HOLM TRUTHS

Down to earth advice for savers and investors from independent investment commentator Mary Holm

WINTER 2005

Seize the chance

Talk of tax cuts is in the air. How big they will be and when we will benefit from them depends largely on who wins the next election. Regardless, though, a tax cut of any size gives you a golden opportunity to boost your savings.

The same goes for:

- ***A pay rise – whether it comes from your current employer or a move to a new job.***
- ***Any reduction in expenses. Perhaps you no longer need to pay for child care, or to support an older child. Or you've just paid off a mortgage, car, student loan or other debt. Or you've simply decided to spend less on something.***
- ***An inheritance, redundancy or other one-off payment.***

I'm not saying you should save all the extra money. There's a lot to be said for enjoying life now. But – if you're concerned that you won't have enough money in retirement – how about promising yourself that you will save at least half of the smaller amounts and three quarters of any large lump sum?

WHAT ABOUT INFLATION?

You: *It's all very well planning to save half of any pay rise, but sometimes my rises aren't even as big as inflation.*

I need that extra money just to keep up with bill payments. I can't save any of it.

Me: *Sure you can!*

It's true that my proposed saving plan is a bit sneaky, in that your standard of living might fall a little because of inflation. But it might be well worth it if your living standard in retirement is higher. A small loss now could mean a bigger gain later.

Think about what you spend your money on. Much of what seems essential was a luxury or didn't exist 10 or 20 years ago. Most people can easily get by without quite so much.

Researchers in behaviour say there are four major roadblocks to saving. Here they are, and how such a plan might help you to get around them:

• Reluctance to cut spending

Most people find it difficult to give up spending. It means they have to change their habits. But this won't be a problem if you plan to increase your savings only when you have extra money to do that.

• Can't work out how much to save

There are all sorts of formulas and calculators that can tell you how much you need to save to have a certain standard of living in retirement.

For some people, they work beautifully. Others feel there are so many future unknowns in their income and spending that the calculations don't mean much. Or the required current savings are unrealistically high.

If the calculations don't work well for you, forget about goals and just plan to regularly save a fixed portion of all future increases in income or decreases in expenses.

Whatever amount you end up with on retirement day will be much better than nothing.

• Lack of self control

Most people are better at denying themselves something in the future than now, says US economist Richard Thaler. "For example, given the option of going on

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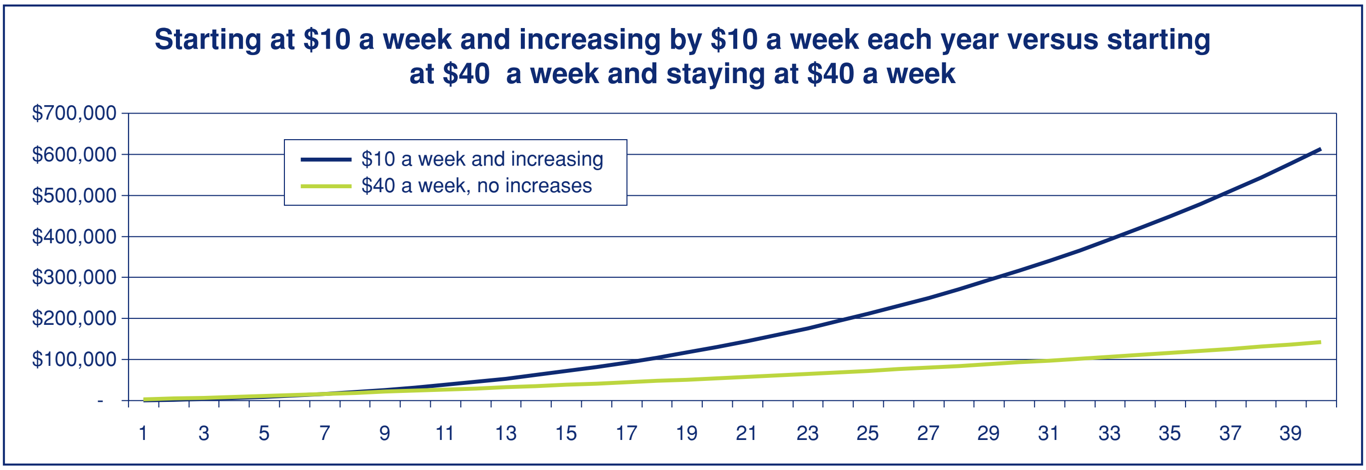
HOW MUCH WILL YOUR SAVINGS ACCUMULATE?



If you start your savings at just $10 a week, and increase that every time your income grows or your expenses fall, over the long term you should end up with much more than someone who starts at $40 a week but doesn't change that amount.

In our graph, we've estimated that you will boost your contributions by $10 a week each year although, in reality, your pattern will be more erratic than that. We've assumed the savings will grow by 2.5% a year, after fees, taxes and inflation.

(SEIZE THE CHANCE, CONTINUED)

a diet three months from now, many people will agree. But tonight at dinner, that dessert looks pretty good."

But it's important to make your promise work. Maybe you need to write it out and stick it to your bathroom mirror, fridge door, or financial files. Do whatever it takes to keep reminding yourself.

• Inertia

Even with the best of intentions, you might find that in the week you get your next boost in income or cut in expenses, setting up a savings programme is not a top priority. A few more weeks go by, and it just doesn't happen.

Beat that inertia by taking the first vital step this week. Set up an automatic transfer of a regular amount into a new savings account.

I'm breaking the deal here, asking you to save without getting extra money! But if you make the amount small – perhaps just $10 or $25 a week – you probably won't even miss it.

It's best to make the transfers on the day you receive your income – weekly, fortnightly, monthly or whatever.

Then all you will need to do is increase the amount whenever your financial circumstances improve – and try to let inertia prevent you from decreasing the amount if your circumstances deteriorate!

(Of course, if your income drops or your expenses increase drastically, you may have to reduce your regular savings – but try to limit this.)

WHERE TO PUT THE SAVINGS

That's easy if you have credit card debt, hire purchase agreements or any other high-interest debt. Using your savings to repay that debt improves your wealth as much as an investment that pays 15%, 20% or whatever the interest rate you are being charged. Great stuff!

Once you've paid off that debt, tackle your mortgage or student loan, getting rid of whichever one is charging higher interest first.

If you can direct your savings straight into debt repayment, without having to transfer it via a savings account, all the better.

When you've repaid all debt – or have made big inroads in that direction and want to diversify and learn about other markets – you might want to save in a diversified fund or share fund.

Many funds will accept regular – even quite small – investments. If the minimum deposit is too high, accumulate the money in a savings account and set up an automatic transfer to the fund every month or three months or however long it takes to reach the minimum.

Those who are close to retirement or are more conservative, and who have repaid all debt including mortgages, might prefer just to save in term deposits, high-quality bonds or the like.

If you have access to a savings scheme subsidised by an employer, it's probably best to put your savings into that scheme, after you have repaid high-interest debt.

MORTGAGE INTEREST

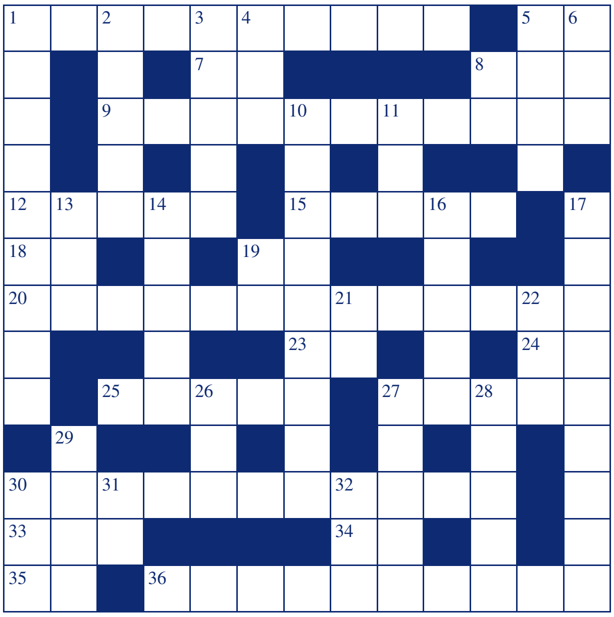
Most recent changes in mortgage interest rates have been upwards, but of course they do move downwards too.

Whenever rates fall, save the difference – by putting the extra towards repaying the mortgage or other debt.

Whenever rates rise, try to absorb the difference by cutting other spending. Over the life of the loan, you will be much better off.

Believe while others are doubting.
Plan while others are playing.
Study while others are sleeping.
Decide while others are delaying.
Prepare while others are daydreaming.
Begin while others are procrastinating.
Work while others are wishing.
Save while others are wasting.
Listen while others are talking.
Smile while others are frowning.
Commend while others are criticising.
Persist while others are quitting.

William Arthur Ward, US scholar, pastor and author



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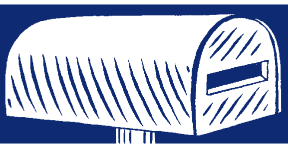
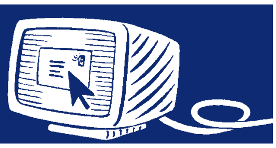
HOLM TRUTHS CROSSWORD WINTER 2005

ACROSS
1. Gather (10)
5. Part of the unconscious (2)
7. Belonging to (2)
8. Neither this ___ that (3)
9. Chance (11)
12. Makes a loan (5)
15. Stem (5)
18. In the morning (initials) (2)
19. Greek letter (2)
20. Conditions, situation (13)
23. Opposite to "from" (2)
24. About (2)
25. Japanese city (5)
27. Prickle (5)
30. Legacy, bequest (11)
33. One who excels (3)
34. Michael Jackson verdict (initials) (2)
35. New England (US) state (initials) (2)
36. Illogical (10)

DOWN
1. NZ rugby team (3,6)
2. Royal headgear (5)
3. Poems (anagram) (5)
4. Flying saucer (initials) (3)
5. A small bit (4)
6. Not wet (3)
8. Most populated NZ island (initials) (2)
10. Train Tess (anagram) (9)
11. Country with biggest sharemarket (initials) (3)
13. Big recording company (initials) (3)
14. Wharves (5)
16. A meal (5)
17. Vital (9)
19. Head of government (initials) (2)
21. Same as 23 across (2)
22. Make a mistake (3)
26. Atmosphere (3)
27. Maori funeral (5)
28. Sea (5)
29. 1/12 of a foot (4)
30. Boy's name (3)
31. Not she (2)
32. Insect (3)



From the Mailbox



Dear Mary:

We have $400,000 invested in the stock market, with 20% in NZ shares, 70% international index funds and 10% in the NZ index fund FONZ.

We have two mortgage-free properties – a house and a bach – and are three to five years away from retirement.

A trusted but acknowledged "enthusiastic amateur" friend has suggested that we also need a secure investment – something that would be there if "all else failed" or the bottom dropped out of the property and share markets.

The suggestion was to get $60,000 in government Kiwi Bonds, which have an AAA rating and are giving about 6% interest.

I have rung our investment adviser and he has suggested several other products, most recently Commonwealth Bank bonds, which provide approximately 8% return and are AA- rating and have some tax credits.

We are now uncertain and would like your comment about the proportions in our portfolio and in particular the future low risk component.

Dear Reader:

Your friend is right that you should move some of your savings into less volatile investments. And it should be more than $60,000.

- **Put short-term spending money in term deposits, middle-term in bonds, the rest in shares.**
- **In retirement, spend your savings and leave the kids the house.**
- **Buy only investment-grade bonds.**

A rule of thumb for everyone is to put:
- savings you expect to spend in the next three years into term deposits;
- savings you expect to spend in three to ten years into high-quality bonds or similar;
- the rest into shares or perhaps property.

Why? You don't want to take the risk that the money you will soon need will lose value in the meantime, which is always a possibility with shares or property. As your friend says, bottoms sometimes drop out of markets.

On the other hand, over ten years or more it's highly unlikely that you will lose in property or well diversified shares, and highly likely that you will earn more than in bonds.

The three-year cutoff between term deposits and bonds is based largely on the fact that, for shorter periods, it's not worth paying the higher costs to buy bonds. Over longer periods, however, the higher returns on bonds make up for the higher costs.

A good first step for people approaching retirement is to work out how much of your savings you will spend each year.

Many people these days are happy to plan to use up their financial savings during their retirement, with the idea of leaving their home to their children or a charity.

If they don't live long or their financial investments perform well, there will be more to inherit. If things go badly or they live an unusually long life, they can always free up some of the equity in their home.

Let's assume you feel that way, and don't want to "use up" the bach or the house – which, by the way, removes any worries about the ups and downs of property prices.

We'll also assume that you retire in four years, and that your $400,000 will grow by 2.5% after fees and taxes between now and then. That will give you about $440,000.

The life expectancy of a healthy woman at 65 is about 22 years. For a man, it's a bit shorter. To be on the safe side, we'll say the longer-lived spouse will live 25 years after retirement. *(CONTINUED PAGE 4)*

(FROM THE MAILBOX, CONTINUED)

A simple but sound plan is to just divide your $440,000 by 25 years, and say you can spend $17,600 a year. This, plus NZ Super of about $20,000 a year after tax for a couple, will give you annual income of $37,600.

What about the investment return on your savings over the years? After taxes, fees and so on, it will probably be a bit more than inflation.

That means you will be able to increase your $17,600 by inflation each year, and perhaps more, as your savings accumulate. It's good to have a buffer.

So where does all this leave you?

Presumably you don't plan to spend any of your savings over the next four years, until you retire, so you don't need term deposits.

But I suggest you transfer six years' worth of spending, or about $106,000, into bonds. Set it up so that some bonds mature every year or so in your retirement, so the money is available to spend as you need it.
The rest can stay in shares. But every year or two you should move some of that money into bonds.

A good adviser or stockbroker will be able to suggest which bonds.

Kiwi Bonds are as safe as you can get. But – given that you have invested heavily in share funds and so obviously you're not conservative investors – I think you're sacrificing too much return for safety.

Your adviser's suggestion is a possibility. So are any other "investment grade" bonds, which have a rating of BBB minus or better. And – just in case the highly unexpected happens and a bond issuer gets into trouble – it's best to spread your money over lots of different issuers.

P.S. If you expect to save over the next four years, before retirement, put that money into bonds. That will mean that you can boost your annual retirement spending and also that you will need to transfer less of your current savings out of shares.

P.P.S. If you would like more spending money, you can always sell the bach and add the proceeds to your capital.

WHEN TO TRANSFER?

It's all very well suggesting you transfer $106,000 from shares to bonds, but should you sell that much all at once?

People in these circumstances are often tempted to wait until the share markets rise.

But when will that be? And how big a rise before you sell?

Generally, it's better to get on with your plans rather than try to time markets.

On the other hand – just to avoid any regret if the markets boomed right after you sold all $106,000 worth – you could plan to sell, say, a third now, a third in three months and a third in six months.

Another factor to consider: You get a better deal if you buy bonds when they are newly issued. So you could time your share sales to free up money to buy new issues as they come up over the next six months or so.

Retirement requires the invention of a new hedonism, not a return to the hedonism of youth.

Mason Cooley

Holm Truths Crossword Solution

A	C	C	U	M	U	L	A	T	E		I	D
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WRITER AND PUBLISHER

Award-winning journalist Mary Holm writes the *Money* column for the NZ Herald and *The Investor* column in the Waikato Times, Dominion Post, Christchurch Press, Otago Daily Times and other major newspapers. She runs seminars, and is the author of *Investing Made Simple* (Penguin, $27.95, at good bookstores) and *Snakes & Ladders – A guide to risk for savers and investors* and *The REAL Story – Saving and investing now that inflation is under control* (both published by the Reserve Bank. They can be downloaded from www.rbnz.govt.nz. Click on publications.). Mary holds a BA in economic history, MA in journalism and MBA in finance.

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You're welcome to send questions to From the Mailbox. Email them to maryh@pl.net, or mail them to P.O. Box 8520, Symonds Street, Auckland, and please include your phone number. Unfortunately, Mary can't answer all questions in Holm Truths, and cannot correspond directly with readers.