

HOME IS WHERE THE HEART IS....



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Home Is Where The Heart Is

For most homeowners and homebuyers, home is our most significant single asset.

Take a drive through any suburban street or take a look at any significant block of units and you are almost certainly looking at millions of dollars of assets. You are also looking at millions of dollars of money being wasted.

Why?

The opportunity to use that asset to make money is very often not utilised. We all want to own our own home outright and feel that would be a wise investment. Failure to put this asset to work represents an “**opportunity cost**” though when you consider the amount of money that you could make, if you put the asset to work.

Just as the opportunity cost of money sitting in a cheque account not bearing any interest, would be at least equal to the interest that would be paid if it was held in a term deposit. The opportunity cost of your home is the amount of money that you can make by putting that asset to work. If you could earn

Based on the house below worth \$440,000 @ 10% = \$44,000 per year.

Opportunity Cost approximately \$840 per week!!



Just to live in my own home???

In the early 1900's, Australian home ownership increased significantly but as late as the 1950's, a mortgage was something you hid in the corner cupboard. The Australian dream was not only to own your own home but to get rid of the mortgage as well.

The 1970's produced a different mindset - in certain quarters the \$200,000 mortgage became a badge to be worn with pride. To get a \$200,000 mortgage you had to have substance, and “substance” meant an expensive home, with an income to support the borrowing.

Unlike the situation in the UK & North America home loan mortgage expenses are not tax deductible expenses in Australia. Under our tax system “home loan expenses” are not allowed as deductions, unless the purpose of the loan is for something other than providing a primary residence.

Why pay off the mortgage? Good advice?

Many advisers recommend and we read regularly, in the financial press, the first thing to do in building your wealth is to “pay off your mortgage”.

Yes that is good advice! What next?

The best advice in many cases is to get another mortgage; but make sure that this mortgage is separated and different. The difference relates to its tax deductibility, because the purpose for the loan is different. This new money is borrowed for the purpose of investment in your future, to take the “cost” out of opportunity cost, and if done smart, leaving only opportunity.

Why are the banks in business?

You would think the banks would view a customer with lots of borrowings as a very good customer because they would pay high levels of interest.

This is not the case!

Banks focus on the SECURITY the customer can offer and ensuring the borrower has an ADEQUATE INCOME, to support their borrowing level.

Because of the changed attitude of the Banks (subject of course to these two criteria being met) new financial products have been introduced to the marketplace.

One of the most useful of these products is the HOME EQUITY LOAN or a LINE OF CREDIT where the security remains a mortgage on the family home but the purpose of that loan is something other than completing the purchase of that particular house.

What is security?

The word “security” has two meanings relevant to a discussion on investing and borrowing for that investment.

The first is the sense of well being safety or comfort that an investor feels when he/she has made an investment and particularly in the case where money has been borrowed, to make that investment. The “what ifs” come tumbling out and the terrifying prospect of total loss will threaten everyone’s sense of security. Adopting a sensible investment strategy means this would be impossible, unless the world did not exist, as we know it.

“Security” is also the asset over which the lender takes a charge - the camera or diamond ring deposited at the Pawn shop, the shares your grandfather left you in his will, or real estate. The mortgage is given in exchange for the money lent. No repayment and the asset is used, that is, sold, to repay the debt which it covers.

Remarkably, real estate remains the #1 favoured asset of banks when they are seeking security to support your borrowing. Remarkable because selling real estate is not as easy as selling most other forms of security such as shares or managed funds.

Banks love taking mortgages over your property. This factor constitutes the greatest threat to the security (ie. the emotional feeling of well being) of huge numbers of Australian homeowners.

The feeling of insecurity about having a mortgage is irrational but very, very potent.

They will also now allow you to use shares or managed funds as security to borrow. Some people find this more palatable but it has other risks attached that real estate security does not.

What is gearing?

“Gearing” or “leveraging” refers to the process of mixing some of your money with borrowed money and thus producing a larger pool for investment.

Negative gearing occurs when your costs of borrowing exceed the return on your total investment. This has always struck me as being a particularly bad exercise. Some do this on the belief the investment, will eventually grow to produce positive income but until this time they will minimise tax they pay. They need to understand they are effectively LOSING MONEY! Not a great strategy.

Positive gearing is the opposite - total returns on the investment exceed the costs of borrowing and you make a profit from using someone else’s money while getting a return on your own invested money.

During the 1970’s and 80’s the term “negative gearing” became the buzzword in the investing world, usually and unfortunately linked with speculation/investing in residential real estate. Unfortunately the real estate salesmen who continue to promote this as a surefire means to wealth, fail to make their clients aware of the huge changes in tax scales and that of the tax introduced by Paul Keating when he was Treasurer – **CAPITAL GAINS TAX!!**

Prior to 1985 gearing into investments, including real estate, was taxpayer heaven. You were able to claim interest as a tax deduction (you still are) and with tongue firmly planted in your cheek you told the Tax Office that the sole purpose of the investment was to generate income. When the income generating investment was sold what a delight to receive a totally unexpected and totally tax free capital gain! The introduction of Capital Gains Tax in September 1985 changed all that.

It remains a great pity that many investment houses recommending gearing into various investments other than residential real estate have adopted the term “negative gearing” and emphasise (quite wrongly) the tax “advantages” of gearing.

True “negative gearing” has never made financial sense. Unless the borrowed funds can be put to work for you to earn more than the interest cost of those funds then it is costing you money. Admittedly this cost is subsidised by the Tax Office but that is small comfort if at the end of the day you finish with less money than when you started.

More and more financial institutions are offering investment loans based on various levels of gearing. Some are offering various forms of guarantee that will ensure that you are unable to lose your money but inevitably the interest charged that is coupled with such a guarantee is more than double “normal” interest.

Of course interest on money, borrowed for gaining assessable income is tax deductible. Anyone who borrows money, which results in nothing but a tax deduction with no eventual profit, has the wrong strategy.

There is nothing new about gearing. Every public company in the world has some level of gearing. Most of them use borrowing conservatively and sensibly to enable them to achieve their growth aspirations.

For many years the concept of gearing for investment purposes, whether into real estate, or any other investment, was regarded as being too risky. Every investment has risk attached. There is the possibility that the investment will have lost the opportunity to make a profit. Gearing simply magnifies this risk in both directions. If the venture fails you have not only lost the opportunity to make a profit but you have to find something else to generate the cash to repay your borrowing.

Gearing also magnifies the gain. If you invest \$10,000 of your own money for a \$5,000 gain that should be regarded as a good return on that investment. If at the same time you borrowed \$10,000 and made \$5,000 profit on that as well your total profit becomes \$10,000 less interest paid to the lender. If that interest is say, \$1,000 then gearing has increased your profit from \$5,000 to \$9,000.

Homeowners with equity in their homes are most favoured by lending institutions. For historical reasons but no good commercial reason real estate is regarded as a superior form of security so that banks will (a) lend more money as a percentage of value and (b) charge a lower interest rate if real estate is offered as security.

That should not deter non-homeowners from borrowing for investment purposes. A regular investment program can be linked to a regular borrowing program.

Gearing is and always has been a legitimate wealth creation process. **Positive gearing that is. What are MANAGED FUNDS?**

In its simplest form a managed fund is a pool of money where the decision about what happens to that money is made by someone other than all the contributors to that pool. The “manager” could be the stakeholder for a group of people having a bet at the races where that person decides where the bet is placed. Investing in serious mode stays away from the racetrack.

While a lot of the population believe that investing in the sharemarket is a “bit of a punt” the fact is that the sharemarket is the place where the collective wealth of the significant public companies of any country is traded on a daily basis and therefore is the only place in which you can buy a share of the wealth of the producers of that country.

Traditionally banks and insurance companies were the only fund managers. Except that the management function was performed in the case of banks to make profits for themselves and in the case of the big Life Offices to make money to be paid to their members as bonuses, usually when they died.

There are now many fund managers in Australia, many managing billions of dollars on behalf of investors. Most managers now offer their investments and that of others through products called platforms. This is where you can access many different and high quality managers through a single administration platform. This then gives you a consolidated view on your investments as well as overall tax reports and a wide range of other reporting, usually through internet access.

The old concept of not having all your eggs in one basket can be achieved by using different fund managers and using different funds organised by the chosen managers. Because we are innately conservative, it is rare for us to recommend only one fund from one fund manager. That will usually only happen when the amount being invested in a regular investment program is at the minimum level.

We believe that complementary management styles can be put together and that there are balances that can be achieved blending managed share funds, which concentrate on different parts of the market and different parts of the world.

The fund managers provide a professional service. They come to work every day and work at managing your money using skills and knowledge that is not available to an ordinary investor. Of course they charge for doing the job, but we monitor the managers we use to ensure they add value for their fees. It makes sense to use a professional who demonstrates they make you more than they charge.

For this reason we usually recommend investment via managed funds.

What is Dollar Cost Averaging?

Dollar cost averaging could be described as saving coupled with savings. When applied to shares (whether direct or through managed funds) the system recognises that the market is subject to rises and falls and a regular monthly investment of the same amount of money will buy more shares when the market is down and fewer shares when the market is up. This system takes the uncertainty out of the market. It is not necessary to pick the highs and lows because the systematic regular investment of the same amount of money ensures that highs result in fewer shares and lows result in more.

Dollar Cost Averaging – an example

The foolproof system of investing into the sharemarket over time is to purchase the same dollars worth of units in a managed fund at regular timed intervals. It could be done weekly but all Fund managers who offer a regular savings plan arrange for the investment to be made monthly.

If this strategy (known as “dollar cost averaging”) is followed, the investor is happy when the market is down because of the “Sale price” on offer and happy when the market is up because the value of the total investment has risen.

Dollar cost averaging in practice is illustrated below (total investment in both cases \$3,600):

	(A) CFS Australian Small Companies		(B) ING Australian Share	
Month	Unit Price	Units Purchased	Unit Price	Units Purchased
January 2004	1.3107	228.8853	1.4831	202.2790
February 2004	1.3627	220.1512	1.5005	199.9334
March 2004	1.3710	218.8184	1.5241	196.8375
April 2004	1.3941	215.1926	1.5387	194.9698
May 2004	1.3546	221.4676	1.5022	199.7071
June 2004	1.4234	210.7630	1.5807	189.7893
July 2004	1.3684	219.2341	1.5056	199.2561
August 2004	1.4212	211.0892	1.5109	198.5572
September 2004	1.4856	201.9386	1.5858	189.1790
October 2004	1.5722	190.8154	1.6222	184.9340
November 2004	1.6158	185.6665	1.6899	177.5253
December 2004	1.6198	185.2081	1.7746	169.0522
January 2005	Total Units	2,509.2300	Total Units	2,302.0199
	Balance (\$1.6738)	\$4,200	Balance (\$1.7918)	\$4,125

The columns above demonstrate the application of the principle of dollar cost averaging over a one-year period (2004) for (A) the Colonial First State Australian Small Companies fund and (B) the ING Australian Share fund.

In both cases a \$300 monthly investment (total of \$3,600 invested in each fund for the period) is made at the price applying on the 20th of each month. The left hand column for each Fund is the price used to purchase the same AMOUNT of money’s worth of units in a managed fund, so that when prices are higher fewer units are bought and conversely when prices are lower more units are purchased.

No account has been taken of distributions made by the Fund managers but the four income distribution additions made during the year by the Fund managers to achieve a compounding effect adds to the result. The principles of compounding and dollar cost averaging come into effect when distributions are all reinvested because a distribution made when lower values prevail will produce better value buying, coupled with the benefits of reinvested funds continuing to earn further profits from the managed fund.

Every twelve-month period will not necessarily produce results like this (approximately 14% - 17%) but the figures above demonstrate clearly that the very worst decision to be made by an investor is to sell at the low point. This is the obvious time to buy because no one can ever say with certainty that the bottom of the market is here now. The safer and more certain procedure is to use the principle demonstrated above and thus avoid the necessity of trying to pick the market.

When should I act?

Even with banks and other financial institutions falling over themselves in the race for the Home Loan market, the ramifications of the Credit Act place very severe restrictions on the capacity of asset rich but low-income earners to borrow.

“Redraw” facilities on a home loan, which is effectively an overdraft facility secured by a house mortgage or a “Line of Credit” secured by a mortgage, has given anyone with a house and a satisfactory income, the opportunity to borrow now and NEVER pay back until the house is sold. For investing purposes an interest only loan is an effective vehicle.

With this facility the equity in your home is always working for you, it provides a roof over your head and the OPPORTUNITY to use someone else’s money to make some for yourself through sensible and judicious investing.

Finally, we would recommend and you are not obliged to use **all** your Line of Credit, but it’s nice to know that it’s there when you want it, as an important plank in your financial planning platform.