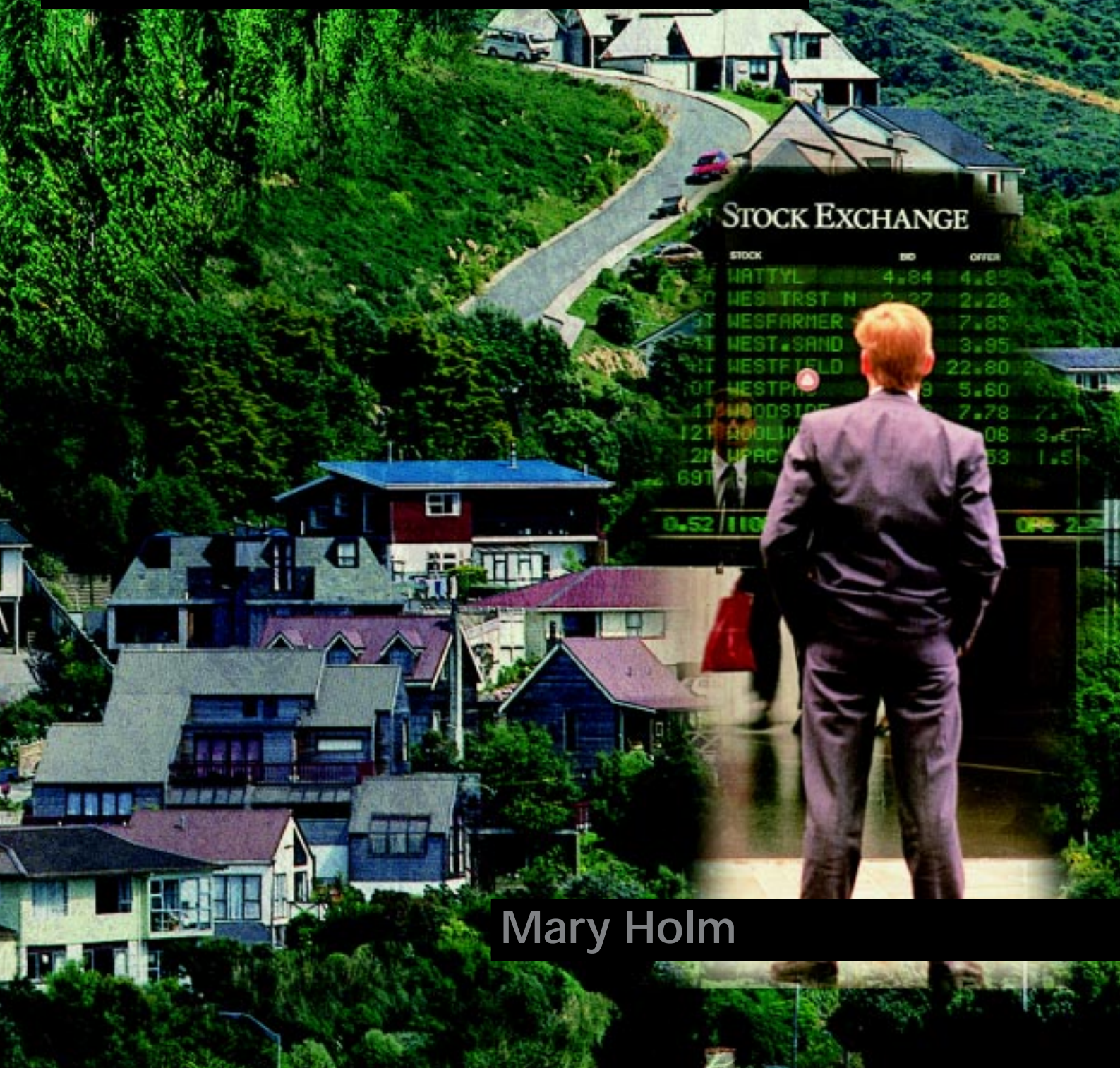


# The REAL Story

Saving and investing now that  
inflation is under control



Mary Holm

# The REAL Story

Saving and investing now that  
inflation is under control

by

Mary Holm

with Tony Alexander

Tore Hayward and Frank Pearson

Commissioned by the Reserve Bank of New Zealand

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## Foreword

New Zealand achieved low inflation back in 1991. However, too many New Zealanders have wrongly gone on assuming that by borrowing as much as possible, and investing in physical assets, they can keep making inflation-driven capital gains indefinitely. In some cases these people are putting themselves at risk financially.

In reality, the inflation-driven capital gains of the past have come to an end. This publication, *The REAL Story*, suggests that as a result people may need to re-think their personal savings. Some ideas for doing this are then provided.

I believe those who learn the lessons of low inflation will be better off individually. Therefore, let me be absolutely clear. The Reserve Bank of New Zealand Act 1989 requires the Reserve Bank, as its top priority, to pursue “stability in the general level of prices.” A separate contract that I have signed with the Treasurer defines price stability in detail. The instructions from the Government are explicit, and the Reserve Bank will not shirk from its responsibility. People can be confident that price stability is now a fact of life, and make their personal savings decisions on that basis.

I commend this small book to everyone, and thank all those who took part in its creation.

Don Brash  
Governor  
Reserve Bank of New Zealand

## Introduction

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### Why *The REAL Story*?

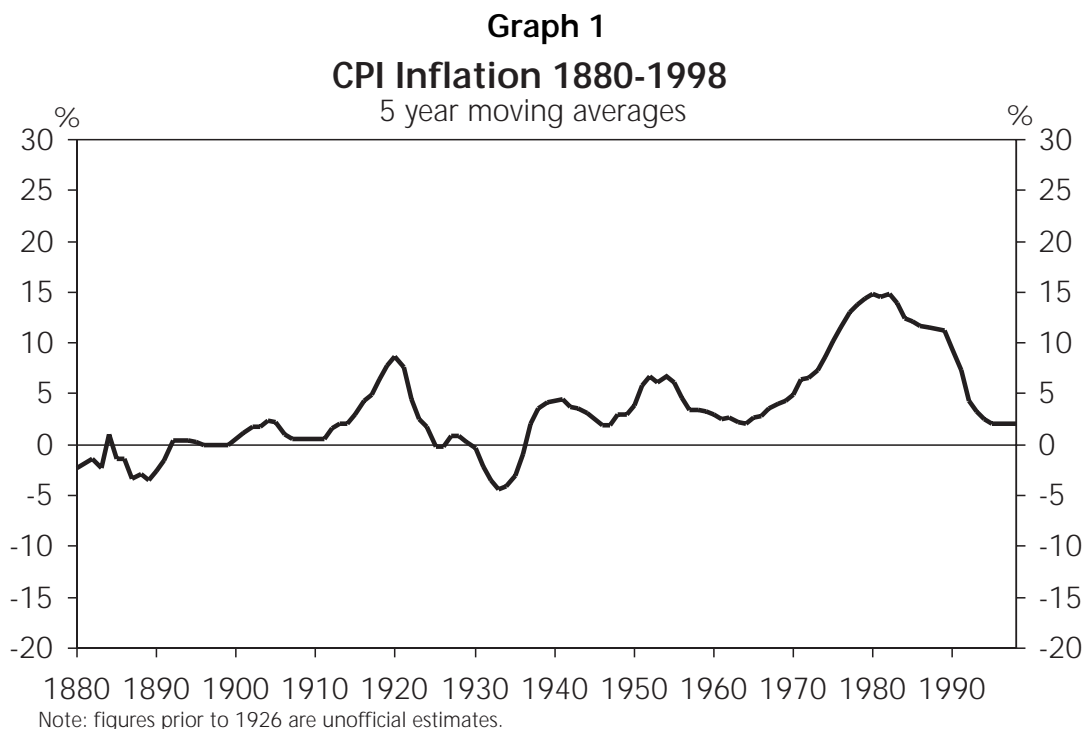
When it comes to money, the word “real” has a precise and potent meaning. If a number is “real”, it’s adjusted for inflation. For example, to decide whether making an investment is worthwhile or not, you need to consider the **real** rate of return - that’s the money made, minus any inflation during the period of the investment. Then you have *The REAL Story*.

### How to use this book

*The REAL Story* contains two main sections, on *Some Basic Money Concepts* and *Types of Investment*. It is important to read *Some Basic Money Concepts* first.

### Times of change

The New Zealand investment environment has changed in a fundamental way in the last decade, but many people have not yet caught up with this change when managing their personal affairs. We’ve moved from high and volatile inflation - amongst the highest in developed countries - to low and relatively steady inflation.



*The high inflation of the 1970s and 1980s was abnormal.*

If you look back, low inflation is normal for New Zealand during peace time. Over the last 120 years, inflation below 5 per cent was common, and periods of inflation were offset by periods of deflation (see graph 1).

The high-inflation period from the early 1970s to the late 1980s was historically unusual. But it lasted long enough that we got used to it, allowing for it - and in some cases taking advantage of it - when making decisions to do with money. In short, we learned how to live with it.

Now, with low inflation back again, to do well financially we have to un-learn those high-inflation lessons, and learn new ones. Those who understand how to make the most of a low-inflation environment will be the winners when it comes to saving, investing and generally managing their money.

Many of the rules of investment don't change regardless of inflation. They are:

- Spread your risk by diversifying into a wide range of investments.
- If you're expecting a higher return, the investment will almost certainly be riskier - in terms of volatility and the likelihood that you'll get your money back.
- Take on only as much risk as you feel comfortable with, bearing in mind how soon you want to use the money you're investing.
- If you're going into volatile investments, such as shares and property, stay in for the long term. Don't try to time markets.
- Don't rely on past performance as a guide to what will happen in the future.

Still, all investment is heavily affected by inflation or deflation, or their lack. This book explains how to approach saving and investment, given that inflation is now low and stable, and expected to remain so.

It is based partly upon an in-depth discussion with three experts in the field, Bank of New Zealand Chief Economist Tony Alexander, Tower Investment Strategist Tore Hayward, and financial advisor Frank Pearson.

# Some Basic Money Concepts

*And how they are affected by the change to low and stable inflation*

## Inflation

Inflation is when prices on average are going up. We are not talking here about prices of individual goods and services rising because of changes in their supply and demand. Inflation happens when prices rise across the economy as a whole, in spite of supply and demand. It means money is losing its value.

The **Consumer Price Index** or **CPI** is the most widely used measure of inflation. It shows how fast prices are changing for items that the average consumer buys.

## Deflation

Deflation is the opposite to inflation. Average prices are falling.

## Real and nominal returns

A return on an investment is the extra money you make, over and above what you put in in the first place. It's usually expressed as a percentage. If you put in \$100, and at the end of the year you have \$106, your return is 6 per cent.

Returns can be interest, dividends, rental income or any other payments received. They also include capital gain - how much more the investment itself is worth at the end than at the beginning.

When you're trying to decide whether a return is good, it helps to understand the difference between a **nominal** return and a **real** return.

**Nominal** numbers are before adjusting for inflation. They're the numbers we usually use, for everyday purposes, when we talk about prices, growth and so on.

**Real** numbers are after adjusting for inflation. High inflation can badly distort growth or trends. When we use real numbers, we remove that distortion, to show what's *really* happening to the value of things.

For example, if you buy your house for \$100,000 and sell it a year later for \$110,000, you've made a nominal gain of \$10,000, or 10 per cent.

But if inflation during that year was 7 per cent, subtract the 7 from the 10. Your real gain, after taking inflation into account, is 3 per cent. The rest of the gain is unreal, because it doesn't get you any further ahead in terms of buying goods and services with your money.

(A note for the mathematicians: This arithmetic is only approximately right. But it's close enough for most purposes.)

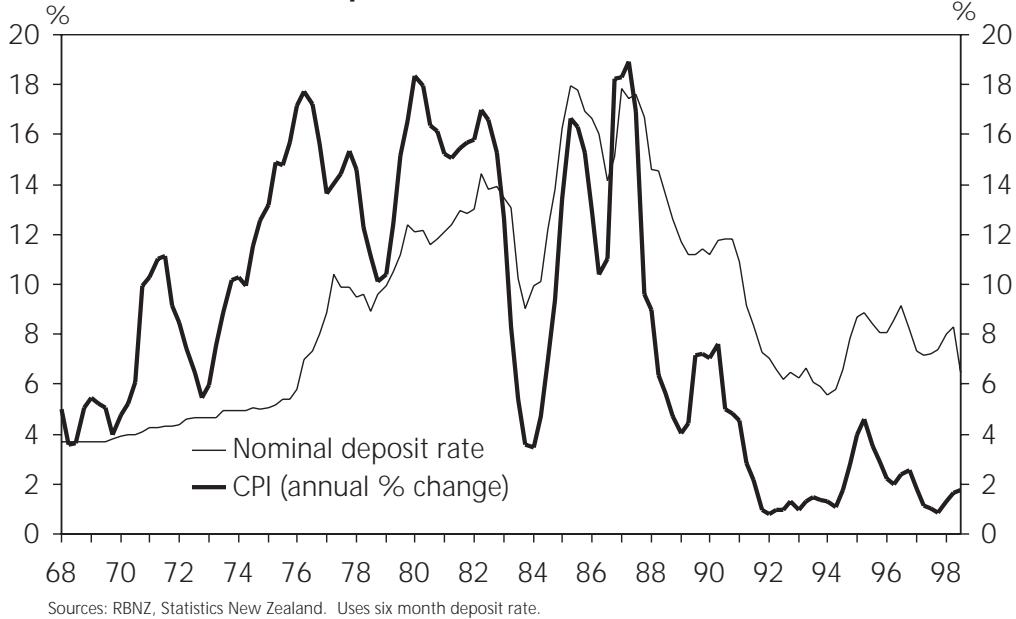
In the current low-inflation times, with nominal returns on many investments much lower than a decade ago, you might feel you're not doing as well as you used to. But don't be fooled.

In times of high inflation, the value of your money is being whittled away, year by year. You will want a higher return from that money to compensate for this loss of value. Likewise, the companies and financial institutions that provide the returns are willing to pay more, as they are making more nominal dollars as prices rise.

This means that, generally, nominal returns are higher when inflation is high, and lower when it is low. We see this when we look at interest rates on term deposits, which tend to follow a similar pattern to inflation, particularly in recent deregulated years (see graph 2).

Often, though, when inflation is high, interest rates aren't high enough to fully compensate. Real returns may be low, or even negative. This happened from 1968 to 1983, and was particularly bad in the mid 1970s.

**Graph 2**  
**Bank Deposit Interest Rates and Inflation**



*Whenever inflation is higher than deposit rates, as in the first half of the period shown, savers are losing money. When inflation is lower than deposit rates, as in the last ten years, savers make real returns.*

Since 1991 we've had low inflation. And for much of this decade real interest rates have been high, staying well above inflation and bringing high real growth to savings.

Just lately interest rates have fallen. But they would have to fall a long way further - quite close to zero - before we got into negative real rates of return again. That seems unlikely.

The key point is that in considering the worth of any investment you should always look at the real return.

## Income

The same distinction between real and nominal numbers applies to increases in income. Nowadays, with inflation low and stable, you can be sure that if you get significantly higher pay or higher returns on an investment, you are genuinely better off.

That hasn't always been so. In times of high inflation, people might have thought they were better off when their incomes rose. But, if prices were rising just as fast as incomes, they were not making real gains. If prices were going up even faster, in real terms they were going backwards.

## Tax

From a tax perspective, some kinds of investment - most notably interest-bearing ones - are much better now that inflation is low.

In times of high inflation the tax system substantially penalised some investors.

How did that happen?

We've already noted that:

- nominal returns tend to be higher when inflation is high;
- part of those higher returns is compensation for the fall in the value of each dollar.

The trouble is that with taxable investments we are taxed on those high nominal returns - including the compensation for inflation. So we lose part of the compensation, and end up falling behind.

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**“If the government did it the other way, and knocked the inflation off first before they removed the tax, then we would be fine.” - Frank Pearson**

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This happens whatever the inflation level. But it's much less harmful when inflation is low.

Let's look at an investment that brings a *real* return of 4 per cent, before tax, to a taxpayer in the 33 per cent tax bracket.

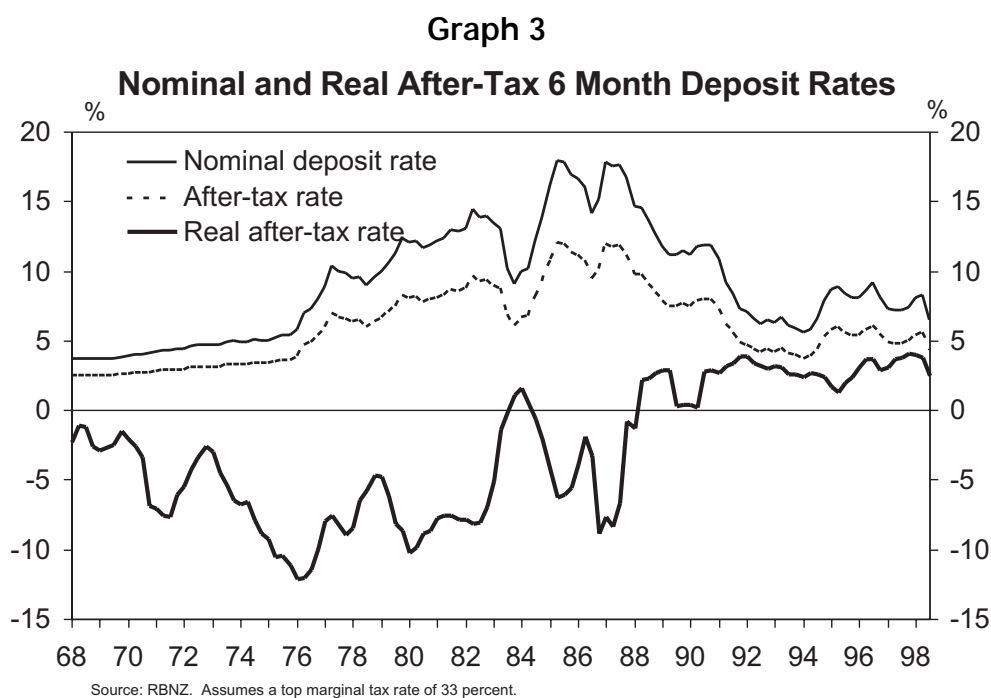
- If inflation is 11 per cent, the nominal return is 15 per cent. The taxpayer pays 5 per cent to the government, and is left with 10 per cent. That sounds good until you consider that, with inflation at 11 per cent, the investment is actually losing value.
- If inflation is at just 2 per cent, the nominal return is 6 per cent. The investor pays 2 per cent in tax, and is left with 4 per cent. Even after tax, the investment is growing quite a lot faster than inflation.

What happens when the real return is not 4 per cent but negative?

As we said earlier, that happened throughout the 1970s and early 80s. When you add the effect of tax, things were worse still.

An investor might be earning 12 per cent while inflation is 15 per cent (a real return of minus 3 per cent). He or she paid tax of 4 per cent, which left 8 per cent. With inflation at 15 per cent, the investment was rapidly losing value. (NB: To compare periods this assumes a 33 per cent top tax rate. In fact, in the 1970s and early 1980s top tax rates were higher, making savers even worse off.)

With the extra blow caused by the tax system, real, after-tax returns were quite deeply negative for almost an entire 20-year period, from the late 1960s to the late 1980s (see graph 3). Savers in fixed-interest securities or bank deposits were going backwards year after year. No wonder nowadays we have a poor savings record, given this experience.



*In 1968-88, nominal returns on six-month term deposits grew rapidly. But throughout that period real after-tax returns were almost always negative. When inflation dropped in the early 1990s, nominal returns fell, but real after-tax returns went well into positive territory.*

On the flip side, because New Zealand does not have a capital gains tax, when inflation was high capital gains were particularly attractive. With inflation now low, capital gains are much reduced. The lack of a capital gains tax no longer matters so much when people are making investment decisions.

The important point is that many people are still making investments based on tax advantages or disadvantages that are markedly reduced. This is a mistake.

In a more general way, too, the tax system is fairer - and more encouraging for savers and investors - in a low-inflation environment.

When inflation is high, taxpayers are hurt by a stealthy little game sometimes called *bracket creep*.

It happens because the tax system has several brackets, or income ranges, within which a certain tax rate applies.

New Zealand at the time of writing has three income tax brackets. Taxable income up to \$9,500 is taxed at 15 per cent. Income of \$9,501 to \$38,000 is taxed at 19.5 per cent. Income over that is taxed at 33 per cent.

When inflation is high, people's nominal incomes grow faster. Often, people are no better off, but every now and then they'll find themselves dragged into a higher tax bracket.

This means that their income is taxed at a higher rate. The government gets more, and they get less.

In times of low inflation, this is much less likely to happen. If some people's incomes grows significantly, it will be real growth. They'll have to pay more tax, but this is fair, as they are better off.

Bracket creep can affect investment decisions. It can, for instance, bias people away from investments that bring in income. But, with inflation low, bracket creep no longer needs to figure in your decision making.

## Certainty

Most investors don't like uncertainty. They prefer to know where they stand. That's one reason shares and property tend to bring higher returns than, say, term deposits. Investors demand more as compensation for taking on a less certain investment.

Inflation, and particularly variable inflation, exaggerates volatility and uncertainty. If price rises are large one year and small the next, that feeds into the unpredictability of return levels.

And when inflation is high, it's also likely to be more variable, as graph 4 shows.

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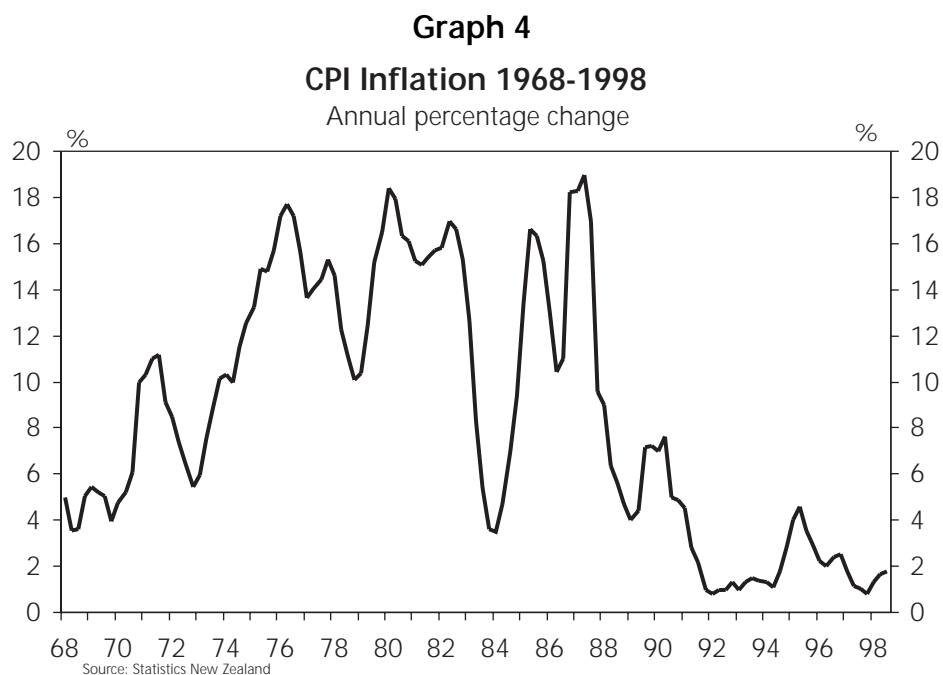
**“The high inflation environment tends to be a volatile inflation environment as well. You're not sitting on 10 per cent. You're going 6 per cent, 12 per cent, 15 per cent.” - Tony Alexander**

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Recent inflation has not only been much lower, but it has also generally stayed within a narrow range. As a result, returns have tended to be less volatile.

This reduction in uncertainty lowers the risk of investments - to everyone's advantage.

Stable prices encourage investor confidence and therefore economic growth.



*Inflation in the 1970s and 1980s was not only high, but changeable, soaring and plunging from year to year. Since 1991, it has moved within a much smaller range.*

If you are reasonably daring, stable low inflation might enable you to take on an otherwise too risky investment. If you are conservative, preferring to stick with bank deposits, there's less risk that the real value of your money will decline.

Lower variability in inflation also helps people to plan their savings and investments.

If you're trying to work out how much you will need to save for a project, or so you can retire comfortably, it's simpler when inflation is low and stable. And when you retire, you can more accurately plan how to invest and use your savings.

## Transparency

With low inflation, it's easier to see how an investment is really doing. If a company, a project or a fund is doing poorly, that will show in declining returns, or even losses. Reported growth is much more likely to be genuine.

However, when inflation is high a company or an investment may look good when it's not. Income or returns may seem to be rising each year, when their real value is falling.

Now that inflation is lower and less variable, it's also easier to see how well you are using your own money.

In past high-inflation times, for instance, many retired people lived on the interest, dividends, rent or other income from their investments, but didn't use the capital. They hoped this would ensure they had enough income for life.

The trouble was that the real value of their capital was falling fast. So was the real value of the interest, dividends or rent it generated. Twenty years after retirement, they might have received similar nominal income to what they got when they first retired, but it bought a lot fewer goods and services.

Nowadays, with inflation lower, nominal returns tend to be lower. For retired people to have the same standard of living as in the past, they will have to use up some of their capital as well as the returns. But, with the real value of the capital falling more slowly, spending some of it won't make them any worse off than in the old don't-touch-the-capital days.

The total effect is the same. The value of the retired person's capital is getting smaller. Now, though, he or she realises this and can plan around it. The situation is more transparent.

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**“People sometimes look back nostalgically to the time when they could get 15 per cent returns and felt they could live off that without consuming the capital. But if you look a bit deeper, inflation was eroding the real value of the capital. If you look at the purchasing power of capital during low inflation times, people tend to get less income but their capital doesn't shrink away as fast.” - Tore Hayward**

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Together, higher transparency and reduced uncertainty make knowing what to expect easier. You can make wiser savings and investment decisions.

This is good in itself. It also has a flow-on effect. When everyone can see more clearly what's going on, money goes to where it can best be used. This boosts economic growth, which in turn boosts your returns.

### Saving

These days - with inflation low, real after-tax returns higher and taxes less damaging - saving makes a lot more sense than it used to. Money you put aside can grow quite fast, in terms of what it will buy for you in the future.

Over the long term, with real returns compounding, a relatively small sacrifice today can make a big difference to your lifestyle in decades to come.

By contrast, when inflation was high it could be downright discouraging to save, especially over long periods.

For example, you might have made some big sacrifices, in terms of spending, and put away 20 per cent of your income. Ten years later, inflation had tripled or quadrupled your income and expenses. However, your savings - hit by both inflation and taxes - might have bought much less than when you put the money away.

**The bad times and the good times for savings**

Through the 1970s and first part of the 1980s, real after-tax returns on term deposits were negative. Taking minus 5 per cent as a typical real after-tax return of the period, in the first column of the table below we can see what happened to the *real* value of \$1000 in savings. The second column shows what happens to the real value of \$1000 when the real after-tax return is 3 per cent, which is typical of recent low inflation years. Over long periods, the difference is huge.

Real Value of	1970s/early 1980s	1990s
\$1,000 after:	-5%	+3%
1 year	\$950	\$1030
2 years	\$903	\$1061
5 years	\$774	\$1159
10 years	\$599	\$1344
20 years	\$358	\$1806

When it comes to really long-term saving - perhaps for retirement 30 or 40 years away - high inflation and taxes used to erode the value of your early savings so much that they became pathetic.

“Why bother?” people used to ask. Even the most enthusiastic fan of retirement saving was hard-pressed to come up with a good answer.

These days, there’s plenty of reason to bother.

## **Borrowing**

Borrowing is the opposite to saving. The switch to low inflation affects it in the opposite way. Saving is now much smarter than it used to be, while borrowing is now much riskier.

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**We Kiwis want stuff now. - Tony Alexander**

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When inflation was high, it was clever to borrow - especially if interest rates were lower than inflation. You paid back the debt with “cheaper” dollars, in the sense that they were easier to earn.

Now, though, nominal incomes aren’t rising very fast, and a debt or mortgage of \$1,000 or \$100,000 won’t diminish much - in terms of how easy it is to pay off - as the years go by.

To top it off, real interest rates in recent times have been unusually high, and even now, despite large rate drops, they are still pretty high by historical standards. So you pay handsomely for the opportunity to use other people’s money.

Borrowing makes the least sense, financially, if you do it to buy goods or services that are used right away, such as meals, entertainment or travel. After you’ve enjoyed the experience, you’re left with the bills.

It’s also not a great move if you borrow to buy items like cars or appliances. You’re paying interest on them even as their value falls.

Does that mean all use of a credit card is bad? That depends on whether you pay your credit card bill, in full, every month. If you do that, the card is just a convenience. What’s more, you get up to two months free credit. But if you don’t pay the full credit card debt, you are paying very high interest. The pleasure you get from your credit card purchases comes at a high price.

Hire purchase is similar. Interest rates there, too, can be extremely high.

Borrowing isn’t as bad - from a financial point of view - if you do it to buy something whose value you expect will increase, or if you are investing in your education or a business. Still, it doesn’t work as well as it did when inflation was high.

Many New Zealanders don’t yet realise this. They’re used to hearing that they should borrow as much as possible for a house or a property investment. In the long run, they’ve been told, it will make them rich.

In most cases, this is no longer true.

When you borrow to buy your own home, or to make an investment in a rental property, shares, collectibles or anything else, in the jargon of economists, you are “gearing”. And that involves more risk when inflation is low.

Let’s look at an example of a \$100,000 investment. You pay \$20,000 up front, and borrow the remaining \$80,000.

There are three types of outcomes:

- High inflation. A few years later you sell the investment for \$150,000. Your \$20,000 has more than tripled to \$70,000. While you’ve paid a lot of interest on your mortgage, you’re thrilled with your profit.
- Low inflation. You sell the investment for just \$110,000. Your \$20,000 has grown to \$30,000. That’s 50 per cent growth - but it’s reduced considerably by all the interest you’ve paid.
- A market downturn when inflation is low. You might sell for less than you originally paid. If you sell for \$90,000, your \$20,000 has halved. If you get only \$80,000, you’ve lost your deposit altogether - as well as paying interest. If the price falls below the outstanding mortgage amount, you have what is known as negative equity. This has happened in housing markets in several countries in recent decades. It can be financially disastrous.

Now let’s look at what would have happened if you had bought the investment with no borrowing, or gearing, paying the full \$100,000 up front.

- High inflation. Your \$100,000 becomes \$150,000. That’s good, but not nearly as good as tripling your money.
- Low inflation. The \$100,000 grows to \$110,000. Nothing to write home about.
- A market downturn when inflation is low. The \$100,000 drops to \$90,000, \$80,000 or less. That won’t make you happy, but it certainly beats losing the lot. And you haven’t spent thousands on interest.

The moral of the story is that gearing ups the ante. You can do much better or much worse than if you didn’t borrow. And, in times of low inflation, it’s much more likely that gearing will have a bad outcome.

While gearing applies to both borrowing to buy your own home and borrowing to invest in shares, property or any other investment, there are some important differences.

If you borrow to invest, and receive rent or dividend income, that will partly or fully cover your interest payments and other expenses. What’s more, those expenses are tax deductible. And, in many cases, you don’t have to pay tax on any capital gain on your investment - an advantage over some other investments.

Still, these advantages are smaller now that inflation is low.

Nominal interest rates are lower, so your deductions are smaller. And non-taxable capital gains are also likely to be lower.

In short, while borrowing to invest can be a smarter move than borrowing for other purposes, it's not nearly as clever in periods of low inflation.

In many cases it can leave you worse off than if you hadn't borrowed. With low inflation it's much less risky to fund investments out of your savings.

### **Putting your debt on a diet**

Borrowing - particularly for non-investment purposes - makes much less sense financially now that inflation is low.

One way to retire with lots more money than you would otherwise have is to put yourself on a "debt diet" for, say, six months or a year or two.

The rules of the diet:

- Don't take on any more high-interest debt (credit cards, hire purchase and similar). If you can't buy something you want with cash, save until you can, or do without it.
- Systematically reduce any non-investment debts you have. It might be best to set yourself a target of so many hundred dollars a month. Perhaps set up an automatic transfer from your bank account.
- Change your way of thinking. In the same way as a weight loss diet won't work long-term if you go back to your old eating habits, a debt loss diet won't work if you go back to your old borrowing habits. From now on, save for items before buying them. That way, interest is working in your favour, adding to your savings, rather than working against you.

One of the miracle aspects of this diet is that when you're at the second step, repaying your debt, you can make huge progress.

If you pay off non-investment debt with an interest rate of 18 per cent - such as credit card debt - you improve your wealth as much as if you had an investment bringing in 18 per cent after tax. What's more, it's like a risk-free investment.

You'll probably never do as well in any other investment.

If you're repaying a mortgage, which will be at a lower interest rate, the results aren't quite as dramatic. So it's best to pay off your highest-interest debt first.

But then continue on, repaying all debt, before you stop.

Paying back a home mortgage, with interest of 7 per cent, is still the equivalent of

making 7 per cent *after tax* somewhere else. That's an excellent return.

What about paying back a mortgage on an investment property? With tax deductible interest of 7 per cent, that's equivalent to making 7 per cent *before tax* elsewhere. It is still a good return on a risk-free "investment" .

A final thought: With many of today's flexible mortgages, you can use funds set aside for emergencies, or other money you don't need for a while, to temporarily reduce your mortgage - and hence your interest payments. You can take the money out again when you need it.

This can be a very effective use of short term savings. Discuss your options with your mortgage lender.

## Types of Investments

*And how they are affected by the change to low and stable inflation*

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### Your home

The vast majority of New Zealanders live in their own homes, and many others hope to do so in future.

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**Culturally, I think, we are home owners.**

**- Tony Alexander**

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Buying and owning your own home is part investment, part consumption. You hope the value of the investment will grow. At the same time, day by day, you get shelter and security.

In recent years, the whole house-owning situation has changed quite radically in ways many people don't realise.

New Zealanders have grown up with stories of their parents selling a house for ten times what they bought it for.

Many of us have had the same experience ourselves. We laugh now at how little we paid for our first house, and how easy it turned out to be to pay off the mortgage as our income climbed.

At the same time rapid growth in house prices was tough on those struggling to buy for the first time. It pushed some into buying too early, while others despaired of ever getting their own home.

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**With high house price inflation, fear drives first home buyers to get in two or three years earlier than they really can afford to, because they're too scared of prices going up. - Tony Alexander**

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For good or bad, the days of huge sustained house price rises seem to be over.

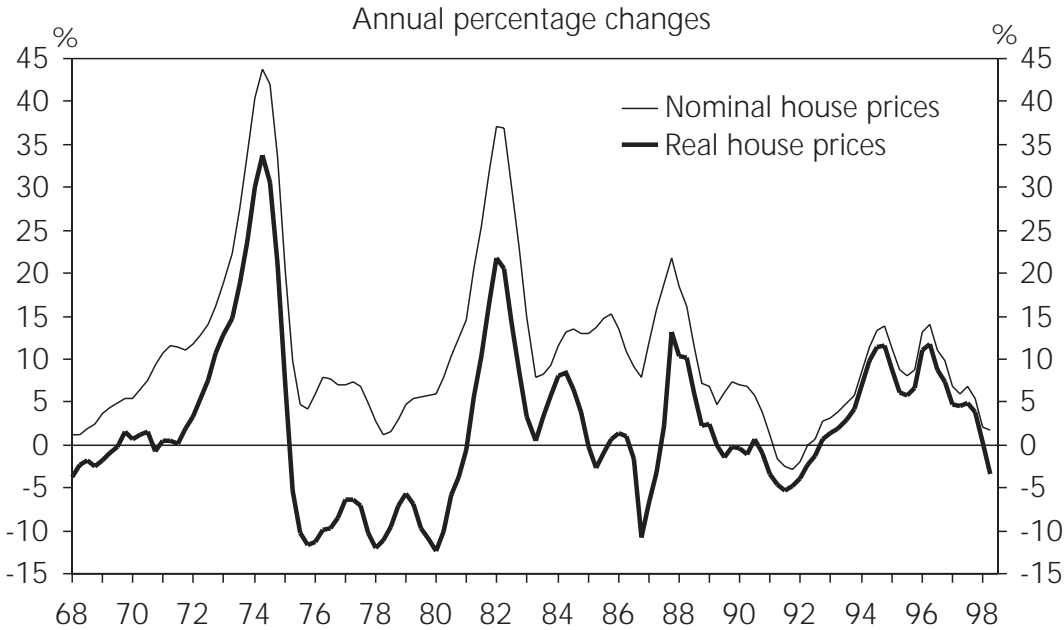
In recent times, indeed, property prices have fallen in some regions. This is not expected to become a long-term trend. Historically, it's unusual for nominal prices to fall for long. Generally, people respond to a slow housing market by trying to avoid putting their property up for sale. Market volume drops, and nominal prices are inclined to be static rather than decline.

Real house prices, however, have fallen fairly often (see graph 5. Where the line is below zero, real prices have dropped.)

Graph 5 also shows that house prices are volatile. No doubt, there will be more short-term regional spurts, like the one in Auckland in the mid 1990s - fueled perhaps by immigration or population influxes from elsewhere in New Zealand. There will also be short-term plunges.

Over the longer haul, growth in house prices seems unlikely to exceed inflation by much. Since 1963 general inflation has averaged about 8 per cent a year, and house prices have gone up 2 per cent a year faster than inflation.

**Graph 5**  
**House Prices**



Sources: Valuation NZ, Statistics NZ. House prices are deflated by CPI ex-credit services.

*While nominal house prices have almost always grown, real house prices have quite frequently fallen. This was particularly true in the high-inflation late 1970s.*

Regardless of price trends, you may well decide to buy a house anyway. That's fine, but try to keep the borrowing as low as possible.

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**Housing is not just investment. It's also something we consume. It provides us with services as well. - Tony Alexander**

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As stated earlier, taking out a large mortgage is not as wise a move as it used to be.

While you might enjoy living in a \$300,000 house more than a \$200,000 one, you will probably be better off in the long run if you buy the cheaper house. If your heart is set on a \$300,000 house, consider saving longer so you have a bigger deposit when you buy.

If you've already got a mortgage, pay it off as fast as possible. This is the equivalent of making a tax-free risk-free investment at whatever your mortgage interest rate is.

About the only drawback against putting all your available savings into mortgage repayment is that you're not diversifying into other types of investment.

If, instead, you put some of your money into shares, you would be spreading your risks over a wider range. You would also learn about other investments, perhaps with relatively small amounts involved, so that any hiccups would have only a modest impact.

Still, it's a great idea to put a large portion, if not all, of your available money into mortgage repayments. And, once you've paid off your mortgage, don't go on a spending binge. Keep up the payments into alternative investments - preferably not property.

### **The improvement factor**

Rising house prices can be deceptive. They may reflect improvements in house quality, rather than just appreciation.

New houses typically have at least two bathrooms, modern fixed appliances and often a family room as well as a living room - features not included when older houses were built. Many older houses, too, are being improved with renovations and additions.

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**The quality of housing tends to rise, so you say house prices are rising. But you're not comparing the same houses. - Frank Pearson**

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If you look at an individual house that has been maintained but not improved, its value will not rise as much as houses on average - because many others have been upgraded.

If you do make improvements, of course, you have to subtract the costs of the improvement when considering how much the value of your house has risen.

Don't over-capitalise, making your house worth much more than your neighbours', and don't be fooled into thinking that home improvements are an easy way to make money.

Think of the value of your labour if you are a do-it-yourselfer, in terms of what else you could do with that time. And if you pay a builder to do home improvements, don't count on making capital gains. You may not get your money back.

## **Rental and commercial property**

Now that inflation is low, it pays to be more cautious than in the past about property investment.

Whether you're looking at residential or commercial investment property, values can be pretty wobbly in the short-term. They are affected by interest rates, immigration, regional growth and the general state of the economy.

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**Shed the lessons that were learnt in the 70s, like property is a bullet-proof asset. - Tore Hayward**

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Don't take on more than you can comfortably handle. And plan on staying in a property investment for the long term, rather than just a few years. You don't want to be forced to sell when the market is down.

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**In the property market, the transaction costs are so great that, if you end up folding because you're over-extended, that's a very expensive exercise. - Frank Pearson**

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As with owner-occupied homes, many people who invest in residential property borrow to do so. If you get a mortgage, your tax deductions for mortgage interest and other expenses can make the whole proposition better financially than your own home is.

As well, in most cases you won't pay tax on any capital gain you make on an investment property - a big advantage over some alternative investments.

Even so, in a low-inflation environment, it's not the investment it used to be. As we said earlier, the tax deductions are now smaller. So are the capital gains. And the tax advantages over interest-bearing investments aren't so powerful.

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**Buying rental property is okay if you can do your own plumbing. - Frank Pearson**

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Another point: you can no longer count on rents or property values rising fast, to ease cash flow problems.

In years past, an investor who borrowed had to cope for only a short time with a negative cash flow - in which rental income didn't cover mortgage and other expenses, so they had to put in other money. The problem was quickly fixed when rents rose with inflation. And the investor was richly rewarded at the end with a large capital gain.

In recent times, however, rents have fallen in some parts of the country. There are more rental properties available than tenants, and landlords have had to drop rents or face periods when their property is not rented.

Negative cash flows are common, and now sometimes last for years.

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**You should really think of housing as a volatile asset class. It can work for the investor or against them over certain time frames. That's the animal you buy. I'm just saying understand the animal. - Tore Hayward**

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With commercial real estate - industrial, retail and office properties and so on - many additional factors affect how fast its value grows.

The scarcity of land puts upward pressure on land values as population grows. At the same time, though, technological developments make land use more efficient. And location makes a huge difference to the appreciation of a property.

Returns on commercial property vary enormously. In times of low inflation, when there is no assurance of a capital gain, it matters more to know the market. Many small investors have made bad investment decisions in this area.

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**In the old days inflation used to bail you out of all your errors in single property investments. Now single property investment has become a very risky business. The buildings offered are patchy. Many are technologically obsolete. You possibly end up with a specialist local distribution unit out in Petone, when the trend is overnight courier from Auckland. - Frank Pearson**

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Look closely at leasing agreements and forecasts of increases in rents and property values. Don't rely on estimates from those selling the investment - whether it be a rental house or units in a commercial property fund. Some of them are making highly unrealistic forecasts.

Seek independent advice.

If you want to go into commercial property, it's generally less risky to buy into lots of properties - via property shares or a well diversified fund - rather than one or a few properties.

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**Even if the building is okay, there may be a gap when there is nobody leasing it. And then all of a sudden there is no income. - Tony Alexander**

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Investing in property without borrowing is a different proposition. You can't deduct mortgage interest, but you don't run the risks that go with borrowing.

Given that property values tend to grow at about the rate of inflation, the level of inflation doesn't affect the real value of this type of investment greatly over the long term.

Whatever the inflation rate is, the investor will, of course, hope that his or her property is one that appreciates faster than average. Scarcity value - if a property is on a coast, has a wonderful view and so on - may help here. But be careful. This is probably built in to the price when you buy.

Property has often been regarded as a haven in times of high inflation. Now that inflation is low, it makes more sense to consider alternative investments. They may well do better than property.

## Shares

By international standards, New Zealanders tend to under-invest in shares and over-invest in property.

This is probably partly because New Zealand has taken much longer to recover from the 1987 share market crash than most other countries. That has made people wary of the share market, and recent market upheavals don't help. Some argue, too, that New Zealand regulations offer less protection for small investors than in other share markets.

The fact is, though, that over the long term, shares in New Zealand and elsewhere tend to perform better than most alternative investments, including property.

Returns are volatile, so the share market is not as good a place for short-term money. When you take your money out, there's too big a chance it will be worth less than when you first invested. But over, say, ten years or more, returns are almost always higher than most alternatives.

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**The worst thing to do in the share market is to be there if you can't see it out when it gets ugly. As renowned US investor Peter Lynch has remarked, as far as share markets are concerned, the stomach rather than the brain is the vital organ. - Frank Pearson**

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How does the pace of inflation affect all this? At first glance it seems likely that shares wouldn't be affected much. If prices in general are rising fast, we would expect share prices to rise fast, too.

Also the fact that shares tend to outperform other investments suggests they are more likely to overcome the obstacles of high inflation and bring positive real returns.

Even so, the historical record shows that the share market does better with low and/or falling inflation. In several pieces of research - in different countries and different time periods - shares have tended to bring higher real returns in periods of low inflation.

Of course, there can be no guarantees. Many other factors affect share prices too. As recent history has shown, a share market can certainly plunge in a low-inflation period. But over the long haul, there does seem to be a relationship between falling or low inflation and good share market returns.

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**I don't want anyone to reach the conclusion that low inflation means the share market will automatically perform well. - Tore Hayward**

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One possible explanation is that it's easier for companies to plan when inflation is low and stable. If they can make more accurate forecasts, they are more likely to make moves that enhance shareholder value.

Another explanation is that companies aren't suffering from the over-taxation that comes with high inflation.

Or it could be that, in periods of high productivity growth, inflation tends to be low and company earnings high. This boosts share prices. Or that low inflation boosts optimism, and so raises interest in the share market.

Nobody knows how important each factor is. But whatever the linkage, the argument to invest in shares is stronger in times of falling or low, steady inflation.

It's interesting to note, when looking at other countries' experiences, that share markets don't seem to thrive if low inflation is taken to its extreme - deflation, when prices are falling. This probably reflects the fact that an economy with deflation is usually going through a severe downturn.

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**Investors have a strong stake in maintaining an environment of low and stable inflation and also not slipping into deflation, as in Japan. - Tore Hayward**

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The best way for most individuals to get a broad enough spread of shares - which considerably lowers risk - is to buy shares or units in a share fund.

Look for a share fund that charges low fees and, preferably, doesn't have to pay tax on capital gains. Index funds and UK investment trusts are good vehicles.

You'll lower your risk still further if a significant proportion of your share investments are overseas, probably also via a managed fund.

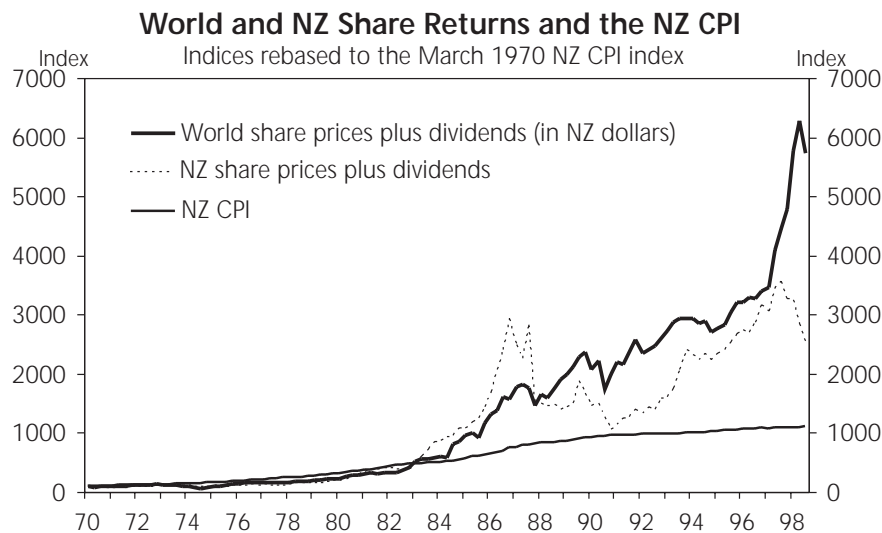
Whether you invest directly in shares or in a fund, be prepared for the value of your investment to fall at times. But if you stick with it, you will probably do better than elsewhere - especially in a low-inflation environment (see graph 6).

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**Shares do tend to grow above the rate of inflation, even after tax. But it's a bumpy ride.**  
**- Tore Hayward**

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## Graph 6



Sources: Frank Russell Company (NZ) Ltd, Credit Suisse First Boston/NZ Stock Exchange, Statistics NZ.

*Share returns are volatile, but the long-term trend is upwards.*

### Interest-bearing investments

Investments that pay interest include government bonds, bank term deposits and corporate bonds.

One huge advantage of low inflation for interest-bearing investments is that the value of your principal is not eroded. If you put \$1000 in a five-year term deposit, when you get it out again it will buy almost as much as at the start - which was not true when inflation was high.

As far as interest rates are concerned, periods of high inflation can be deceptive. As we saw earlier, returns in those periods might look good, but after tax and inflation are taken into account, they can be negative.

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**All assets get hurt by inflation, but fixed interest assets get hurt the most. - Tore Hayward**

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This deception is less likely to happen in times of low and steady inflation. If real returns at such a time are poor, it is much more obvious.

What's more - and this is important - when inflation is low, fixed interest investments don't suffer nearly as much from disadvantageous tax treatment.

Not long ago, short-term real interest rates were at unusually high levels, sometimes higher than longer-term rates. Historically, this is not the way things usually are.

Think hard, though, before choosing a short-term investment because it pays a higher rate.

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**The short-term interest rate is just that. - Tore Hayward**

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Whenever short-term rates are higher than longer ones, this means the market, in general, is expecting interest rates to fall.

In that situation you might prefer to take, say, a three-year fixed interest investment, rather than a one-year investment that pays more. Otherwise, when you come to renew your investment in a year's time, rates are quite likely to be lower.

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**The biggest risk you take is that short term rates plunge and you suffer a loss of income when your existing investments mature. - Frank Pearson**

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Some experts, in fact, recommend investing in a fixed-interest investment with as long a term as you can find, perhaps with the government, local government or a bank for security.

There is some risk in doing this. If you find that you later have to sell that investment before maturity, its value might have fallen (if interest rates have risen in the meantime).

But, as long as you don't have to sell, there are some clear advantages to long-term fixed interest. You know exactly how much income you will get. And, with inflation likely to stay low, the value of your principal won't be eroded nearly as much as in the past.

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**The most important thing we do for our clients is probably the simplest - putting them in long-term fixed interest, so that they know where the money for their future grocery bills will come from. - Frank Pearson**

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## Managed funds

Managed funds include superannuation schemes, unit trusts, investment trusts, group investment funds, index funds and others in which the savings of many investors are pooled.

Some managed funds invest only in shares, interest-bearing investments or property, often with a small amount in cash. Others hold a combination of these investments.

Funds usually give investors more diversification than they could obtain on their own, and require less management than a portfolio of investments. There is, however, wide variation in the quality of management of the funds, in fees charged and in how the funds are taxed.

In general, the effects of low inflation on these funds follow the effects on the types of assets the funds have invested in.

## Collectibles, agricultural ventures and so on

Over the long haul, and over a wide range of items, the value of collectibles probably rises at about the same pace as inflation. Investments in forestry, emus, chestnuts, vineyards, kiwifruit and other agricultural ventures may, on average, bring in returns somewhat above inflation, because of their riskiness.

However, there is huge variability. One painting's value might grow ten-fold in a year; another's value might drop fast.

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**Somebody makes money out of every (collectibles) investment. It's a lotto game. - Tony Alexander**

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In periods of low inflation, it's easier to see what's really happening with these types of investments, some of which have trapped the gullible in the past. Promoters' projections don't look as impressive as when inflation was high, and poor returns are more obvious.

As far as collectibles are concerned, experts generally advise against investing in them for purely financial reasons. While you might do brilliantly, there is often also a high risk that you will do badly.

However, if you enjoy owning certain items, and you can afford to see their values fall, you may want to buy them. It's safer, though, to regard them as belongings rather than investments.

In agricultural ventures, one danger is putting too much of your savings in one area. Generally speaking, you shouldn't invest more than, say, 5 per cent of your funds in any one venture. And it should be money that you can manage without, if things go wrong.

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**I go and buy this forest when I'm 30 years old and that's my retirement sewn up. And the risk is, I think I don't actually need to save any money, I've got a forest...  
- Tony Alexander**

**...And it may turn out to be not worth very much at all. - Frank Pearson**

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## Annuities

If you buy an annuity, you give an insurance company a lump sum and they give you regular income, usually for life.

Annuities are more popular overseas, but are quite widely available in New Zealand. They are usually bought by retired people, who are concerned that they might outlive their savings.

Now that inflation is low, annuities are more likely to come into their own in this country. The value of a fixed income for life won't be eroded away nearly as quickly as in the past.

Even so, if you're expecting to receive annuity payments for many years to come, you may want some protection from inflation regardless of its level. Even 2 per cent inflation adds up over a decade.

Annuity providers offer inflation protection via an approximate inflation adjustment. You nominate a percentage, and your payments will grow by that amount each year.

That protection adds to the cost of the annuity. The higher the annual adjustment, the higher the cost. These days, though, many purchasers are happy with a low adjustment - say 2 or 3 per cent. It costs much less than the 10 or 15 per cent people might have required in the past.

If you feel fairly confident that inflation won't rise much in the future - and, of course, confident about the annuity provider - buying an annuity can give you some security in old age.

## Getting the Right Spread

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As we said earlier, a basic rule of investment is to spread your risks by investing in a wide range of product types.

Most people's main investment is in their home. If they also invest in other property, their total investments may be heavily into real estate.

Furthermore, often it's only one type of real estate: housing. And, if they own a rental property near where they live, their property is all in one area. This over-exposes them to regional downturns, which can be permanent, especially if population is leaving the area.

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**People tend to have rental properties where they can keep an eye on them. But if the prosperity of the region starts to weaken, it's likely to hurt the value of the houses in the area, and it's going to imperil the jobs people have. You might question the value of having a rental property whose fortunes are related to your earning power. - Tore Hayward**

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Often, they will have little or no money in shares, and not much in interest-bearing or other investments.

This lack of spread, or diversification, increases risk. If property does badly - or even if it rises more slowly than alternatives - that can't be balanced out by another type of investment doing well. All the eggs are in one basket.

This is particularly risky in a low-inflation environment when, as explained above, investing in property doesn't tend to work as well.

What's more - and this is perhaps more important - investing in alternatives, such as fixed interest and shares, tends to work better in the current environment than in the past. It would be a pity to miss out on potentially good returns in those areas.

When inflation is low and stable, then, the argument for diversification is even stronger than otherwise.

There are a couple of points to note here.

Firstly, if you are repaying a mortgage (or other debt), it makes no sense to diversify into fixed-interest investments until you've repaid the debt.

As explained earlier, when you repay a non-investment loan you improve your wealth as much as you would in an investment that pays the same interest rate as the loan, *after tax*. Generally you won't find such an investment in fixed interest, unless you take on high-risk lending.

Secondly, diversification has a cost. There will be times when you'll wish you were only in shares, or only in property, or even emus - because that investment is doing particularly well for a while.

But there will also be times when you're very relieved you have spread your money around. In the long run, you'll do better.