they will be prepared to pay only \$60,000 for an investment yielding \$3,000 per year. (As you can see, 5% of \$60,000 equals \$3,000.)

If Bruce can sell for only \$60,000 what he originally bought for \$100,000, then he'll face a big loss.

Take an honest look at negative gearing

Salespeople who sell negative gearing schemes often hide the truth. Investments can lose value because of economic forces beyond your control. Faced with this fact, every investor takes the risk that they may lose money. However, in time, if they choose good quality investments, they will win out and should make a decent return.

We suggest you need to do at least 3 things to succeed with negative gearing

- 1 Buy good quality investments, preferably with a reliable and rising income stream.
- 2 Borrow conservatively so you can survive interest rate rises and possible loss of income.
- 3 Maintain reliable income from your job or other sources to cover your borrowing costs, especially in the early years.

If you borrow up to your eyeballs, especially if you're investing for the first time, you're risking financial ruin.





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Keeping your Credit Card Under Control

1. The typical credit card usually has the following characteristics:
 - A minimum monthly repayment - often as low as 2.5% of the balance
 - Any interest is charged from the date of purchase
 - Interest rates are at 16% or more per year.
2. By only making minimum repayments to your credit card can turn a \$1000 credit card bill into an 11 year loan, and a \$10,000 debt into a 27 year loan.
3. It is important to understand that your credit cards probably incur the highest interest rate of any of your debts - so you should pay this debt first, and endeavour to pay it off in full each month.
4. But since that may not be realistic come Christmas time, we suggest that paying more than the minimum repayments would achieve significantly better results.
5. For example, making monthly repayments of \$50 and \$500 respectively in the above two scenarios, would result in the loan being cleared within 2 years!

What to do in a falling sharemarket?

Falling share prices around the world can make anyone think twice about their financial plans. Investors with margin loans are especially affected.

If you own shares directly, you are probably experiencing losses, at least on paper. If you own shares indirectly through your managed fund or superannuation, you will also be affected.

What should you do?

The case for doing nothing

Falling markets take away a lot of the froth and bubble, creating better value and more room for future reward. If you own shares as part of a good financial plan that suits

your needs and personality, then you will have been prepared for these events even though you may not welcome them.

If your shares pay steady, reasonably reliable dividends, then changing share prices may be less relevant. Many Australasian companies pay regular and often generous dividends.

Historically, shares have been worth the risks as long term investments, but sometimes dangerous for medium and short term.

How long is long term? That would depend on exactly which shares you held. Let's assume you owned a basket of shares that represents the market as whole. How long has it taken in the past to come out ahead of cash in the bank or money invested in bonds, even if you bought at the worst (the highest) prices?

For New Zealand, 'long term' to date has meant around 20 years. Other countries have had different experiences. For example, the worst crash in the US market occurred in 1929-31, and allowing for inflation the US market did not recover until 1955, some 24 years later. In some countries, they had to wait up to 40 years or more.

Unfortunately, 'long term' kept getting shorter for many people, especially during the 1990s. Too much success made even 3 years sound like 'long term' share investing.

Falling markets are the risk that you must bear, as a shareholder, in return for the extra returns you may expect to make.

The case for doing something

Is it time to buy? You may decide that since share prices have fallen, it could be time to buy. In the past, the Australian/ NZ market has recovered lost ground. We have no idea if prices will go even lower or will recover only after a long time. We cannot advise you, and we doubt if anyone knows the right answer.

However, suppose your personal circumstances mean that shares suit you as an investment. Suppose you regularly save enough money each year to add to your portfolio. In those circumstances, it could be more logical to buy than sell, because you get more shares for your money in a falling market than a rising one.

If you need advice about whether such a strategy would suit you, please talk to a financial adviser.

Is it time to sell? In general, our answer must be the same. We don't know. Do be cautious about switching money out of shares into some other asset which may be performing better right now. In the past, this switching strategy has often failed. You might end up selling near the bottom of the share market to buy near the top of the real estate market, for example, and lose money twice over. Avoid chasing get rich quick schemes and the latest fads in 'wealth creation'.

Be cautious too if you own shares through managed funds. Switching from Fund A to Fund B, just because Fund B may be performing better right now, can also be a mistake. In the past, some advisers have exploited their clients to make money in commissions by 'churning' them through different funds. Switch only if you are convinced that your current fund no longer suits you.

If you have money in shares that you need soon (within a year or two), you may face an awkward dilemma. Sell now or wait? You might consider selling in stages to reduce the risk of selling everything in one go, so long as you check your brokerage costs.

Bad markets can expose weaknesses in specific companies, businesses and their management. If you own shares in a company that struggles to make a regular, decent profit, whose business is unfamiliar or strange to you, then you may want to consider selling. Holding on to shares during a falling market requires confidence that the company and its business will prosper. Do a bit of homework on the company and talk to a financial adviser who knows about shares.

How are you managing your risks?

Whether these events pass quickly or not, check how you are managing your risks.

If you hold shares in only one or two companies, you might be too exposed. If those companies perform very well, you will do much better than the market. On the other hand, they may perform much worse.

It's usually wise to spread your risks, and many successful investors will own shares in about 8-14 companies in different industries, across the economy. So long as you get a good spread across different industries, the investment literature suggests you don't need to own shares in 30 to 50 companies. Large superannuation funds and managed funds often hold many more companies, but have the time and staff to manage the portfolio.

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