HOLM TRUTHS

Down to earth advice for New Zealand savers and investors from independent journalist Mary Holm

WINTER 2002

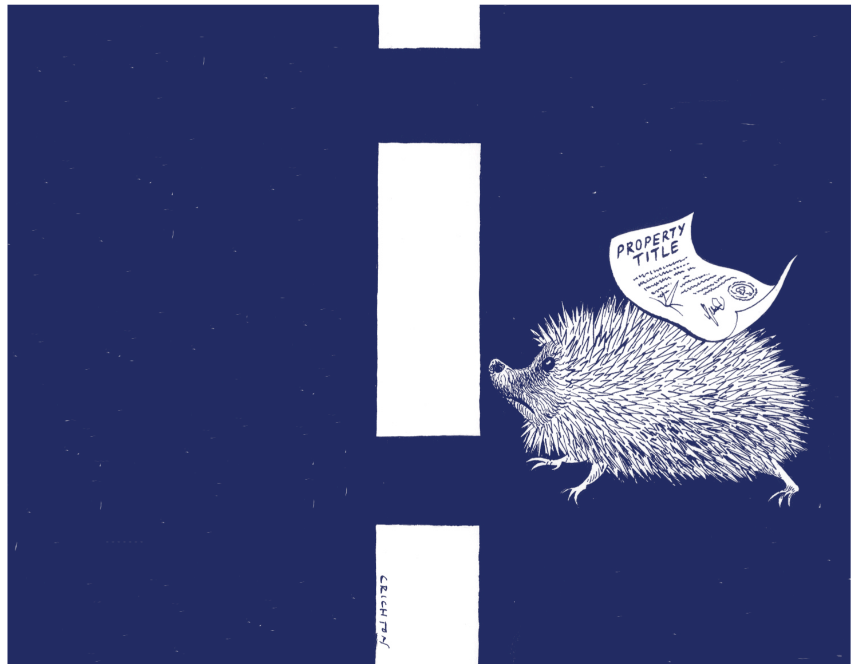
Getting Into Gear

Gearing ups the ante. It makes a good investment better and a bad investment worse.

A geared (or "leveraged") investment is one for which you have borrowed some of the money you invest.

You can gear any investment. The most common is property, but people also borrow to buy shares and sometimes such investments as forestry or collectibles.

Whatever the investment, gearing raises its potential rewards and its riskiness. And the larger the proportion of your capital that is borrowed, the higher the potential rewards and risk will be.



Any investment that makes a gain will make a bigger gain if you've borrowed half the money, and an even bigger gain if you've borrowed most of the money.

On the other hand, a loss-making investment will lose more if you've borrowed half the money, and even more if you've borrowed most.

It's not uncommon for an unsuccessful geared investor to not only lose the money they've put in, but end up owing money as well. *(See How Gearing Works on Page 2.)*

Gearing is risky in another sense, too. It enables you to get into an investment in a big way from Day One, at whatever the price is on that day.

That's good if it turns out to be a below-average price. But it might turn out to be a relatively high price.

By contrast, if you drip-feed money into an investment over time, prices will vary. You won't buy the lot at top dollar.

Because of its riskiness, geared investing is not for everybody. In fact, many experts argue that only people who like risk and who are in a strong financial position should consider it.

Before you go into any geared investment, check out the following:

• Is the return likely to be higher than the interest you're paying on the loan?

If not, you'll be paying out more than is coming in, and going backwards financially. *(CONTINUED PAGE 2)*

THE CHEAPEST LOANS

Let's say you've weighed up the risks and decided to borrow to make a geared investment.

If you have a mortgage-free home or a small mortgage – considerably less than the value of your home – the cheapest loan will probably be a new mortgage or an addition to your mortgage.

Lenders charge lower interest on mortgages than other loans because they have your house as security.

If you haven't got enough equity in your home to raise money this way, that might signal that you're not in a strong enough financial position to make a geared investment.

(GETTING INTO GEAR, CONTINUED)

Use after-tax figures when making this comparison. The interest you pay will probably be tax deductible. *(See Interesting Deductions below).*

The return on many investments will include not only rent, dividends or other regular income but – with any luck – a capital gain.

If the regular income doesn't cover the loan repayments, the investment may still work well – as long as you have the necessary excess cash.

But be wary of counting on a gain to make a bad geared investment into a good one.

An expected gain doesn't always happen. Or it's too small to recompense you for all the extra money you've put into the investment over the years.

Remember, too, that if you've financed the investment with a mortgage, interest rates may rise.

• Are you in for the long haul?

To make a high enough return, a geared investment will always be somewhat risky – even before the gearing.

That means annual returns will probably be volatile.

If you invest for just a few years, there's a fairly big chance that you'll come out with less money than you put in. And gearing will magnify that loss.

You must be prepared to hang in there, through a loss period. If you've chosen an investment that is basically sound, its value will probably rise again.

• Have you minimised other risks?

Because gearing adds to risk, it may be best to reduce the riskiness of the underlying investment.

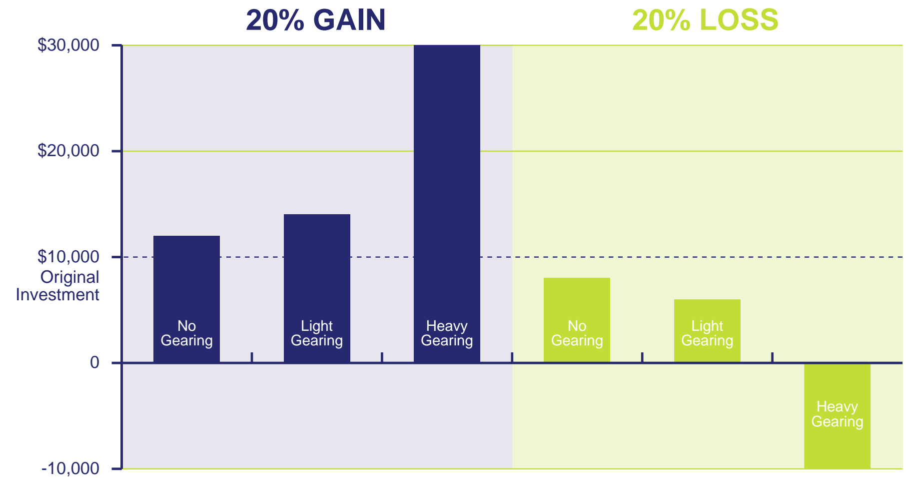
You can do this by spreading your money over many different assets, such as lots of properties or lots of shares.

(CONTINUED PAGE 3)

Money is the seed of money, and the first guinea is sometimes more difficult to acquire than the second million."

Jean-Jacques Rousseau, 1712-78

HOW GEARING WORKS



Start with $10,000 of savings

NO GEARING	LIGHT GEARING	HEAVY GEARING
$10,000	$10,000 + $10,000 loan = $20,000	$10,000 + $90,000 loan = $100,000
A) After several years, you've made a *20% gain.* The investment is worth:		
$12,000	$24,000	$120,000
You sell the investment, and pay back the loan (if any). You're left with:		
$12,000	$14,000	$30,000
Your $10,000 has:		
Grown by 20%	Grown by 40%	Tripled
B) After several years, you've made a *20% loss.* The investment is worth:		
$8,000	$16,000	$80,000
You sell the investment, and pay back the loan (if any). You're left with:		
$8,000	$6,000	Debt of $10,000
Your $10,000 has:		
Reduced by 20%	Reduced by 40%	Disappeared, and you owe another $10,000

Interesting Deductions

If you borrow to invest, you can normally deduct the interest payments (but not the principal repayment) on your tax return.

To find out your after-tax interest cost:

- *In the 21% tax bracket (income less than $38,000) multiply the interest rate by 0.79. For example on 8% interest, your after-tax rate is 6.32%.*
- *In the 33% bracket (income of $38,000 to $60,000), multiply by 0.67. On 8% interest, your after-tax rate is 5.36%.*
- *In the 39% bracket (income over $60,000), multiply by 0.61. On 8% interest, your after-tax rate is 4.88%.*

Note that you can deduct interest only if you have borrowed specifically to invest.

If, for example, you borrow to buy a new home and decide to rent out your old home, your interest payments will not be deductible.

Risky Business

The article above may seem, at first glance, not to apply to rental property.

Many New Zealanders don't regard rentals as particularly risky.

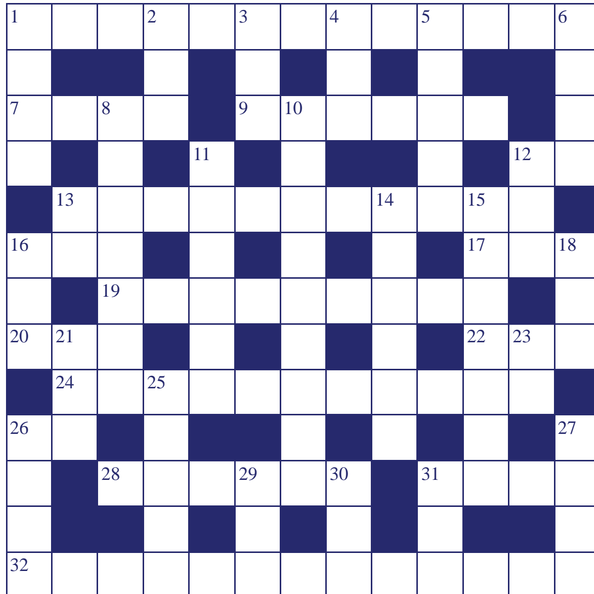
But the rules still apply. If your return isn't higher than the interest you've paid, you would have been better off not gearing.

And if your cash outgoings exceed your rental income, you're negatively geared. Unless the gain when you sell the property is more than your total cash losses, you would have been better off not investing, never mind not gearing.

Another point: If you own just one rental property, you are undiversified.

Before investing in rental property, you should also consider whether you could cover mortgage repayments if you don't have tenants for several weeks or months.

If not, you may be forced to sell when property values are low.

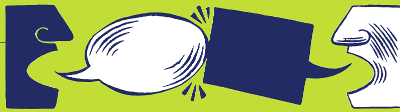


HOLM TRUTHS CROSSWORD Winter 2002

ACROSS
1. Charges for borrowed money (8,5)
7. Good fortune (4)
9. Improvement, rise (6)
12. Biggest share market (abbrev.) (2)
13. Eg. Shares, property (11)
16. Also (3)
17. Hot colour (3)
19. Not cheap (9)
20. A tree (3)
22. Amazement (3)
24. Legacy (11)
26. After Christ (abbrev.) (2)
28. Bet, wager (6)
31. Rage (anagram) (4)
32. Common savings goal (4,9)

Solution: Back page

DOWN
1. Lazy (4)
2. Deer (3)
3. Big bird (3)
4. Young child (3)
5. Kitchen garment (5)
6. He reaps what he _ _ _ _ (4)
8. Denounce, criticise (7)
10. Into plate (anagram) (9)
11. Place of worship (6)
12. Employ, utilise (3)
13. Not out (2)
14. Hebrew prophet
15. Syrup (6)
16. Beer (3)
18. Female deer (3)
21. Cover, top (3)
23. You and I (2)
25. Haul, throw (5)
26. Vault, span (4)
27. Excursion or stumble (4)
29. Front of boat (3)
30. Scrimp, be frugal (3)
31. Not solid or liquid (3)



GREAT DEBATE • GREAT DEBATE • GREAT DEBATE

FIXED vs FLOATING MORTGAGES

Pretty much everyone who gets a mortgage is faced with the question: Do I go for a fixed or floating interest rate?

And there's no clear answer.

As our list of pros and cons suggests, a fixed loan will be better if interest rates turn out to be higher than expected.

But a floating loan will be better if rates turn out to be lower than expected.

The issue is not, then, whether rates are likely to rise or fall, but whether they end up rising or falling more than we thought they would.

For example, at the time of writing, interest rates are expected to rise. This can be clearly seen from a list of mortgage interest rates.

The floating rates and the one-year fixed rates are the lowest, at around 7.5%. On a three-year fixed mortgage, you will pay around 8%.

(CONTINUED PAGE 4)

FIXED PROS	FIXED CONS
☑ Certainty of payments	☒ Early repayment penalties
☑ You win if future rates are higher than expected	☒ You lose if future rates are lower than expected

FLOATING PROS	FLOATING CONS
☑ Flexibility of repayment	☒ You lose if future rates are higher than expected
☑ You win if future rates are lower than expected	

(GETTING INTO GEAR, CONTINUED)

• Have you considered the hassle factor?

Even if the return on your investment is higher than the interest you're paying, you'll benefit from gearing only to the extent of that difference.

For example, if your after-tax interest cost is 6% a year, and the investment returns 8% a year after tax, you are 2% a year better off.

While that can amount to a fair bit over several years, it might not be worthwhile if you have to put considerable effort or worry into the investment.

Acquaintance, n.: a person whom we know well enough to borrow from, but not well enough to lend to."

The Devil's Dictionary, Ambrose Bierce, 1842-1914

(FIXED vs FLOATING MORTGAGES, CONTINUED)

And, on a five-year fixed loan, around 8.4%.

Roughly speaking, the five-year rate should be the average of expected rates over the next five years. That suggests that lenders expect interest rates to rise above 9% in the next five years.

If you, as a borrower, think rates will go even higher than that, you would choose a five-year fixed mortgage. It seems expensive now, but in the next few years, 8.4% will be a bargain.

But if the rate rise is lower than expected – let's say it peaks at 8% – you're going to be pretty unhappy sitting on your 8.4%.

The reverse applies with a floating mortgage. If you think rates won't rise as much as the markets expect, you will be better off taking a floating loan.

If you're right, you'll be laughing. But if rates zoom up above 10%, you'll wish you'd chosen a fixed loan.

Enough!

All of this assumes borrowers have a good feel for what future interest rates will be. That's pretty silly. Even the experts get it wrong often.

The fact is that we take a bit of a gamble when we choose either a fixed or floating mortgage. If we're lucky, the rates will move in the right direction. But we might just as easily be unlucky.

How, then, should a borrower choose? Here are two factors to consider:

- **Are you likely to be able to repay the loan early?**

This is often hard to predict. But if you think it's likely you could receive a redundancy payment, an inheritance or some other large sum during the next few years, you might want to avoid a fixed interest mortgage.

There are nearly always early repayment penalties on fixed mortgages.

The penalties can be high, so that it's not worthwhile to make what would otherwise be an excellent financial move: to use the lump sum to pay off all or part of your mortgage.

Note, though, that repayment penalties don't always apply in practice. It depends what has happened to interest rates since you took out your mortgage.

If rates have risen, and you repay an 8% fixed loan early, the bank can lend the money out to someone else at 9%. They're likely to be quite happy with your early repayment.

In those circumstances, ask the lender if they are flexible about the penalty.

- **How financially stretched will you be?**

If, when you take out the mortgage, you're worried that you'll barely be able to cover the repayments, you should favour a fixed loan.

That way you won't be in for a rude shock if floating rates rise.

But if you're comfortable with your loan, and could fairly easily pay more, you might be better off with a floating loan.

All other things being equal, the average floating loan should be slightly cheaper. That's because the lender has the flexibility to change the rate with market changes.

That lowers the lender's risk, and raises yours. And that should translate into a somewhat lower interest rate.

Still not sure what to do?
It's not silly to go 50:50, with half your loan fixed and half floating.

Holm Truths Crossword Solution

I	N	T	E	R	E	S	T	R	A	T	E	S
D			L		M		O		P			O
L	U	C	K		U	P	T	U	R	N		W
E		O		T		O			O		U	S
	I	N	V	E	S	T	M	E	N	T	S	
A	N	D		M		E		L		R	E	D
L		E	X	P	E	N	S	I	V	E		O
E	L	M		L		T		J		A	W	E
	I	N	H	E	R	I	T	A	N	C	E	
A	D		E			A		H		L		T
R		G	A	M	B	L	E		G	E	A	R
C			V		O		K		A			I
H	O	M	E	O	W	N	E	R	S	H	I	P

A rule of thumb?

People sometimes come up with rules of thumb about fixed versus floating mortgages.

But they're not worth much, according to BNZ economist Tony Alexander.

One rule, for instance, says you should go for a fixed loan whenever the fixed rate is 1% or more below the floating rate.

"Let's apply this situation to the middle of 1998," says Alexander. At the time, the floating rate was 11% and the five-year fixed rate was 9.3%. People jumped into the fixed rate.

"Then, at the end of the year, they came knocking on bank doors wanting to break out of the fixed rate and go floating."

The floating rate had plummeted, to 6.5%. The fixed rate ended up around 7.2%.

What about home ownership?

We've said that gearing is risky. But most New Zealanders own their homes, and almost all buy them using a mortgage. Is that risky, too?

Yes it is. If you buy a home with a large mortgage and end up having to sell after prices have fallen, you could lose your deposit.

Generally, though, people hold on to their homes long enough to be pretty certain that prices will have risen.

In home ownership, too, the property has provided you with rent-free accommodation.

That, combined with a probable capital gain, means home ownership is usually a good financial proposition.

WRITER AND PUBLISHER

Award-winning journalist Mary Holm writes the *Money Matters* column for the NZ Herald and *The Investor* column for about 20 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

Design and Production:
Scriven Art Studios Ltd., Auckland

Copyright © Mary Holm, 2002.
No part of this publication may be reproduced, stored in or introduced into a retrieval system, or transmitted, in any form or by any means (electronic, mechanical, photocopying, recording or otherwise) without the prior written permission of Mary Holm.