HOLM TRUTHS

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

Autumn 2001

Terms of enrichment

A stranger sidles up to me at a party. "Where should I invest my money?," he asks. He might as well ask what career he should take up, or where he should live.

There is no one-size-fits-all investment. Nobody can give you good advice about where to put your money without knowing a bit about your circumstances and personality.

Two considerations are how well you can cope with rising and falling investment values, and what other investments you already have. Of equal importance, though, is how long you want to tie up your money.

If you're saving to buy a car in several months, or to pay education fees in a couple of years, you're best to go with a fixed-interest investment, such as a bank term deposit.

Over a short period, there's too big a chance that a more adventurous investment – in shares, property or a superannuation scheme or other managed fund that includes either – will fall in value. *(See For Gamblers Only, below)*

On the other hand, if you're putting away money for retirement in ten years or more, shares, property and related investments are generally better choices.

There's only a slim chance that the value of a well-structured investment in these assets will decrease over a decade. And there's a pretty good chance it will rise impressively.

It's highly likely that you will end up much better off than if you had put the same amount in term deposits.

Why? Investments in shares, property and so on are riskier in two ways: returns are more volatile; and there's a bigger chance you could lose your money. But riskier investments generally bring higher returns.

There's logic behind this. The people who offer riskier investments have to pay out more on average – in dividends, rents, interest or capital gains – than those offering safer investments. Otherwise, nobody would go for the riskier ones.

Note, though, that I said they pay higher returns *on average*. There's always the chance that you will be unwise or unlucky, and your investment will perform below average.

Worse still, a company in which you hold shares might go belly up, and the shares

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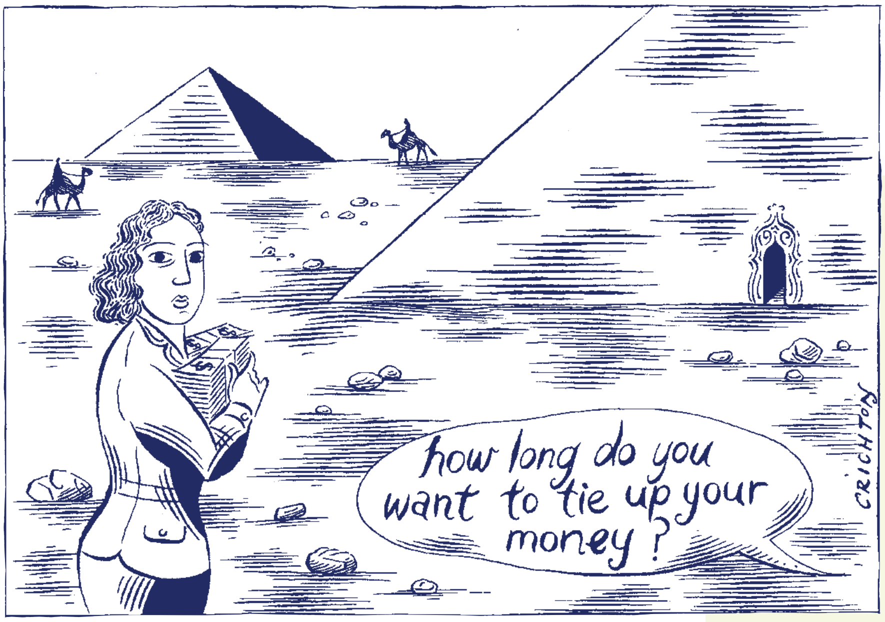


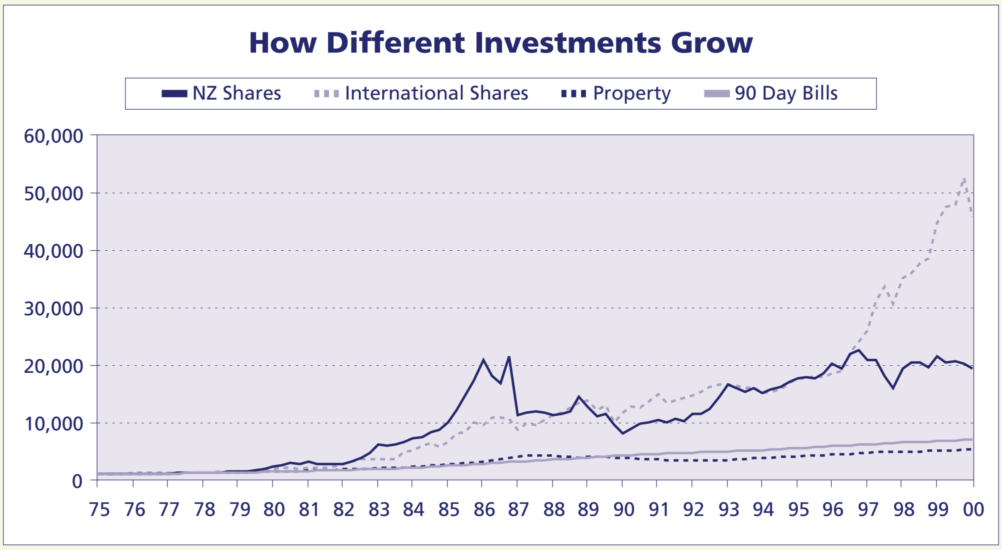
FOR GAMBLERS ONLY

Thinking of investing in shares for a few months? You're mad! For a decade? You're probably wise.

From 1958 to 2000, returns on New Zealand shares, including dividends, were negative in a little more than a third of the quarters. And that's without taking into account brokerage and taxes.

Over single years, returns were negative 23% of the time. But over three-year periods, it had fallen to 14%. By the time we get to decades, there were no negative returns. And that's looking at ten-year periods ending on every March 31, June 30, September 30 and December 31 in the 43 years.

If you invested $1000 at the end of 1975, and paid tax at 33%, you would have much more by now in shares than in property or fixed-interest investments. But shares are more volatile. The value of a share investment is quite likely to fall in the short term. It's better to invest in shares over long periods. (The graph shows shares including dividends and capital growth, and property including rental income and capital growth. International shares are shown in NZ dollars.)



(TERMS OF ENRICHMENT, CONTINUED)

become worthless. Or the neighbourhood around your rental property might deteriorate, leaving you with negative equity (the house is worth less than the mortgage). Your savings could be wiped out.

Because of that danger, it's not wise to invest in just one or a few shares or properties. Get into as many as you can.

Then, if one or two holdings turn out to be duds, chances are that others will be big winners, and more than make up for it.

This is especially true if you go for shares in different industries and different countries, or a mix of commercial and industrial properties in different regions.

The easiest way to invest in such mixtures is via managed funds – unit trusts, superannuation schemes and so on.

So where are we? Over a couple of years or less, invest in term deposits. Over a decade or more, invest in share or property funds.

What about half a decade or so? Your choice depends on your tolerance for risk, and on how much it matters if the value of your money falls.

Let's look at two scenarios:

• You're going on a trip in three years. Whether it's two months in backpackers' lodgings or six months in hotels depends on how well your savings grow in the meantime.

• You're planning to quit work and do a degree in six years. You will need a fixed amount for fees and a minimum amount for living expenses.

You'll be saving for twice as long in the second case. Normally that means you might take more risk.

But, in the first case, you could cope with lousy investment returns from volatile investments.

In the second, that would ruin your plans. You would be wise to stick with term deposits, or at least a combination of those and a conservative share fund.

So your investment has plunged? Hang in there!

It's all very well for someone to tell you to put your long-term savings into an investment that can go up and down in value.

But how are you going to feel if you put, say, $5000 in a share fund and a year later it's worth $4,000? Panicky? Keen to crawl back to the safety of term deposits?

That's the response of many investors unlucky enough to strike a down period soon after they first venture into risky investments.

Even those who have been in such investments for some years sometimes jump out if the going gets tough.

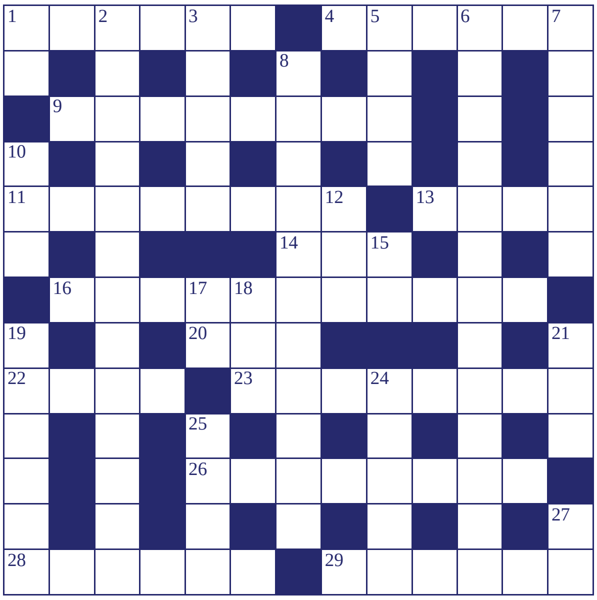
It's a human response. But it's foolish.

For one thing, if you bail out when your investment has had a bad run, chances are that you'll be selling when the price is particularly low. A year later you could bitterly regret your move.

More importantly, you shouldn't bail out at any point – regardless of price. As long as the investment was sensibly selected in the first place, stick with it.

Your short-term worry could well turn into long-term jubilation.

Money is like an arm or a leg – use it or lose it.
Henry Ford



HOLM TRUTHS CROSSWORD Autumn 2001

ACROSS

1. They tell us how much things cost (6)
4. Shoe or lazy person (6)
9. ___ __ for state schools? (5,3)
11. They keep out nosy neighbours and morning light (8)
13. American smell (4)
14. Also (3)
16. A diversified investment (7,4)
20. Holiday goal? (3)
22. Work wear (4)
23. You might hire them to do 8 down (8)
26. Called in to a troubled company (8)
28. Serious, unsmiling (6)
29. What you want your investment property to be (6)

Solution: Back page

DOWN

1. Annually (abbreviation) (2)
2. Beyond NZ borders (13)
3. More than enough (5)
5. Chances (4)
6. Conservative investment (5, 8)
7. What risk takers hope for (6)
8. A rental property expense (11)
10. Political party or part of a play (3)
12. Turf or unpleasant fellow (3)
15. Rate ___ return (2)
17. In every email address (2)
18. Cavity, space (3)
19. Not liabilities (6)
21. Check if it's included in 1 across (3)
24. Conmen love ____ people (5)
25. Measure of weight (4)
27. Doctor (abbreviation) (2)

GREAT DEBATE • GREAT DEBATE • GREAT DEBATE

SHARES vs RENTAL PROPERTY

By world standards, rental property is a highly popular investment in New Zealand. Should it be?

If you ask landlords why they would rather rent out a house than own shares, many of their answers boil down to one issue: property is less risky.

Finance textbooks agree with that. But once we take into account the way we tend to invest in these two assets, it's not so clear. There are three issues here:

• You probably own your own home. A rental property is much the same sort of asset.

What's more, it's likely to be close to your home. That's convenient, but it puts many of your eggs in one basket.

If house values in your area fall, or just don't rise as much as other investments, the homeowner-cum-landlord is hit hard.

• It's easier to own lots of shares than lots of rental properties.

This spreads your risk – around the world if you wish.

The landlord without tenants gets no income. But the owner of shares in many countries won't lose all dividend income at once. And it's highly unlikely the value of all the shares will fall at once.

• People usually borrow to buy rental property, but not to buy shares.

It doesn't have to be that way. You can invest in rental property without a mortgage. And – if you've got a good income and credit record and some assets behind you – you can probably borrow to invest in shares.

But most people think borrowing for share investment is too risky. Certainly, many of those who took out loans to buy shares in the mad share market of the mid 1980s lived to regret it.

The fact is, though, that borrowing makes any investment riskier.

If you get a $90,000 mortgage to buy a $100,000 rental house, and the house value drops to $90,000, you've lost your whole deposit. If you had bought mortgage-free, you would have lost only 10% of your money.

Taking the above three issues into consideration, it's realistic to compare

(CONTINUED PAGE 4)

RENTAL PROPERTY PROS

- ✓ You can drive past your investment
- ✓ Home owners "understand" houses
- ✓ You can improve value by working on it
- ✓ Easier to borrow to invest.

RENTAL PROPERTY CONS

- ✗ Same type of asset as your own home
- ✗ Bad tenants or lack of tenants
- ✗ You're on call, or paying a manager to be on call
- ✗ Maintenance – do it or pay someone to do it
- ✗ Can't easily sell part of investment
- ✗ Often can't sell quickly.

SHARE PROS

- ✓ Easy to diversify, by holding several shares
- ✓ Different type of asset from your home
- ✓ You need less money to get in
- ✓ Lack of hassle
- ✓ Can easily and quickly sell part or all of investment.

SHARE CONS

- ✗ Can't easily "see" investment
- ✗ Can't boost value by your own work
- ✗ A share can become valueless
- ✗ Harder to borrow to invest.

(GREAT DEBATE, CONTINUED)

Leonard Landlord, with his mortgaged rental property a few blocks from home, and Sharon Shareholder, with her unmortgaged investment in a share fund.

Who is in the riskier investment? That's hard to tell. They're probably about equal.

In that case, the better investment is the one that brings in higher returns. So how do the returns compare?

Generally, shares bring in higher returns than property, over the long term.

But that doesn't take into account the gearing effect of borrowing. Just as we said, above, that borrowing makes losses worse, it also makes gains better.

Let's say your $100,000 house, with the $90,000 mortgage, rises in value to $120,000.

After paying off the mortgage, you're left with $30,000. The $10,000 you originally invested has tripled.

If, instead, you had bought the house mortgage-free, your $100,000 would have grown to $120,000. That's not nearly as good as tripling your money.

When we're comparing returns for Leonard Landlord and Sharon Shareholder, then, we should note that Leonard's profit could well be boosted by gearing.

This means Sharon and Leonard's expected returns might be about equal.

Does that sound consistent with recent New Zealand history?

Over the last few decades, many people have made big profits on rental properties.

But times have changed. With lower inflation in recent years, house values have grown much more slowly, and sometimes fallen.

Also, a glut of rental properties in some areas has pushed down rents. More than a few landlords, with rental income not covering their expenses, have been forced to sell – sometimes for less than their purchase price.

While some rental properties still richly reward their owners, quite a few don't.

> *Never invest your money in anything that eats or needs repainting.*
>
> Billy Rose, Millionaire Entertainment Producer

On the share front, returns on New Zealand shares have generally been disappointing since the 1987 Crash.

However, returns on international shares were exceptionally high in much of the 1990s. The wise investor, who holds a large proportion of overseas shares, fared better in recent years than many landlords.

Overall, it's not clear whether Leonard or Sharon will do better. Researchers have compared sample landlords with sample share investors, but their findings depend largely on the assumptions they make.

In the end, people often choose their investments for non-financial reasons. *(See Pros and Cons)*

Many share investors can't think of anything worse than being woken at midnight to be told the tenants' roof is leaking.

On the other hand, many landlords enjoy maintaining their property. It's a hobby, and sometimes a lucrative one.

Some argue that investing in a share fund is simpler than property. But others say they don't understand shares, whereas houses are straightforward.

While all of these things matter, it's important for landlord-cum-homeowners to realise their investments are too concentrated, perhaps dangerously so.

The days when you couldn't go wrong in rental property are long gone.

Holm Truths Crossword Solution

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

Give us a break

Tax breaks are a common attraction of rental property.

Landlords can write off the money they pay for rates, insurance, maintenance, mortgage interest, depreciation and more.

What some people don't fully appreciate, though, is that every deduction except depreciation costs you a lot more than you get back on your tax return.

If you're in the top tax bracket (income of more than $60,000) and you spend $1000 on your property, you're out of pocket $610, after taking your tax deduction. In a lower tax bracket, you're out of pocket even more.

Depreciation is different. You can deduct it without spending a cent.

Still, if you end up selling the property for more than you paid for it – which is usually the case – you have to add to your income that year the depreciation you have claimed over the years. You lose what you gained.

Even if you sell for less than your purchase price, some of your depreciation may still be "clawed back".

All in all, the tax breaks on rental property are nothing to get excited about.

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, $24.95, 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@journalist.com.

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