Andrew Hingston

# 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

Andrew Hingston

# Investment foundations

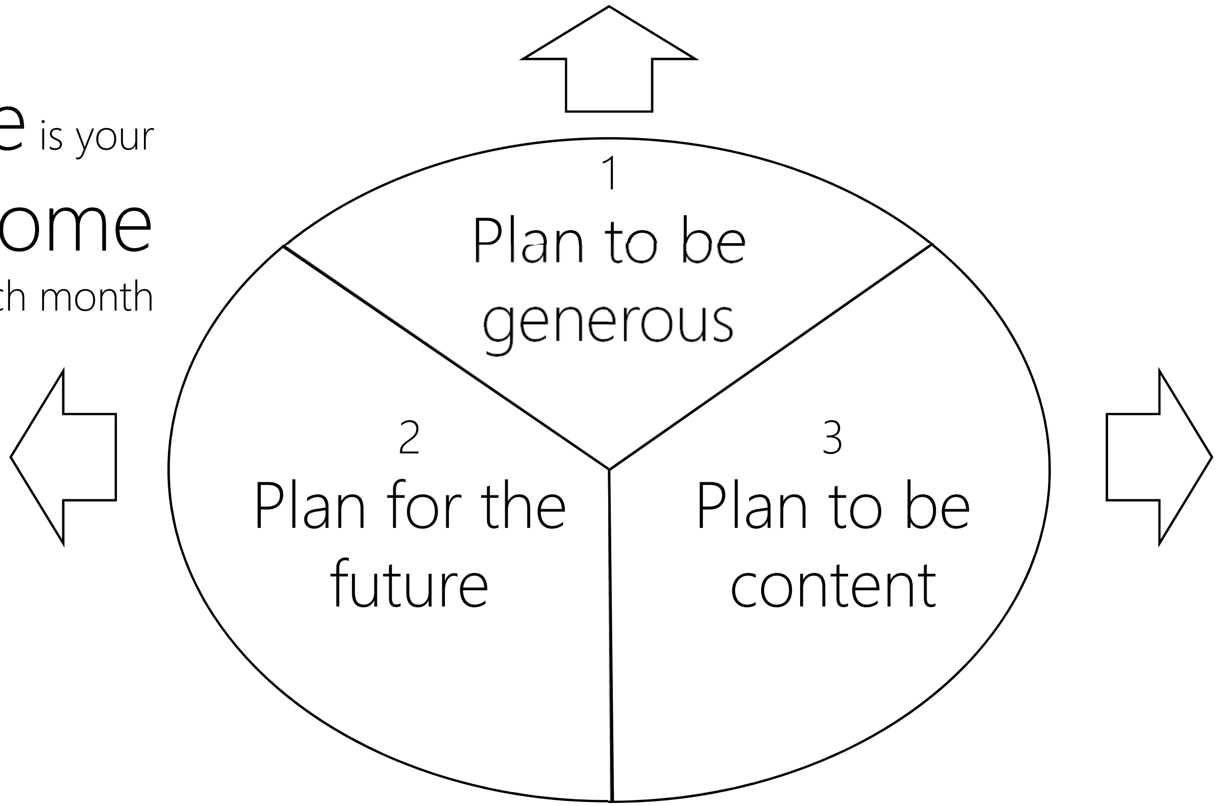
# Think and discuss

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?

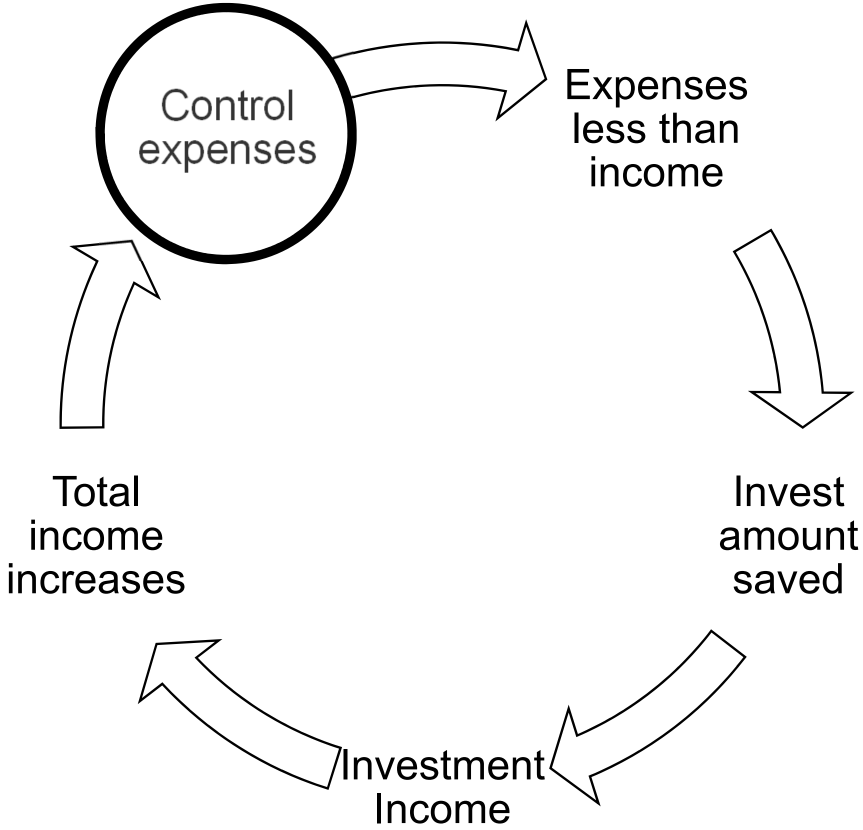
# Recap: The pie

Your pie is your
total income
each month




4 Grow your pie

# 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

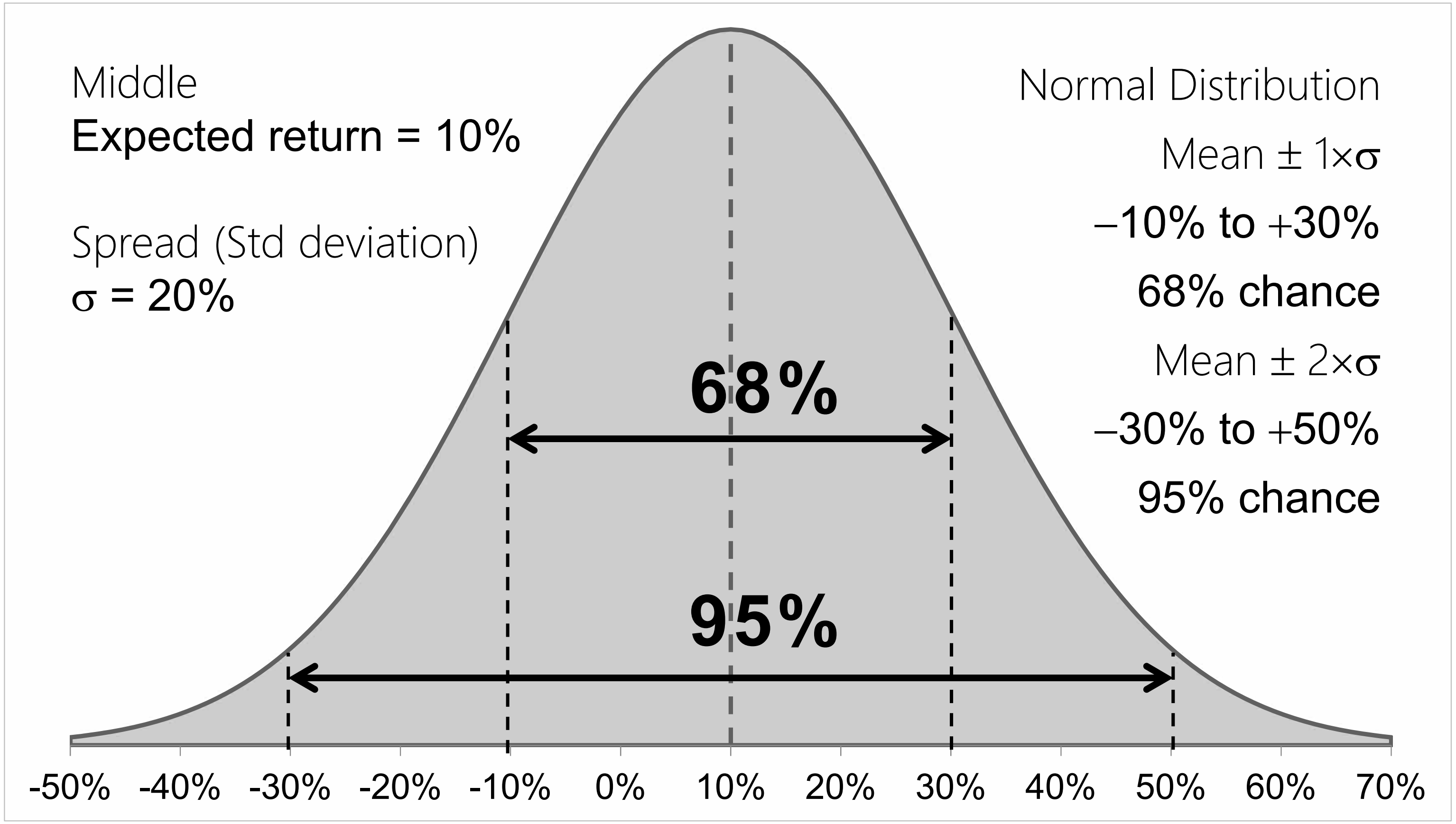
1. **Consistently ‘save to invest’ 10% of your income**
2. **Avoid dumb investment decisions**
3. **Diversify across multiple financial strategies**

# Investment risk

# Key types of investment risk

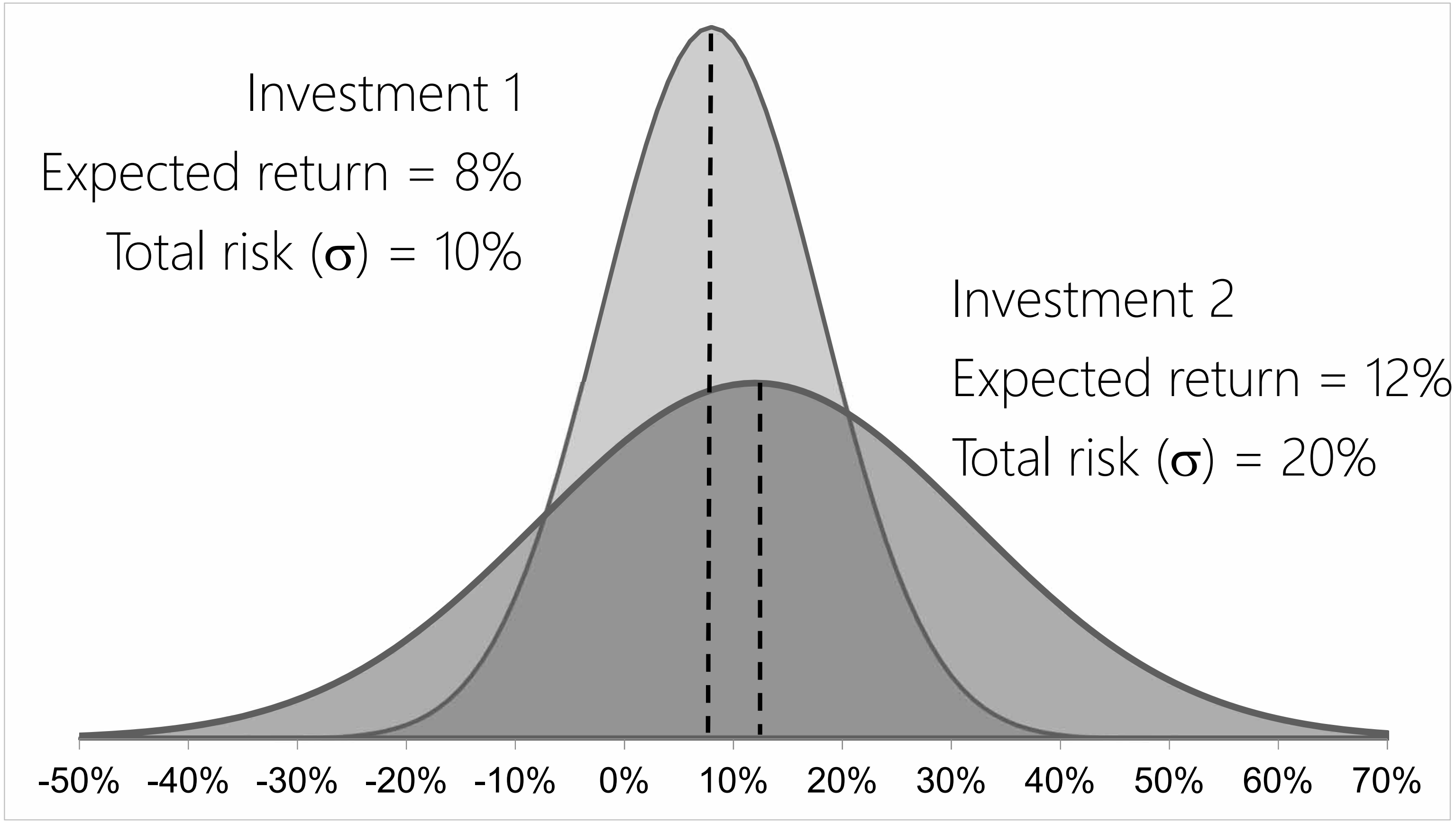
1. **Default risk**
   - **Chance of losing most or all of your investment (catastrophic loss)**
   - **Can be significantly reduced through diversification**
2. **Total risk (sigma σ)**
   - **Uncertainty or volatility of future returns (standard deviation)**
   - **Can be reduced through diversification**
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 <u>not</u> necessarily increase expected returns**
2. **Higher systematic risk <u>does</u> increase expected returns**
3. **Higher systematic risk <u>often</u> involves higher total risk (not always)**
4. **A better economy <u>does</u> increase expected returns**
5. **Higher interest rates <u>do</u> 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 <u>not</u> all and <u>not</u> 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 <u>not</u> 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!**

 Andrew Hingston

# 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 | Commercial properties |
| --- | --- |
| Apartment, Townhouse, Duplex or House | Shops, Office space or Tourism |
| High availability | Lower availability |
| Quite low starting prices | High starting prices |
| Often easy to buy | More difficult to buy |
| Requires less experience | Requires more experience |
| Lower rental yield | Higher rental yield |
| Prices influenced by residential factors | 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

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# 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

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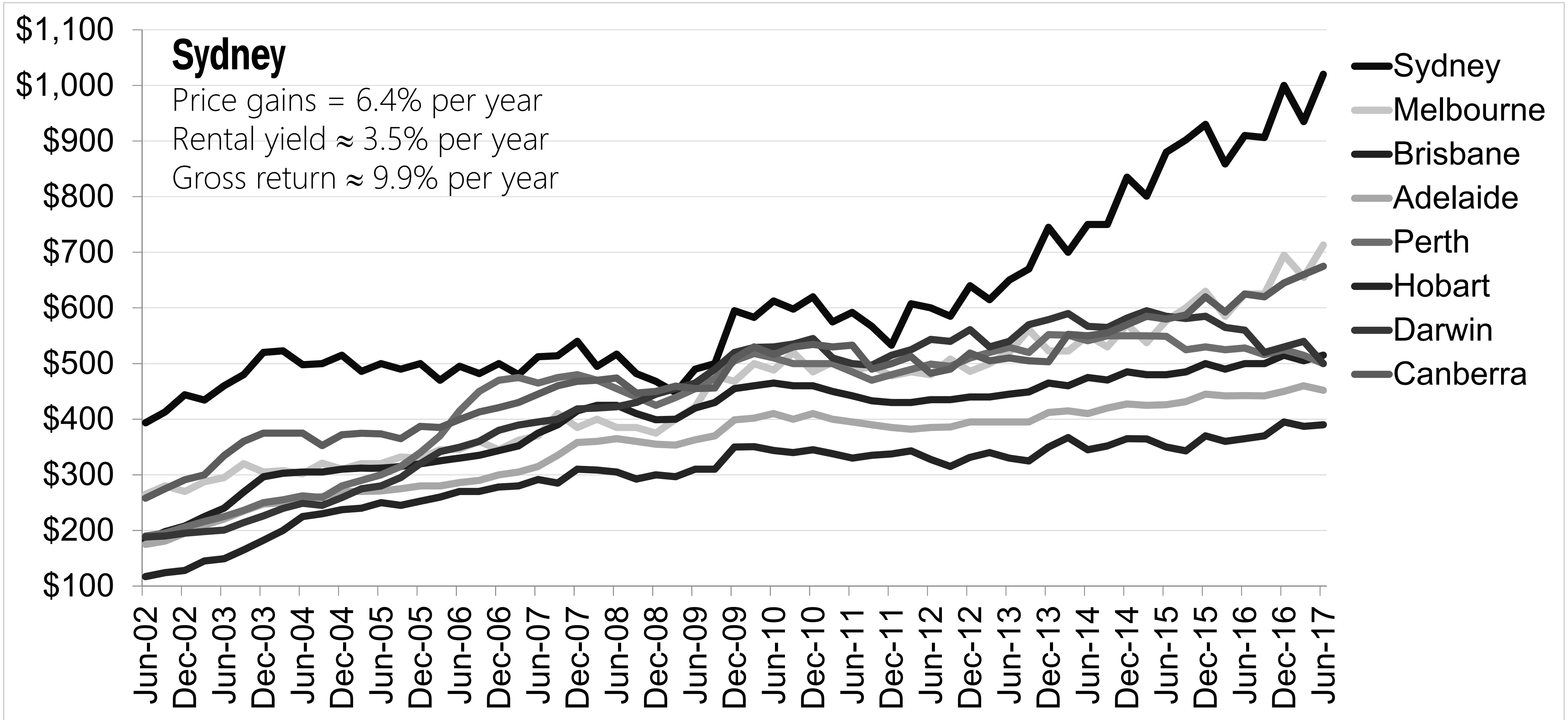
# Property investment in Australia

# 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 <u>not</u> 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

# You need to be able to ...

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