

# Investing in Knowledge

Your **quarterly** newsletter from

2ND QUARTER 2004



creating **wealth**

## Economic update

# The recovery continues

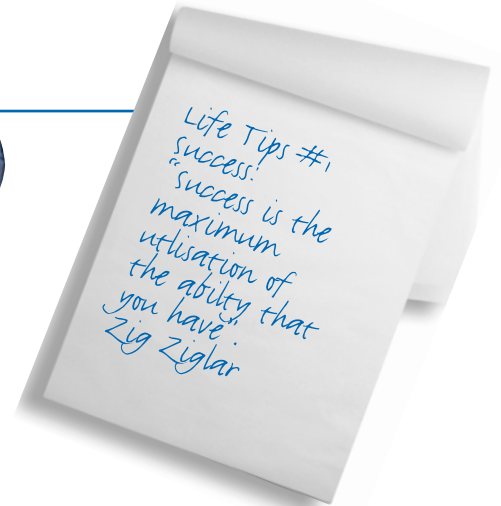
Recent events indicate that the global recovery is continuing. US growth is looking more sustainable and other regions are also showing signs of improvement. In particular business profits are growing strongly around the world.

On the local front, interest rates have risen (reflecting the stronger economy), the dollar has weakened against the US dollar and anecdotal information indicates that housing prices have peaked.

Going forward, we anticipate house prices may fall slightly in some areas, but overall they should stabilise. Elsewhere, business confidence has fallen and farmers are preparing for a tough year in 2005.

Our advice is to develop a well-diversified investment portfolio capable of taking advantage of the local and global economic climates.

If you have a mortgage, consider locking in the rate for the next two years.



## Unlocking your home equity

**For years, many older people have been sitting on an asset they have not been able to use - until now.**

Approximately 500,000 New Zealanders are aged over 65, and 80% of them own their own home but have a median income of only \$22,000 (Statistics New Zealand - 2002). These people are asset-rich but cash-poor. The theoretical plan for many of these people was to trade down from a large home to a smaller home once retired. However, anecdotal evidence suggests that few people do this.

A potential solution is now at hand. A new type of product has recently been launched that enables people to remain in their own home while also using it to borrow money on, in order to enjoy their retirement. The product is known either as a reverse annuity mortgage (RAM) or home equity release (HER) scheme. Both schemes are structured differently but enable older people to release the equity in their home.

Contact us if you would like to find out more about these schemes.

# Inside:

- PAYING YOUR MORTGAGE OFF FASTER VS INVESTING THE CASH
- CHASING THE FINANCIAL POT OF GOLD

## Chasing the rainbow

**We all fantasise about capturing the pot of gold at the end of the rainbow.** It's great to dream but in real life we all know that there is no pot of gold there. However, when it comes to investing, many New Zealanders believe that you can make your own pot of gold by chasing whatever is 'hot' and topical at the time.

Over the past 12 months, New Zealanders have been pouring their money into residential rental property in the expectation of significant capital gains, as well as into various property-based debenture products that have been providing yields 2-4% higher than the bank. Both of these investment opportunities carry risks, but it is fair to say that a prudent investment into good-quality residential property and/or debentures will have paid off.

However, during the same time period, good-quality managed funds, especially equity-based ones, have shown exponential gains far exceeding property and debentures. The rapid recovery of good-quality managed funds (more than 20% in the March 2003 to March 2004 year) reinforces the age-old adage that 'the cycle lives on'. Markets go up and markets go down. The astute investor buys when prices are depressed - in the current cycle, that was back in early 2003.

One example of how well prices have recovered is Private Portfolio master trust (see the chart below). The PPS International Equities Fund has been restructured to make it more of an 'absolute return' type of fund (i.e one that doesn't try to track the benchmark index.)

### PPS Performance to 30 April 04

PPS Fund	3 Months to April 04	6 Months to April 04	1Yr to April 04
NZ Fixed Interest	0.71%	1.74%	2.37%
Intl Fixed Interest	-0.05%	1.40%	2.85%
NZ Equities	5.33%	9.25%	20.45%
Australian Equities	4.53%	4.04%	16.62%
Intl Equities	7.43%	7.50%	18.02%
Asia/Global	9.07%	14.69%	42.65%
Property	-0.05%	5.14%	19.05%
Mortgage	0.94%	1.91%	3.93%
Global Tech	0.21%	2.23%	29.48%
European	4.97%	8.44%	18.29%
Platinum	5.47%	7.40%	26.84%
Diversified Trading	0.83%	1.92%	4.12%
Balanced	4.03%	6.39%	14.54%
Aggressive Balanced	5.76%	8.16%	19.60%

This will help it to perform well in the coming years and potentially minimise losses, should the sharemarket fall.

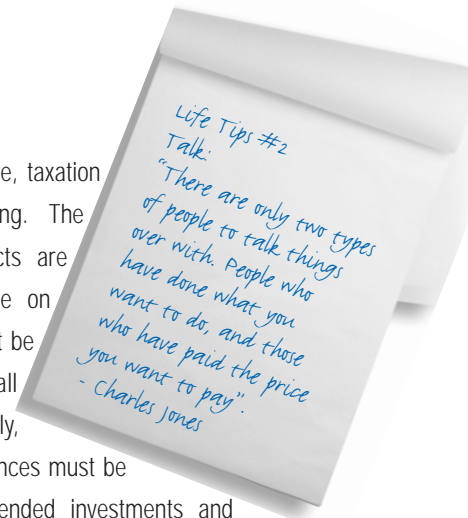
*Contact us on how to position your portfolio to measure risk-adjusted returns.*

## Comprehensive planning pays off

**Recent research undertaken by The Portfolio Group indicates that many New Zealanders are not fully utilising the skills and experience of the financial planner they already have a relationship with.** As a result, they could inadvertently be missing out on valuable information and guidance on how best to achieve their financial goals.

The Australian Government has recognised the importance of comprehensive financial planning. They recently passed legislation, as part of the Financial Services Reform Act (FSRA), that prohibits a financial planner from providing investment advice unless a comprehensive financial plan (they call it a 'statement of advice') is prepared for the client. That plan must establish and discuss the client's current financial situation, goals, issues,

insurances, investments, risk profile, taxation and asset protection/estate planning. The rationale is that all these aspects are interlinked and appropriate advice on what products to invest into cannot be provided until the client's overall situation is fully assessed. Annually, the plan and the client's circumstances must be reviewed to ensure the recommended investments and insurances are still appropriate. As part of our 'best practice' procedures, we endorse the view of the Australian regulators and encourage all our clients to undertake the comprehensive financial planning process with us. *Please contact us to arrange a time to meet.*



## Paying mortgage vs investing

**Financial planners are often asked to advise on the advantages or disadvantages of applying surplus cash to reduce a residential mortgage rather than using the cash flow to invest in managed funds.** The most common questions are summarised below.

- 1) Should surplus cash flows be used to reduce a residential mortgage rather than be invested in managed funds or should managed fund investments be liquidated to reduce a residential mortgage?
- 2) Should a mortgage be raised on residential property and the funds then reinvested in managed investments?

These questions are best considered in four parts: risk, opportunity costs, diversification and investment returns.

a) **Risk** - If surplus cash flows are used to reduce a mortgage, the risk of not being able to meet future payments is reduced, and the risk of an increase in repayments (should interest rates rise) is also reduced. New Zealand's deregulated economy has changed the security formerly associated with steady employment and this is a prime motivation for investors to reduce a mortgage. The residential property market is illiquid and 'inefficient', so increasing an investment in this asset class results in a significant rise in liquidity risk. In contrast, managed fund investments have a high degree of liquidity, with funds always available within a few days.

b) **Opportunity cost** - Opportunities in the future to obtain higher returns may be missed because cash flows and funds are not available. It could be argued that funds can easily be obtained by increasing a mortgage again, but changes in the mortgage market are unpredictable and this may not be an option at the time the investment opportunity is available.

c) **Diversification** - Most New Zealanders have a high proportion of their retirement savings in residential property. It is also important to note that proceeds from a family estate will generally include residential property. This 'double-up' effect further reduces the diversification of investment portfolios and increases the risks.

d) **Investment returns** - Residential property is not subject to capital gains tax and although there is no income flow, there are indirect benefits from ownership as the only alternative is rental accommodation. Interest payments for a mortgage on an owner-occupied residential property is not deductible for tax purposes.

Managed investments are subject to tax on income, realised and unrealised gains, but borrowing costs are deductible for tax purposes. Investment returns should be calculated on an after-tax basis. Residential property and managed investments are both subject to market risk, but residential property is affected by a multitude of factors related only to the specific property. Returns from managed investments are predictable on the basis of probability models. Reducing a mortgage is considered a lower risk strategy than investing in managed funds and investors can therefore justifiably expect higher returns from managed fund investments. This is known as the risk premium.

**Conclusion:** In general terms, there are benefits in reducing a mortgage if prospective returns (including a risk premium) from an investment in managed funds is lower than the mortgage interest rate. *Contact us to discuss your personal situation.*

## Family Trust tips for annual gifting

**Annual gifting is the process by which your assets are gifted away to your trust.** This normally takes the form of completing an IRD gifting statement plus completing a 'forgiveness of debt', which is owed to you by the Trust. This debt arises when you sell your assets to the Trust.

### Helpful Hints

- Each person may gift \$27,000 every 12 months free of duty (\$54,000 for husband and wife).
- Correctly prepared documentation is essential (i.e. Deed of Forgiveness of Debt and Gifting Statement) - see your solicitor.
- Record the amount of the principal sum paid off your mortgage, which you are funding. For example, if this amounts to \$7,000, then you are only able to gift away a further \$20,000 (for an individual) or \$47,000 (for husband/wife) in that year before incurring gift duty.
- Give copies of all documents to your accountant and solicitor and keep a copy for your records.
- Reduce the amount of the outstanding debt by the amount gifted.
- You can do your first set of gifting on day one then the second set of gifting can occur on day 366.
- Keep to a consistent time each year so that you do not fall behind.
- Any substantial gifts you make to children or other family members must be formally gifted away or will be liable for gift duty. Examples of these are houses, cars, boats and investment properties.

*Questions on how to operate your Family Trust? Contact us.*

## Life Insurance - please consider!

**Excellent financial planners do not focus solely on investment products.** When we write financial plans for our clients, investment recommendations are usually found around Chapter 8. Risk management features before investments. There is little point in accumulating wealth if you are not protecting it. Wealth can easily disappear when you incur a major health problem.

Our own situation is a good example of the additional needs that business owners have. We have business loans with a bank, the security of which is our family home. If something happened to either Richard or me the bank would become concerned. I can imagine our bank manager visiting Richard in hospital with flowers and then promptly talking to me about repaying the mortgage. Banks always have the right to 'call up' their mortgages. When there is a health problem and a business partner is ill this is when they are likely to 'attack'. They attack when you are vulnerable and when you need their help the most.

What have we done to protect our clients in the event either of us suffer from a disability or die? Two things: firstly we regularly have full insurance reviews. Richard was recently accepted for an additional \$500,000 life insurance and \$300,000 Critical Care /Living insurance. The premium on this insurance alone is \$355 per month. Our total personal life insurance premiums are now more than \$1,600 per month. We are in our 50's and insurance is not cheap but we would rather have an insurance company carry this risk than risk losing our business should an event occur that prevented us from working.

Our risk protection programme for the business is to have competent staff in a central office. In addition to this risk management we insure with insurance companies.

Thank you Roy for writing your story below and for giving us permission to print it in this newsletter. In this case we had recommended that Roy have both Income Protection insurance and Critical Care /Living insurance. He chose not to and we did not pester him. Our focus with Roy was more on investments than risk management. By the way, the 'major trauma protection' which was included with his life insurance was an existing policy. We do not sell this product!

### So you think you're going to live forever?

I was feeling quite pleased with myself really, good income stream, no debts and an investment plan that would ensure a good income at aged 65 if I continued to earn and save at my present rate. My recent annual health check revealed that for a 59 year old everything was as and where it should be, if a bit worn. My life insurance policy had a 'major trauma' clause that paid out in the event that I came down with

some terrible illness, and ACC would cover me for accidents, so I had all the bases covered. But did I?

I had an appointment at the hospital in early October 2003 for an irritating but minor complaint and they found a large tumour in my bowel. Such was the location and size of the tumour the treatment would take at least six to eight months and involve two operations and daily radiation and chemotherapy for much of that time.

Because I am self-employed there was no benevolent employer to continue paying me during this time, so I was faced with having to use savings and investments to keep ahead of the household bills and provisional and year-end tax payments. The 'major trauma' cover that I had relied on was not as I had thought. The small print revealed that cover reduced each year from aged 50 until it disappeared at aged 60. I was 59 years and 7 months old, and the \$10 or so I would get from the policy was a bit short of my immediate needs.

I recall ignoring advice several years ago that I needed income protection insurance. "But I am fit and healthy" I reasoned, "I can deal with any short-term illness or accident; income protection is for wimps and hypochondriacs". It just shows you what I know; I had covered almost every eventuality except the one that caught me out.

Now it's eight months on, and I am recovering. I was lucky to have a wonderful wife who helped me through the daily trips to hospital and sat in waiting rooms while surgeons did their stuff. I was also lucky to have a great contract in place, and that I was able to work as and when I could until I recovered. But it still cost me six months earnings.

You cannot predict everything that life is going to throw at you and most of us wouldn't have it any other way, but some things you can guard against and income protection would have closed off that one window that I had left open for the gremlins of life to climb through.

*Roy Hanrahan, Waikanae*



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## Contact

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***Providing quality,  
impartial investment advice with integrity***

# More info?

CONTACT US FOR MORE INFORMATION ON  
A WIDE RANGE OF INVESTMENT SERVICES

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