HOLM TRUTHS

Down to earth advice for savers and investors from independent investment commentator Mary Holm

WINTER 2004

3rd Big Question: When?

You've got four weeks' holiday in the year, and your boss wants you to choose your holiday dates.

Should you take all four weeks at the start of the year? Or take the lot later, when you might really need a long break? Or would you get more out of it if you spread the breaks, with four one-week holidays throughout the year?

Similar options can arise with money. Let's say you're lucky enough to receive a lump sum – perhaps an inheritance, redundancy payment, excess from moving to a cheaper house, a decision to move out of an investment, or even a lottery win. You face a series of decisions:

- Spend it or save it?
- If you save at least some of it, where do you invest?
- When do you invest?

We'll assume that you save some or all of it, realising this is a big chance to get ahead.

We'll also assume that you've decided to put the money into one or more of: shares, bonds, or a managed fund that invests in shares and/or property and/or bonds.

With all of these investments, values fluctuate. (The value of bonds fluctuates with interest rates. If rates rise to 7%, bonds paying 5% are worth less if you sell before maturity. But if rates fall to 3%, bonds paying 5% are attractive, and their price rises.)

Whenever values fluctuate, the timing of your investment will affect how well you do. So when should you make your move – now, later, or in instalments?

* **Now** has obvious merits. You've made your decision, so get on with it. The sooner you're in the investment, the sooner you can make returns that, on average, should be better than leaving the money in the bank.

The trouble is that you never know when a market might suddenly fall. As people who invested in world shares around 2000 discovered, it's really discouraging if your investment loses value before it has gained any ground.

Test yourself. Picture the value of your investment dropping by a quarter, or even half, in the first year or two. Would you hang in there, knowing that – as long as you're diversified – it will almost certainly regain the losses and grow healthily over the long term? Or would you lose heart and bail out?

If you would do the latter, it's not a good idea to invest all your money at once.

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THE DAY YOU BUY

For long-term investments, when you buy doesn't make as much difference as you might think.

Let's look at what would have happened if you had invested in the NZ share market during each of the last 30 years, ending December 2003.

In the first year you invested $600, but that amount grew by inflation over the period, so that in 2003 it was close to $5,000.

We'll assume (because of the data we've got) that you always invested on the last day of a month – in other words, each year you had 12 days on which you could invest. We'll also assume that you reinvested all dividends. No allowance is made for tax.

Scenario 1: *You were extraordinarily lucky. Each year, you invested all your money on the day when share prices were at their lowest. Over the 30 years, you would have accumulated $403,000.*

Scenario 2: *You were extraordinarily **un**lucky. Each year, you invested on the day when share prices were at their highest. You would have accumulated $317,000. That's not as big a difference as most people expect, according to surveys.*

Scenario 3: *You simply invested 1/12 of your money on each of the 12 days. You would have accumulated $356,000 – a happy medium.*

*** Later** can be justified only if you think prices will fall, or interest rates will rise. Such timing of markets is tricky stuff. Even the experts frequently get it wrong. While you wait – quite likely earning less in a bank in the meantime – the markets might well turn against you rather than for you. Generally, trying to time markets is not a wise course.

The one possible exception is when a market has been going through an extraordinary growth period. Booms never last, and are quite often followed by rapid price falls.

So if you think an investment bubble is about to burst, you might stay on the sidelines for a while. Note, though, that it's extraordinarily difficult to pick the time a boom will end.

Let's say the market index in your planned investment has grown rapidly from 1000 to 1500, and you decide to wait until it falls.

In the meantime, it might continue to grow to 2000, before falling to 1700. Despite the fall, you would have been better off getting in at 1500.

*** With instalments,** you can avoid the worries of bad timing.

Investing by instalment is particularly attractive during boom markets. But even when markets are stable, many people favour it. You might invest a third of your money now, a third in three or six months, and a third in six or twelve months. If you're dealing with a large sum, you might get fancier, and invest, say, 10% a month. Just as diversifying over a wide range of investments lowers your risk, so does diversifying over a range of entry times.

It's not advisable to stretch the process over more than a couple of years, though. Not only is the uninvested balance missing out on a probable higher return, but there's also a psychological factor: Make your move and get on with life!

It's a good idea, too, to be pretty disciplined about when you make the instalments.

To help with this, you might put the uninvested money into bank term deposits that mature at the times you want to invest.

NOT SUCH A GOOD DEAL

Does dollar cost averaging apply when you invest a lump sum by instalment?

Firstly, what is dollar cost averaging? It occurs when you regularly put the same amount into an investment that fluctuates in value.

In a simple example, you invest $1,200 a month into a share fund. For six months of the year, the units cost $12 each. So you get 100 units a month, or 600 units in six months. In the other six months, units are only $8 each. You get 150 units a month, or 900 units in six months.

The average price over the year is $10, and you've bought a total of 1,500 units.

You would expect, then, to have paid $15,000. In fact, though, $1,200 a month comes to only $14,400.

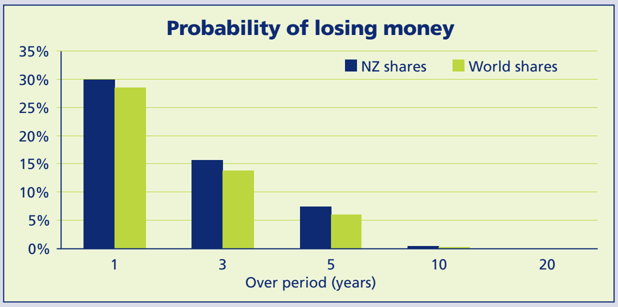
The saving comes because you bought more units when they were cheaper. And the more volatile the investment, the bigger the savings.

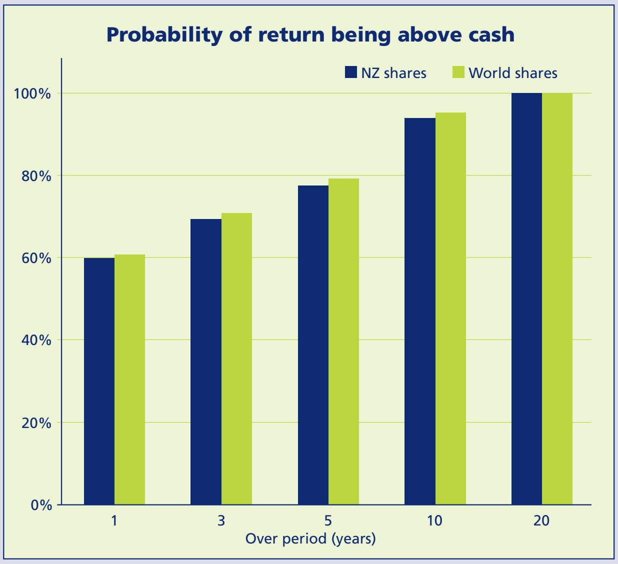
Dollar cost averaging works well for regular savers. But does it work when drip feeding a lump sum into an investment?

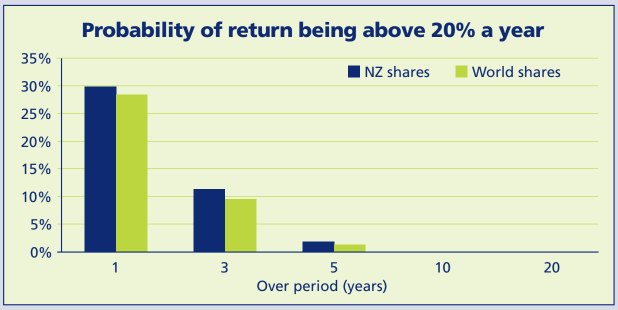
Yes. But there's a downside. You'll be holding back some of the money, probably in a bank account, which will usually pay you a lower return than the investment.

In some cases, that will cancel out the gains from dollar cost averaging. It all depends on the volatility of the investment and the size of the difference in returns.

> ***October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.***
>
> Mark Twain



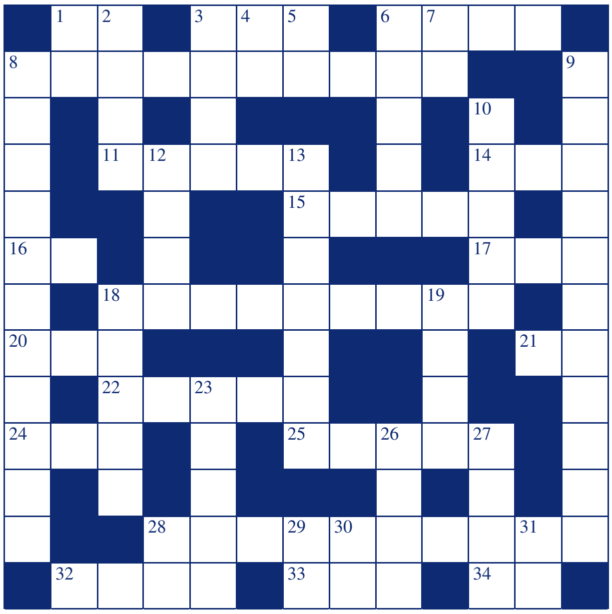




MANY SHARES OVER MANY YEARS

Just as holding many different shares lowers your risk, so does holding shares over many different years. There's a cost to this, though. The best years are watered down by poorer performances. As our bottom graph shows, if you invest in shares for just one year, you have a higher chance of making a really big annual return than if you invest over many years. But, as the top graph shows, you also have a higher chance of coming a cropper. You're better off to invest over the long term, when you can be almost certain to do better than if you invested in cash.

(Probabilities are based on what's happened over the last three economic cycles – about 20 years.
We assume future gross returns of 10% on shares and 5.25% on cash.)



Solution: Back page

HOLM TRUTHS CROSSWORD WINTER 2004

ACROSS
1. Belonging to (2)
3. Cry (3)
6. Series of questions (4)
8. Super spot, C! (anagram) (10)
11. Used to light fire (5)
14. Of us (3)
15. Sea (5)
16. Not off (2)
17. Finish (3)
18. Ease of trading (9)
20. Cow talk (3)
21. Not down (2)
22. Shade of brown (5)
24. Born (3)
25. Return on investment (5)
28. Partial payment (10)
32. Exam (4)
33. Donkey (3)
34. Perform, carry out (2)

DOWN
1. Alternatively (2)
2. Froth (4)
3. Dot (4)
4. Time abroad (abbrev) (2)
5. Before Year 0 (abbrev) (2)
6. Cite a writer (5)
7. Biggest share market (abbrev) (2)
8. A show or production (11)
9. Bank investment (4,7)
10. Cash (5)
12. Against (4)
13. Vacation (7)
18. Roles (anagram) (5)
19. Work (4)
23. Flower, tree etc (5)
26. Long fishes (4)
27. An act (4)
28. Exists (2)
29. Thanks in the nursery (2)
30. Since, when (2)
31. Negative answer (2)

From the Mailbox

Dear Mary:

I have about $35,000 that I have set aside to replace my car. I want to invest it in a reasonably accessible manner until that day arrives, which could be anything from next week to several years away. The obvious choice is a term deposit.

My first question is, how much risk to take to achieve a higher return than on a term deposit?

To date I have been favouring organisations that offer secured first ranked debentures, and have a G5 rating or better, and I look at terms of no longer than two years.

They generally are offering interest rates a good 2% better than the banks. Is this a reasonable low-ish risk strategy?

And is it worth chopping and changing organisations to get an extra 0.5% or 0.75% return?

For example, the money is about to mature with one company that is offering 7.25% for two years (easy to roll over), but another is offering 8%.

If I take the interest rates and cut off a third for tax (e.g. 8% becomes 5.36% net return), there is a $350 difference in the two returns over two years.

However, there is the hassle in having the money returned, filling out the new prospectus form, sending off the cheque etc. in order to change. Is it worth it and I'm just being lazy, or in the scheme of things does it not really matter?

- **The higher the interest paid, the higher the risk.**
- **If you take on risk, spread your money around.**
- **How easy is it to get your money out early?**

Dear Reader:

Firstly, good on you for saving for your car. Too many people don't, and when their old car gives up and they need a new one in a hurry, they have to borrow.

It's far better to be earning interest on your savings than to be paying interest on a car loan.

How much riskier is an outfit that offers higher interest than a bank? Certainly, somewhat.

Everybody, including finance companies, wants to get things as cheaply as possible.

A company that pays 7.25% is doing so only because it has to. It's found that investors will take on the extra risk only if they are offered a premium above bank rates.

For the company that pays 8%, investors have decided the risk is higher still.

This oversimplifies things a bit. The second company may not, in fact, be riskier, but may just want to raise more money faster. Generally speaking, though, the higher the return, the riskier the company.

And several experts reckon that, in New Zealand, the premium above bank rates is often not enough to compensate for the extra risk. Too many investors just don't understand risk levels.

So how can Joe and Joanne Blow tell just how risky these companies are? Not by looking for words like "secure". As one expert says, "Secure just means that it's a little safer than a promise of fresh air."

The G5 rating you mention is from a free New Zealand service called Grosvenor BondWatch. On www.bondwatch.co.nz, it lists ratings for many finance company securities.

G1 is the safest. The highest number, G8, is "for sophisticated investors only." A rating of G5 means "Adequate ability to meet current obligations, but uncertainty about levels of security over the longer term, particularly under adverse business conditions."

The "longer term" is not defined. A two-year investment might be fairly safe, but maybe not.

Keep in mind, too, that Grosvenor uses only the information available in prospectuses and investment statements. Unlike international rating services Standard & Poors and Moodys, it doesn't investigate beyond those documents. What if the finance company is lying?

(CONTINUED PAGE 4)

LADDER TO SUCCESS

A good way to set up your fixed interest savings is what is sometimes called laddering.

Say you're investing for the long term, and you decide on five-year deposits or bonds because, in most market conditions, you can earn higher interest over five years than over shorter terms.

It's best, however, to start out with varied terms, investing a fifth of the money for just one year, a fifth for two years, and so on, with the last fifth maturing after five years.

As each investment falls due, reinvest it for five more years, so it leapfrogs over the other four fifths.

There are two big advantages of laddering:

- ***You minimise interest rate risk.** If there's a period of higher-than-usual interest rates, at least some of your money will fall due at the right time and benefit from that.*
- ***Liquidity.** At any given time, some of your money will be less than a year away from its maturity date, should you unexpectedly need it in a hurry.*

(FROM THE MAILBOX, CONTINUED)

Beyond that, some financial experts have criticised Grosvenor's conclusions from the data it *does* use.

I still think the service has value. I would at least avoid any securities with a high BondWatch rating. But a low rating is no guarantee of safety. And G5 is only middling.

Having said all that, if you insist on riskier securities, at least spread your money over, say, five different companies. If one or two default, you could still buy a cheaper car.

The only trouble with spreading your money around is that it's a bit of hassle, as you say. Perhaps you can be persuaded, though, by the risk reduction. Is a few hours now worth it, to avoid possible sleepless nights later?

One more point, and it's an important one. You might need the money next week. With term deposits you can invest for short terms and keep rolling over. And you can always break a term deposit if you have to, although you will probably lose some interest.

With debentures, even short term ones, there's much less flexibility on when you can get at your money.

Life is short. I suggest you stick with term deposits, avoid the hassle, sleep well, and settle for one less feature on your new car.

You're welcome to send questions to From the Mailbox. Email them to maryh@pl.net, or mail them to P.O. Box 8520, Symonds Street, Auckland, and please include your phone number. Unfortunately, Mary can't answer all questions in Holm Truths, and cannot correspond directly with readers.

"Don't think there are no crocodiles because the water is calm"
Malay Proverb

Holm Truths Crossword Solution

	O	F		S	O	B		Q	U	I	Z	
P	R	O	S	P	E	C	T	U	S			T
E		A		O				O		M		E
R		M	A	T	C	H		T		O	U	R
F			N			O	C	E	A	N		M
O	N		T			L				E	N	D
R		L	I	Q	U	I	D	I	T	Y		E
M	O	O				D			O		U	P
A		S	E	P	I	A			I			O
N	E	E		L		Y	I	E	L	D		S
C		R		A				E		E		I
E			I	N	S	T	A	L	M	E	N	T
	T	E	S	T		A	S	S		D	O	

WRITER AND PUBLISHER

Award-winning journalist Mary Holm writes the *Money Matters* column for the NZ Herald and *The Investor* column for major newspapers around New Zealand. She is the author of *Investing Made Simple* (Penguin, $27.95, 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.

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