HOLM TRUTHS

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

AUTUMN 2004

'His & Hers' Investment Styles

Money knows no gender. But some research suggests:

Women are more likely to favour low-risk investments. And they are more inclined to buy and hold shares and the like.

Men tend to favour riskier investments, and to trade more often.

"That's not true for me!" you may be protesting. Fair enough.

But whether you relate more to Risky Ryan or Conservative Connie doesn't really matter. Everyone can learn from considering the pros and cons of both approaches.

How Much Risk?

Highly risky investment is obviously not a good idea – unless you are doing it for entertainment, and can afford to lose.

If you put lots into a single share or an investment that pays much higher interest than the banks, and you're not careful, there's a fair chance you will lose lots.

And if you borrow heavily to invest in something that might lose value, you could not only lose your money but also end up owing the lender.

Still, taking on some risk can be a good thing, especially for long-term savings.

That's because higher risk investments tend to bring in higher returns. And, especially over long periods, that makes a big difference to how much you accumulate.

Take an investment of $100 a month for 20 years. If your return, after tax and fees, is 2% a year, you will accumulate $29,400. But if your return is 5% a year, you will accumulate $40,600.

To make a higher return than you can get from a bank term deposit, though, you will have to invest in either:

- A fixed interest product, such as a corporate bond, whose issuer could default, leaving you without some of your money, or
- Shares, a share fund, property or some other investment that will probably sometimes decline in value.

Some people – more concerned about losing money than making it – feel they can't cope with default risk or volatility.

Women are particularly prone to this. In one Australian survey, 20% of the women were willing to take few or no risks with their money, compared with 9% of men.

There are, however, ways to reduce the riskiness of these higher-return investments: *(CONTINUED PAGE 2)*

MONEY TALK

- *Men have been found to be more comfortable discussing money with strangers than with friends.*

The exception is close friends with similar incomes to theirs, one study showed. It found that men see money as an expression of competitiveness and power.

Women, on the other hand, are more comfortable talking about money to friends, especially female friends.

- *Men seem to be easier prey for unscrupulous telemarketers.*

Research on cold calling investment scams found that 90% of the victims were men, said the Australian Securities and Investments Commission.

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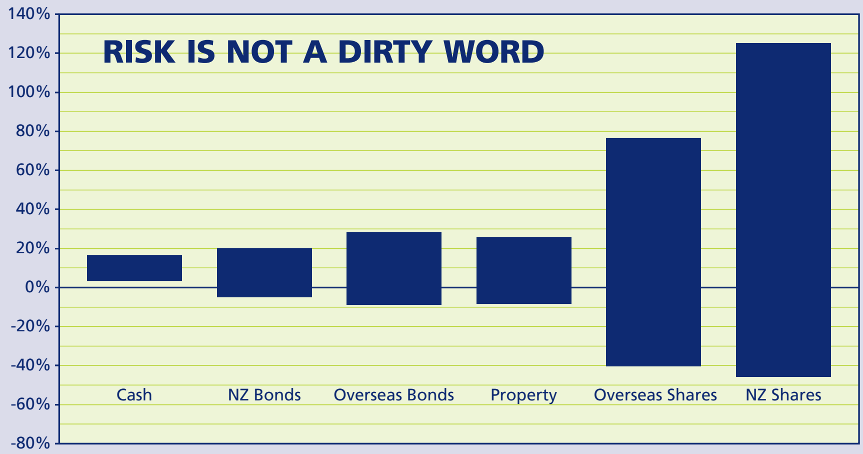

Range of annual returns on different investments over the last 30 years

Higher-risk investments, such as shares, have a much wider range of annual returns. You can do really well one year; really badly the next.

But over the years, average annual returns on these investments are higher. And that can make a big difference to your long-term savings.

If you invested $10,000 30 years ago, here's what it would be worth now in the different asset types, after tax at 33%:

Cash:	$88,400	Property:	$76,400
NZ Bonds:	$79,300	Overseas Shares:	$333,800
Overseas Bonds:	$95,000	NZ Shares:	$252,600

('HIS & HERS' INVESTMENT STYLES, CONTINUED)

- Spread your money over many different bonds, shares or properties, or invest in a fund that spreads the money. If some do badly, others will probably do well.
- Stay in for the long haul. When the value of your investments falls, relax in the knowledge that – as long as you are diversified and you have time on your side – the value is almost certain to rise again.
- If you borrow to invest – for example, using a mortgage to buy property – the less you borrow the lower your total risk will be.
- In fixed interest products, stick with bonds that have high investment ratings.

Note, too, that a different type of risk arises if you keep all your savings in a bank. That's the risk that inflation will erode the value of your money.

This is not just an academic issue. There were times in the 1970s and 80s when New Zealanders' savings bought less when they withdrew bank savings than when they deposited the money years before, despite compounding interest. Inflation, at times more than 18% a year, was higher than interest rates.

It's unlikely that we will return to double-digit inflation soon, but inflation could still top interest rates again. And that's all it takes to make savings lose their buying power.

With shares and property, however, you can get some protection against unexpected inflation.

Returns on shares tend to rise when inflation rises. Companies' costs rise, but so do their prices and profits, and hence the value of their shares.

THE ULTIMATE BUYER AND HOLDER

Anne Scheiber, a frugal New York spinster, was little noticed when she was alive.

But when she died in 1995, at 101, it was revealed that she had converted a $5,000 nestegg in the 1940s into $22 million, mainly by buying shares.

"Her strategy was simple," says Time magazine. "Don't worry about daily market fluctuations; reinvest dividends; hang tough." She never spent any of the money on herself.

While there's probably no New Zealander who can match Scheiber's performance, we may have some who are rather like her.

"Some of my most successful clients are elderly women who have no aspirations to greatness or ego problems," a local financial adviser said recently.

"The essence of long-term investing is patience – and discomfort."

Dr Jack Gray, US Investment Strategist

Property values also go up, as people's incomes rise with inflation.

Trading Frequency

Several US studies show that the more share trading a person does, the lower is their share performance, on average.

One study looked at 1600 investors who switched to trading shares on their computers.

Before going online, their share investments had performed better than the over-all share market by more than 2% a year. In many cases, this was probably just luck. But their success gave them confidence to start trading more often, which they did online. The result: They underperformed the market by 3% a year.

Another study divided investors into five groups, according to how often they traded shares.

The average return for the group with the lowest turnover was a whole 7% higher than for the top turnover group.

Who are the big traders? Researcher Terrance Odean says male clients of a discount broker traded 45% more than females. Marital status mattered, too. Single men traded 67% more than single women.

Why do men trade more? Confidence.

In one US study, men under 20 were almost twice as likely as their female counterparts to think they knew about money. When tested, though, there was little difference in their knowledge.

And male share investors of all ages are more likely than females to believe they can boost their returns by doing better than the market as a whole.

Beating the market with any consistency, however, is far from easy. People tend to buy after a share or a share fund has already risen, and tend to sell after it has already fallen.

Brokerage and other charges, and in many cases tax on capital gains, also hit traders much harder than non-traders. These transaction costs can make a huge hole in returns.

As one observer puts it, "too much testosterone can be bad for your returns."

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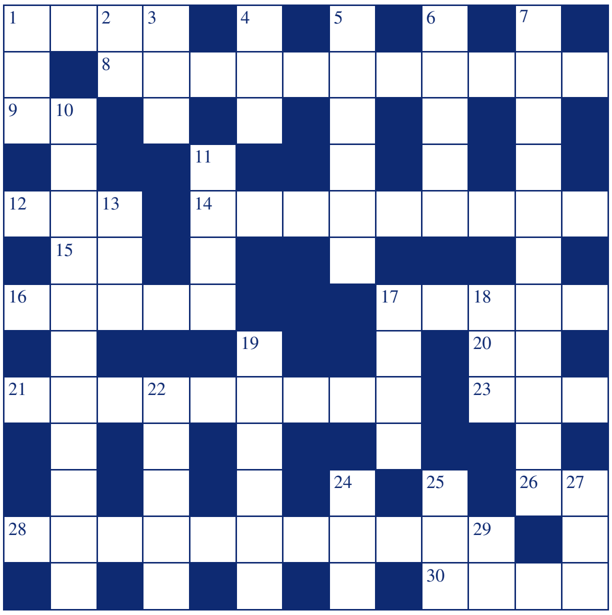

Solution: Back page

HOLM TRUTHS CROSSWORD AUTUMN 2004

ACROSS

1. Female servant (4)
8. Carton is tan (anagram) (11)
9. Street (abbreviation) (2)
12. Mode of public transport (3)
14. Rate of price rises (9)
15. Exist (2)
16. A right to something (5)
17. Profits (5)
20. Modern record (abbrev.) (2)
21. Different one (3,3,3)
23. _ _ _ and yang (3)
26. Move (2)
28. Varied (11)
30. Precious metal (4)

DOWN

1. Spoil (3)
2. Not he or she (2)
3. Arid (3)
4. Small insect (3)
5. Loud chatter (6)
6. Portly (5)
7. Dump goon in C (anagram) (11)
10. From 10 to 99 (6,5)
11. Movie (4)
13. Ocean (3)
17. Entrance (4)
18. Very cold (3)
19. Stand firm (6)
22. Cash (5)
24. Stern of a ship (3)
25. Limb (3)
27. Ancient (3)
29. Perform (2)

From the Mailbox

Dear Mary:

I wonder if you can help me with some info about what money to use for investing.

The question that perplexes me is why I should borrow money from a bank, and pay them 7.5% interest, and then invest that money (whether it be in the share market or rental property!) in the hope that it will bring a bigger return, presumably after the first 7.5% has been taken out.

Dear Reader:

Your question shows you've put a lot more thought into borrowing than many people.

If you borrow to invest – sometimes called gearing – you are quite likely to make more money than if you simply invest your own savings. You've got extra money to work with.

But if the investment does badly, you can end up worse off. Gearing exaggerates everything.

You're right to point out that you must subtract the interest on your loan from your returns. But you need to take tax into account. When you borrow to invest, the interest will generally be tax deductible.

To work out the after-tax interest cost on a 7.5% loan:

- If your taxable income is less than $38,000, multiply 7.5% by 0.79, to get about 5.9%. (If you don't have salary or wages of at least $9,500, multiply by 0.8)
- With taxable income of $38,000 to $60,000, multiply 7.5% by 0.67, to get about 5%.
- With taxable income above $60,000, multiply 7.5% by 0.61, to get about 4.6%.

You will benefit from borrowing only to the extent that your total after-tax return – rent or dividends plus capital gain and minus expenses other than interest – exceeds 5.9, 5 or 4.6% a year.

If the return is lower than that, you will put more in than you get out. Nobody ever got rich that way.

And if the value of your investment falls to the point that your mortgage is bigger than your sale proceeds when you bail out, you will lose your deposit and owe money to the lender.

Even if your return is a few percentage points above your interest rate, you gain only a little. It may not be worth the hassle.

Everybody who makes this sort of investment, though, hopes for a large capital gain at the end.

Let's work through an example on a rental property, worth $200,000.

Your deposit is $40,000, and your mortgage is $160,000.

Rental income is $200 a week, or $10,000 before tax a year (allowing for two weeks vacancy).

Mortgage interest at 7.5% is $12,000 before tax. (We'll ignore repayment of mortgage principal for the time being. More on that below.)

Other expenses – rates, insurance and maintenance – total $2,000 a year.

Yearly cash flow is $10,000 minus $14,000, which leaves you out of pocket by $4,000 a year.

You deduct this loss against your other income. In the middle tax bracket, that leaves you with an after-

(CONTINUED PAGE 4)

- **Borrowing makes a good investment better, but a bad one worse.**
- **Interest costs depend on your tax rate.**
- **Many do well with gearing, but you must stay the course.**

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(FROM THE MAILBOX, CONTINUED)

tax loss of $2,680 a year. (Making annual losses like this is sometimes called negative gearing.)

All will be saved, though, if you sell the house for lots more than you paid for it.

Let's say the house value rises 5% a year, to about $325,000 after ten years.

Still ignoring repayment of mortgage principal over the years – so that you have to repay your $160,000 mortgage – your $40,000 deposit has grown to $165,000.

That's growth of a bit more than 15% a year. Once you take into account your losses over the years, your annual return is a bit more than 11%.

What happens if the market goes through a slow-growth period, averaging 3% a year – which is not infeasible? You would sell your house for $269,000. Your $40,000 deposit has grown to $109,000, or about 10.5% a year. After allowing for your losses, your annual return is almost 7%.

What about:

- **The repayment of mortgage principal?**

That's really just like a savings programme on the side. Every dollar you repay adds a dollar to your equity.

Your return on those savings is, effectively, the mortgage interest rate.

(How come? If you repay $1,000 off your mortgage, you no longer have to pay 7.5% interest, or $75, on that money. That leaves you $75 better off. That amounts to the same thing as earning 7.5%, before tax, on your $1,000).

- **The depreciation deduction?**

If you sell your property for more than you paid for it – and if you don't, you've done really badly – your gains from depreciation will be "clawed back" by Inland Revenue when you sell.

Sure, you've had the use of the money in the meantime, but that doesn't amount to a great deal. And the Government is considering disallowing the depreciation deduction on rental property.

- **Higher expenses?**

Our example doesn't allow for major maintenance expenses, such as a new roof or a modernized kitchen, which might be required.

Rates or insurance might also be higher than in our example. And these expenses, or mortgage interest, might rise in the course of the investment at a faster pace than rental increases.

> ***You can't force anyone to love you, or to lend you money.***
> Jewish Proverb

If you borrow to invest in shares or a share fund, the situation is similar. Your dividend income may not cover your interest and other expenses. But you hope for a capital gain that more than makes up for that.

Note that with all these investments, growth rates are uncertain.

If you can stay in the investment for 10 or more years, you're highly unlikely to lose money. But people sometimes lose their nerve if the value of their geared investment is falling, and bail out at the wrong time.

Others have to get out sooner than expected because of a job loss, ill health or family problems, or because the rental or dividend flow declines, and they haven't got enough other income to cover their costs.

Gearing works well for many investors. But it adds risk as well as potential returns.

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.

HELPFUL CALCULATOR

The Retirement Commission's website, www.sorted.org.nz, has several calculators, including the Lump Savings Calculator, which is useful in working through examples like the ones in this article.

It shows how much a lump sum will grow to over a certain period.

But you can also use it to work out percentage returns. Say your investment has grown from $10,000 to $30,000 over 20 years. Keep guessing at returns on the calculator until you come up with one that brings your total to $30,000.

Holm Truths Crossword Solution

M	A	I	D		A		B		S		C	
A		T	R	A	N	S	A	C	T	I	O	N
R	D		Y		T		B		O		M	
	O			F			B		U		P	
B	U	S		I	N	F	L	A	T	I	O	N
	B	E		L			E				U	
C	L	A	I	M				G	A	I	N	S
	E				I			A		C	D	
O	D	D	M	A	N	O	U	T		Y	I	N
	I		O		S			E			N	
	G		N		I		A		L		G	O
D	I	V	E	R	S	I	F	I	E	D		L
	T		Y		T		T		G	O	L	D

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Award-winning journalist Mary Holm writes the *Money Matters* column for the NZ Herald and *The Investor* column for major newspapers around New Zealand. She is the author of *Investing Made Simple* (Penguin, $27.95, at good bookstores) and *The REAL Story – Saving and investing now that inflation is under control* (which 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. She can be reached at P.O. Box 8520, Symonds Street, Auckland, or by email at maryh@pl.net

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