

Investment mistakes 1

Investment foundations

Investment risk

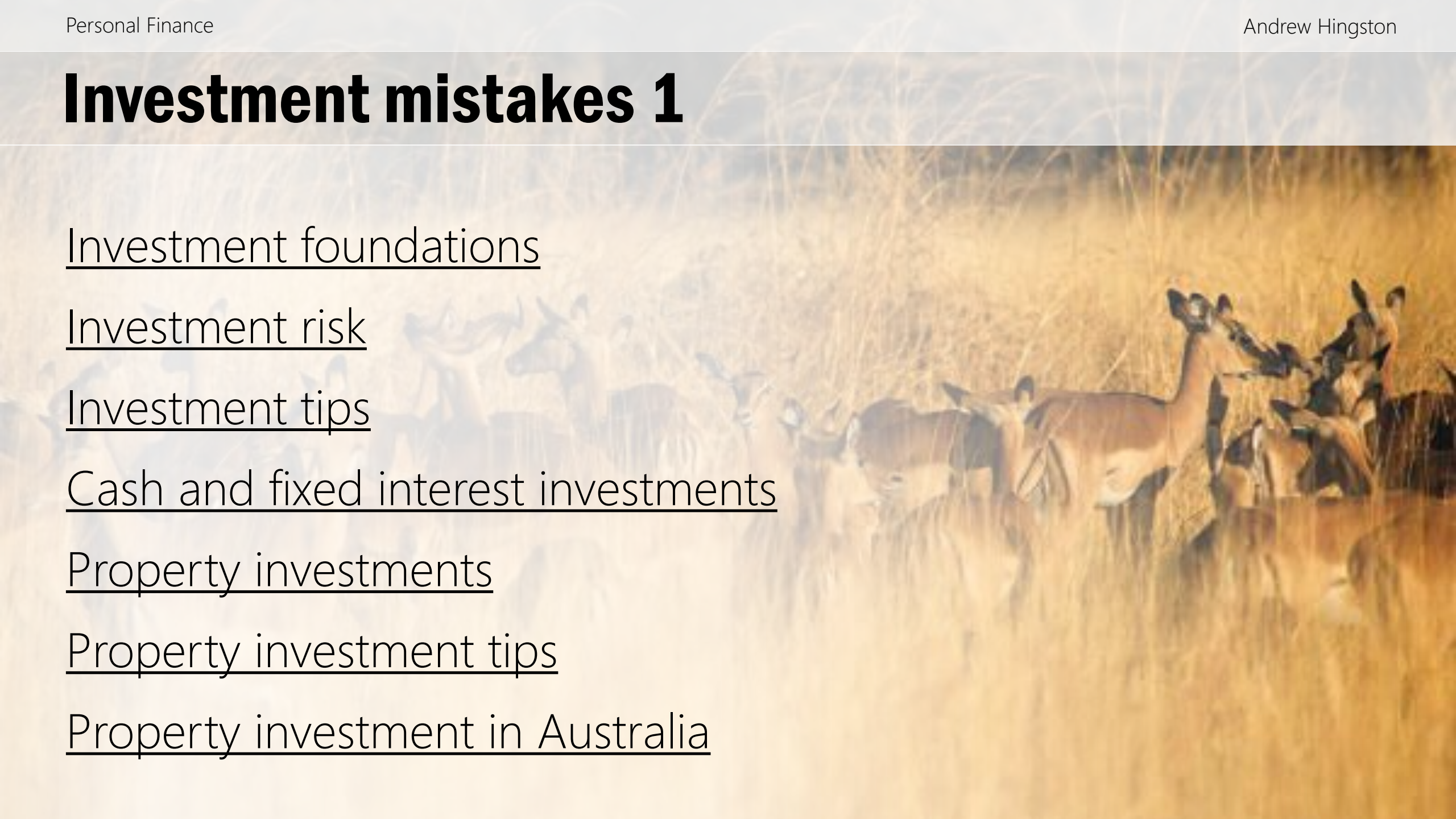
Investment tips

Cash and fixed interest investments

Property investments

Property investment tips

Property investment in Australia

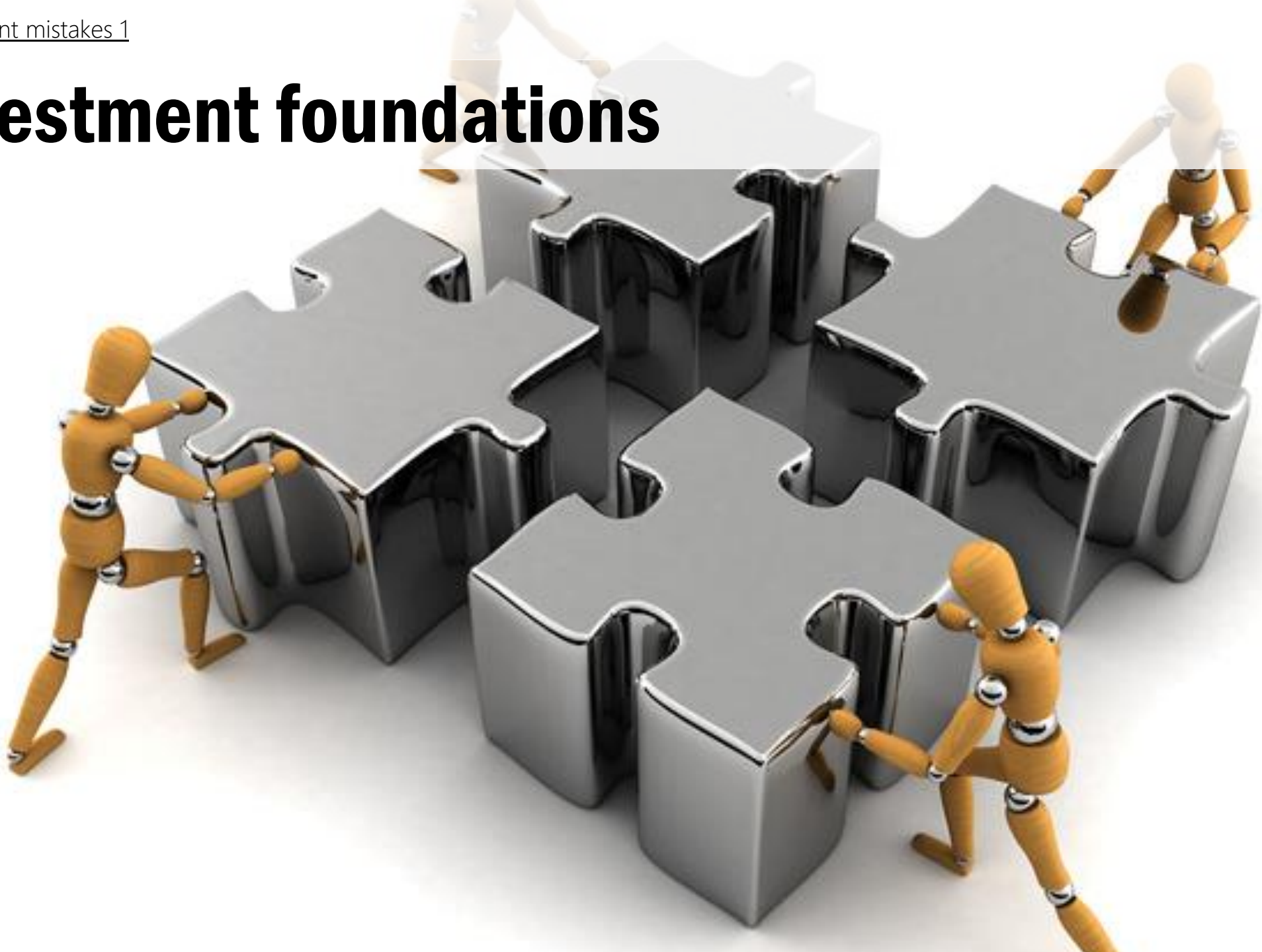


You need to be able to ...

1. **Identify some key investment principles to avoid making stupid investments**
2. **Understand the concept of 'total risk' and how it applies to your investment time horizon**
3. **Explain the logic behind the key investment tips**
4. **Explain the pros and cons of cash and fixed interest investments and when to use them**
5. **Explain the key property investment principles and tips**
6. **Identify property investment issues relevant to your country and local area**



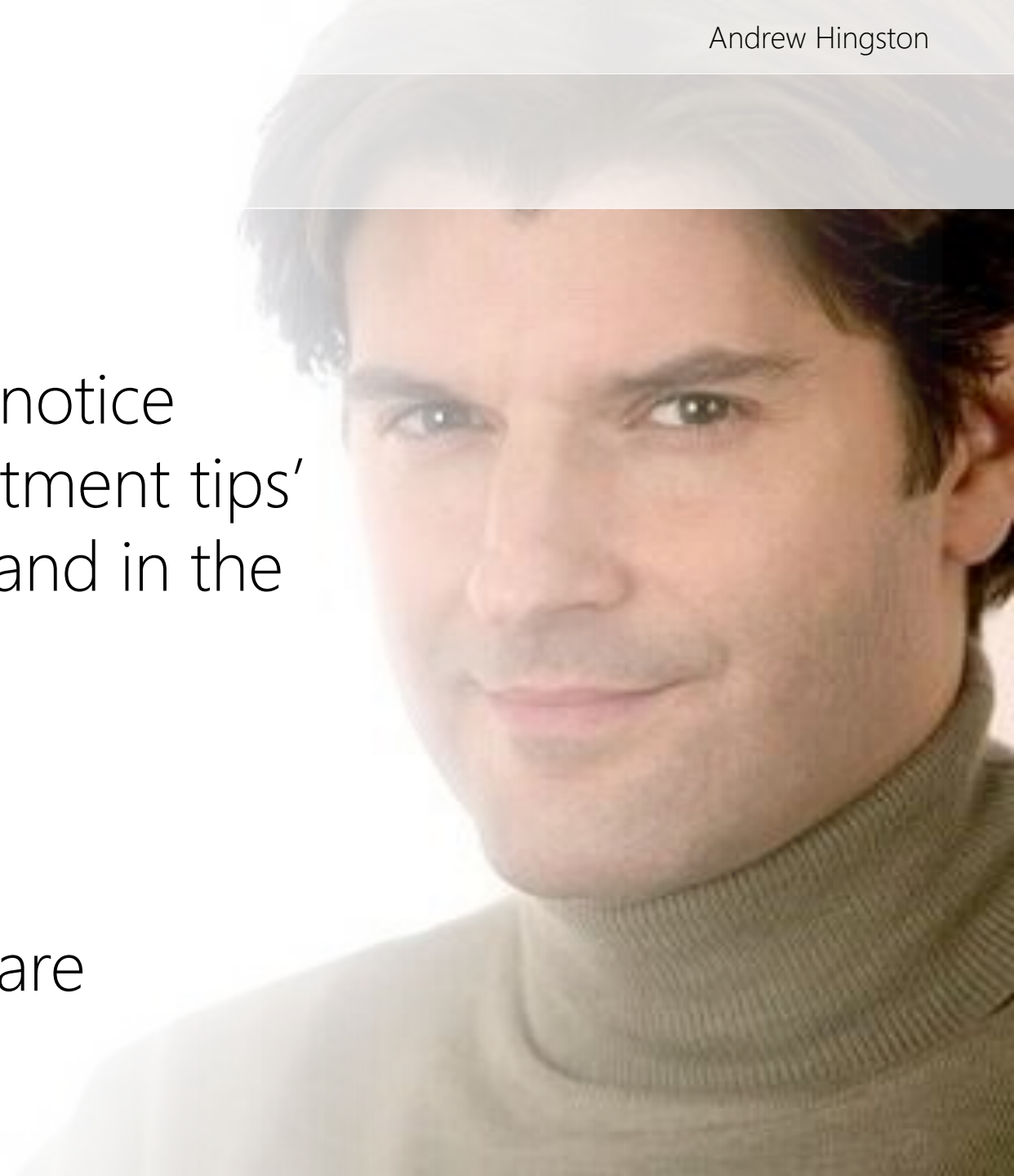
Investment foundations



Think and discuss

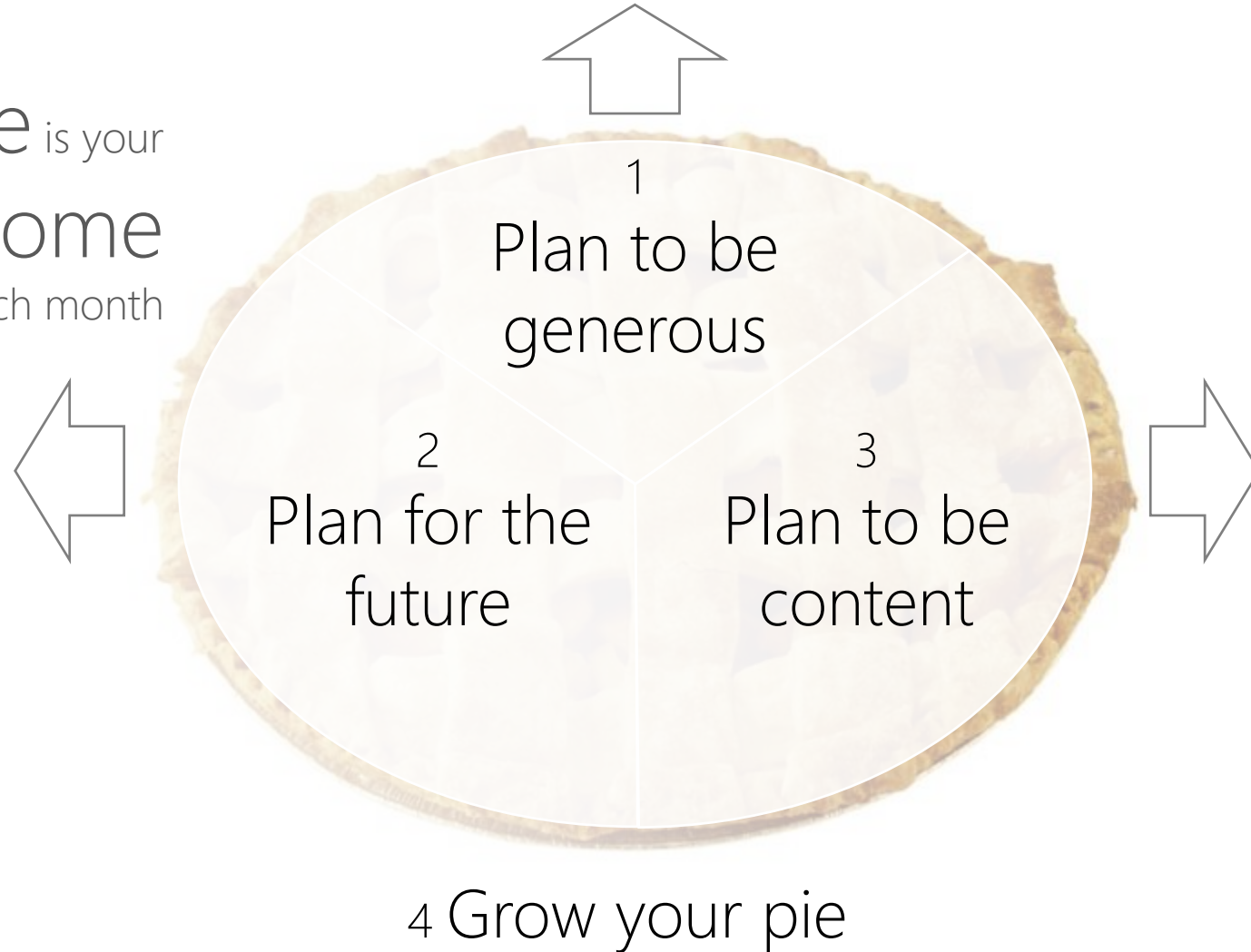
After graduation, you will start to notice a lot more discussion about 'investment tips' in the workplace, at social events and in the media.

What are some things to consider when determining whether these are 'wise' investment tips?

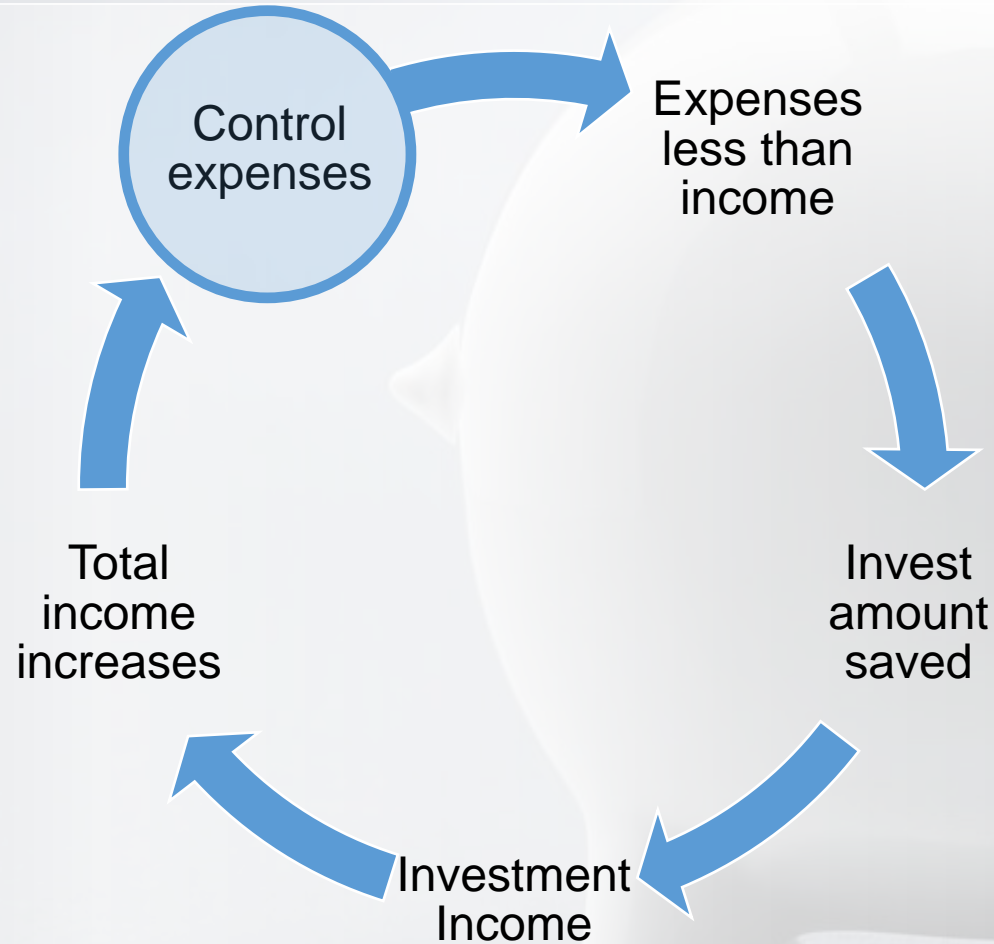


Recap: The pie

Your **pie** is your
total income
each month



Recap: The investment income cycle



Most people never even start on this cycle

Recap: What is the snowball?

It is the **amount saved** each month

Amount saved = Income – Expenses



Long-term wealth management principles

- 1. Consistently 'save to invest' 10% of your income**
- 2. Avoid dumb investment decisions**
- 3. Diversify across multiple financial strategies**

Investment risk



Key types of investment risk

1. Default risk

Chance of losing most or all of your investment (catastrophic loss)

Can be significantly reduced through diversification

2. Total risk (sigma σ)

Uncertainty or volatility of future returns (standard deviation)

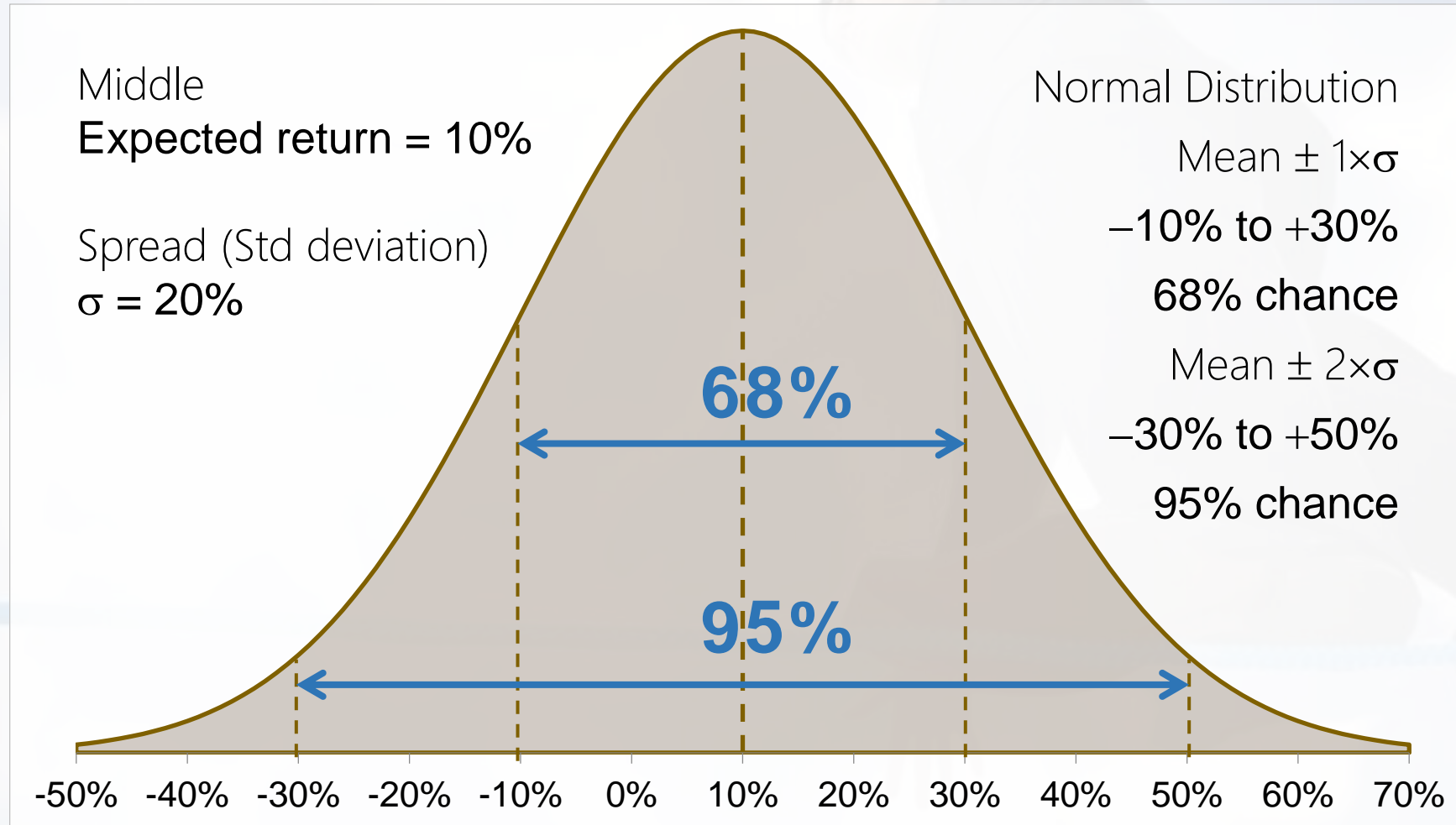
Can be reduced through diversification

3. Systematic risk (beta β)

Sensitivity of investment returns to economic risks

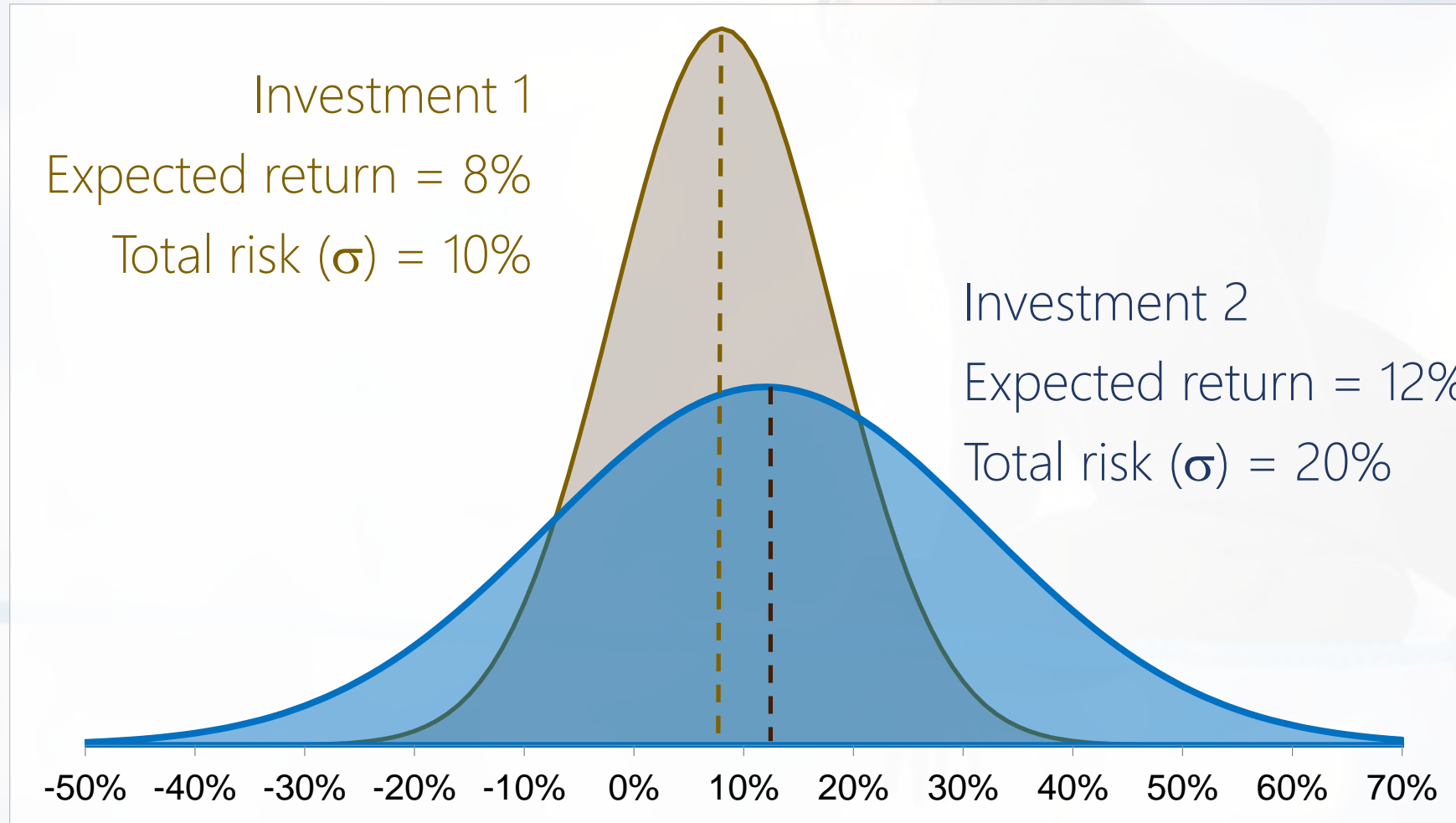
Difficult to reduce through diversification

Visualising total risk using probability



Note that most investments don't follow a normal distribution (the tails are much fatter)

Two investments with different total risk



Note that most investments don't follow a normal distribution (the tails are much fatter)

What drives investment returns in the long-run?

It makes sense to reduce total risk for a target expected return

... according to the logic of the Capital Asset Pricing Model (not covered here) ...

- 1. Higher total risk does not necessarily increase expected returns**
- 2. Higher systematic risk does increase expected returns**
- 3. Higher systematic risk often involves higher total risk (not always)**
- 4. A better economy does increase expected returns**
- 5. Higher interest rates do increase expected returns**

So the more sensitive the returns for a particular investment to movements in the economy ... and the better the expected performance of the economy ... the higher the expected return over the long run.

Some important implications

1. It makes sense to diversify to reduce risk if there is no significant difference to expected long-term returns
2. Higher expected long-term returns usually does require selecting investments with higher total and systematic risk
3. The economy has a major impact on long-term returns
4. The sensitivity of an investment's returns to the economy has a major impact on long-term returns
5. Total risk might not matter in the long-term if the returns in one year are unrelated to the returns in the next year

Investment tips



Tip 1: Save to invest

Save 10% of your income and never plan to spend it

Kicks of the 'investment income cycle'

The most reliable driver of wealth for your first 20 years

Investment returns tend to be more important after first 20 years

Too many people focus on fancy investment strategies

... but neglect the basic strategy of saving!



Tip 2: Invest in what you understand

Sophisticated investors avoid investments they don't understand

For example, Warren Buffett (founder of Berkshire Hathaway)

Avoid complexity

Increase your knowledge over time

Read good books and avoid 'get rich quick' books or courses

Understand clearly how the investment generates profit

Understand the likely outcomes in possible future scenarios (risks)

Understand what events would trigger catastrophic loss

Tip 3: Go with mainstream assets

1. **Cash (savings accounts)**
2. **Fixed interest (term deposits or CDs)**
3. **Residential property (apartment or house)**
4. **Commercial property (shops, office space, tourism)**
5. **Shares in companies in your own country**
6. **Shares in companies in other countries**

Avoid exotic investments

Start-ups, Hedge funds, Agriculture, Films, Foreign Exchange, Timeshare, CFDs, Derivatives ...

Avoid promotional gimmicks and high-pressure sales

Tip 4: Understand the risks

1. Default risk

Chance of losing most or all of your investment (catastrophic loss)

2. Total risk (sigma)

Uncertainty or volatility of future returns (standard deviation)

3. Systematic risk (beta)

Sensitivity of investment returns to economic risks

Higher expected return usually requires higher risk

Higher risk not necessarily a problem if the investments are good quality, diversified and you invest for the long term (5+ years)

Tip 5: Diversify

1. Diversify across quality investments

If you invest in shares ... don't invest in just one company!

2. Diversify across mainstream investment categories

Split your investments across cash, fixed interest, property and shares

3. Diversify wealth creation strategies

Your ability to generate income, Own home, Other Investments, Retirement savings and Own business (but not all and not at the same time)

Tip 6: Diversify over time

For a diversified portfolio of quality investments ...

... the returns in one year

... are usually unrelated to returns in the next year

This reduces total risk over the long-term

Returns should converge on the long-term average

Also a trick called ‘dollar cost averaging’

If you are investing a large amount into a high risk investment then you can decrease your total risk by splitting your investment over a few different years.

Tip 7: Invest based on investment time horizon

Investment time horizon is how many years it will be until you need access to your funds to spend or make other investments

Short-term (0 to 1 year)

Low risk investments to protect the value of the investment

Cash and some secure fixed interest

Medium-term (1 to 5 years)

Moderate risk investments to protect value while achieving a moderate return

Fixed interest and some low risk, diversified commercial property

Long-term (5+ years)

Higher risk investments with higher expected long-term returns

A diversified portfolio of quality shares, commercial and residential property

Use time to reduce total risk ... very bad years balanced out by very good years

Tip 8: Avoid speculation

Speculation involves making money by trying to ‘pick stocks’ or ‘time the market’

This is not investing ... it is gambling

Speculators think they are clever

But most lose in long-term and are stupid

Transaction fees and behavioural biases

Focus on building wealth by:

Save to invest

Diversifying across quality investments

Investing for the long-term

Tip 9: Build your knowledge and experience

Avoid books or courses that focus on:

Getting rich quick

Making money through speculation

Read general books on personal finance and investment

Read specialist books specific mainstream investments

Read ‘money’ columns on quality media and websites

Avoid anyone trying to ‘sell’ you a system

Avoid expensive non-university investment ‘courses’

Supplement your knowledge with professional advice

... but avoid advisers who ‘sell products’ for commissions

Tip 10: Take action

Sometimes taking no action

... is worse than randomly choosing a good investment

Many people get 'choice anxiety' ... and do nothing.

- 1. Start small and invest regularly**
- 2. Stick with quality, diversified mainstream investments**
- 3. Stick with large and trusted financial institutions**
- 4. Don't try to make the 'best' choice ... avoid 'bad' ones**

Cash and fixed interest investments



Think and discuss

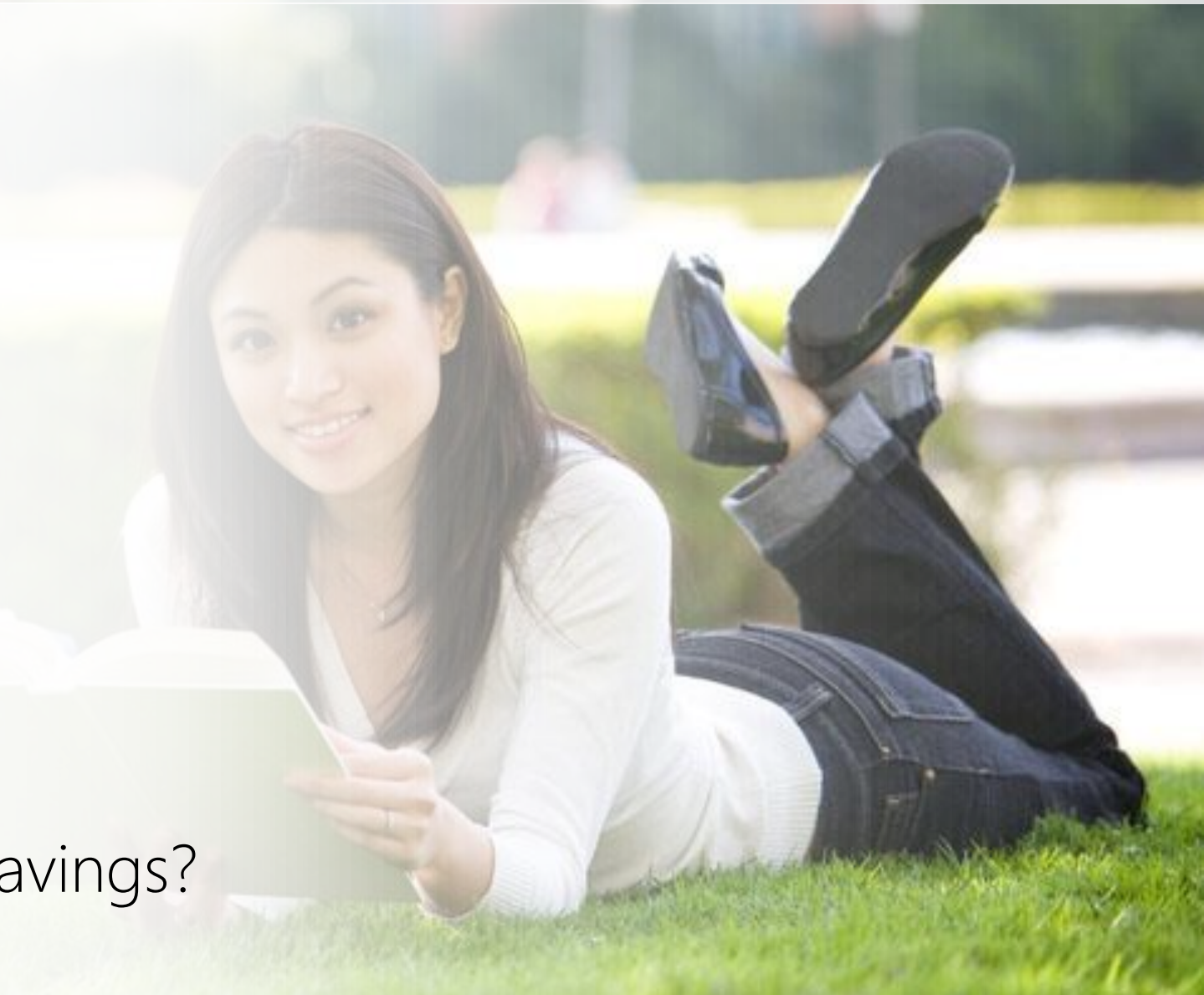
Mary has \$20,000 in savings

She plans to spend \$10,000 in one year when she buys a second-hand car.

She plans to spend \$1,000 in two months on a holiday

She wants to save the rest for when she plans on buying a house in 5-7 years time

Where should she invest her savings?



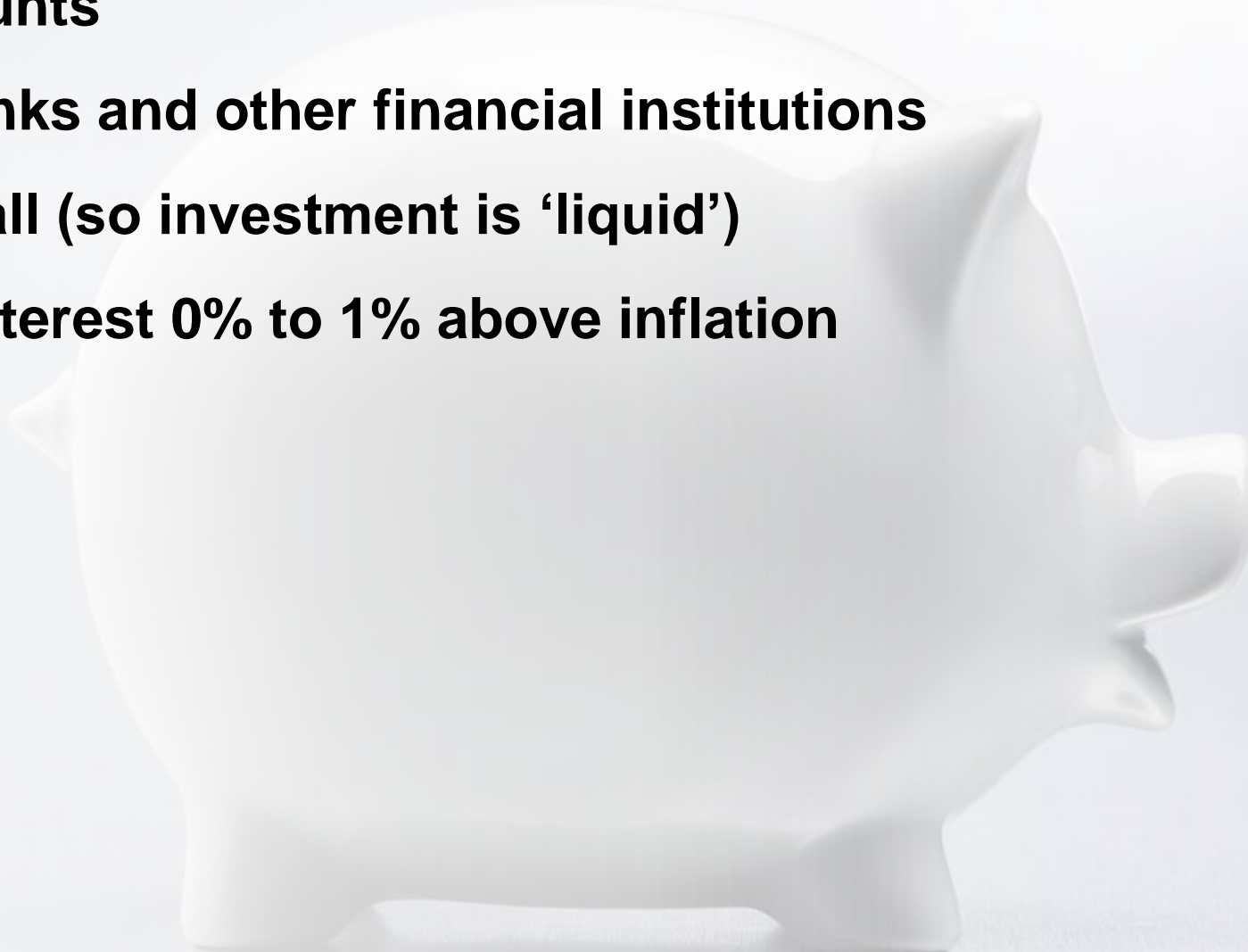
What are cash investments?

Savings accounts

Offered by banks and other financial institutions

Money is at-call (so investment is 'liquid')

Usually pay interest 0% to 1% above inflation



Cash investments ... the good and the bad

The Good

Low uncertainty (risk)

Unlikely to fall in value

Can withdraw easily (liquid)

Good for short-term savings (0-1 year)

The Bad

Low expected return

Inflation can erode your investment

Returns often fully taxed

Bad for long-term savings (5-10 years)



What are fixed interest investments?

Pay a fixed interest rate (or coupon rate)

Mature on a particular date (often 1 to 5 years)

Usually pay 1% to 2% above inflation (higher than cash)

Issued by banks, governments and companies

The issuer may default (and not make payments)

You may lose money if sold before maturity

Examples

**Term Deposits, Certificates of Deposit (CDs), Government bonds,
Corporate Bonds, Debentures, Unsecured Notes**

'Fixed interest' component of mutual fund investments

Fixed interest ... the good and the bad

The Good

Low uncertainty (risk)

Higher expected return than cash

Low chance of losing original investment (depends on issuer)

Good for medium-term savings (1-5 years)

The Bad

Low expected return

Inflation can erode your investment

Can fall in value if you exit or sell before maturity

Returns often fully taxed

Bad for long-term savings (5+ years)

Beware!

Beware of lending to commercial property companies

Nice and 'stable' sounding names

Advertise in popular newspapers and media

'Promise' a high return

The return is guaranteed*

* You are a sucker if you believe the guarantee

Property companies cannot repay when interest rates rise and commercial property prices fall

You may loose everything!

Property investments



Think and discuss

Do you think buying an investment property is higher or lower risk than buying shares in 20 top companies listed on the stock exchange?



Residential property isn't the only option

Residential properties

**Apartment, Townhouse,
Duplex or House**

High availability

Quite low starting prices

Often easy to buy

Requires less experience

Lower rental yield

**Prices influenced by
residential factors**

Commercial properties

**Shops, Office space or
Tourism**

Lower availability

High starting prices

More difficult to buy

Requires more experience

Higher rental yield

**Prices influenced by
commercial factors**

Residential property returns

Return = price growth + gross rental yield – costs

If price increases 5%, gross rental yield is 4% and costs are 1% = 8%

Price growth usually averages 4% to 6% per year

Often irrational in short-term due to speculation

Driven by supply of new homes and overall demand

Price growth should be linked to income growth in long-term

Gross rental yield usually 3% to 5% per year

Gross rental yield = total rent collected per year ÷ price of property

Driven by supply and demand of rental properties

Often falls during period of strong price growth

Costs usually 1% to 2% per year

Maintenance, agent fees, strata management fees, land tax etc.

8 reasons they aren't as good as they appear

1. People underestimate the effects of compounding

If property doubles in price over 10 years this is only 7% per year

2. Average quality of housing improves

3. Average size of houses may have increased

4. Fail to take into account costs of renovations

5. Fail to take into account other costs

6. Often reported over a 'favourable' period of time

7. Fail to take into account inflation

8. Fail to make fair comparisons to other investments

Micro-markets

Prices increase at different rates in different suburbs

Determined by supply and demand factors in that area

“Gentrification” is one factor that affects demand:

When middle class move into areas that were previously lower socio-economic in nature.

Developers buy properties and develop

Middle-class renovate their units/homes

Council spends more money in area.

If areas have large amounts of land being developed then supply will increase and prices may not

Property investment tips



Some traditional tips on location

The golden rule is “location ... location ... location!”

Close to the city centre

Where gentrification is happening or will happen soon

Is aesthetically pleasing or has the potential to be so

Has a unique or rare positive characteristic

Scarcity strengthens your negotiating position when selling

But these tips are old and everyone knows them!

My tips on location

Consider both supply and demand of properties

Supply determined by new land releases, developments and also people “willing” to sell their property.

Demand determined by whether people want to live there!

If supply is low and demand is increasing then prices will rise more quickly (eg. Inner city and trendy areas)

If the supply is growing and demand is increasing then prices will only rise slowly. (eg. City outskirts)

Remember the population is aging

The average age is increasing over time

So the most likely buyer of an investment property from you in 10 years will be an older person

Think about who you will sell the property to in 10 years when you buy it now

Older people prefer:

Single level, good quality, smaller dwellings

Good access to transport and health services

Low maintenance (small gardens)

Clean, quiet and safe.

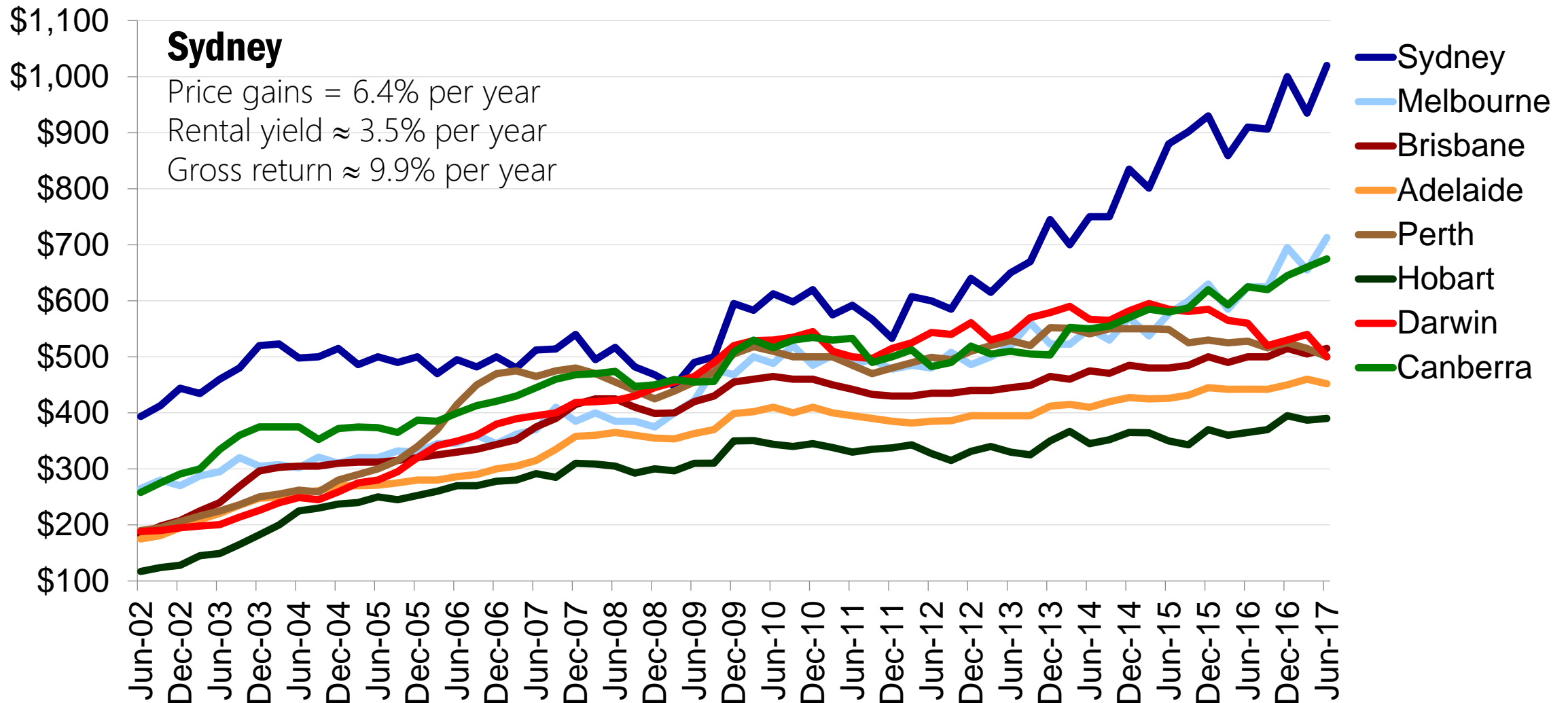
Remember the disadvantages of property

- 1. High costs when buying, owning and selling**
- 2. High entry price in many cities**
- 3. Property prices can fall (sharply)**
- 4. You may be a property with significant problems**
- 5. Properties can develop problems over time**
- 6. Difficult to diversify property investment**
- 7. Properties are not usually 'divisible' assets**
- 8. Risk and return is often inferior to a quality diversified portfolio of shares over long-term**

Property investment in Australia



Median house prices in Australia (\$,000s)



Tax on property returns in Australia

Get an accountant

The ATO is auditing a lot of property investors!

Rent income is assessable income

Interest on investment loan is an allowable deduction

Note that repayments of principal are not an allowable deduction

Other allowable deductions:

Depreciation on the cost of the building

Depreciation on furniture and fittings

Price gains (capital gains) assessable income when you sell property but with 50% discount if held more than 1 year

Land tax in New South Wales

Levied on owners of investment properties in NSW

Principal place of residence is generally exempt if you have dwelled in it for the whole year.

Except if owned by trust or company

Based on assessed value of “land”

Which is usually less than the value of land + building.

Land tax free threshold \$482,000 (2016)

Starts at 1.6% + \$100 of combined land value above threshold

Common strategy is to hold one property in each state

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