



## Managing debt in the face of rising interest rates

With rising interest rates and higher prices putting the squeeze on many household budgets, it's timely to take a look at the basics of debt management. A few simple steps can make a big difference.

***“All debt has to be repaid eventually, and the sooner the better.”***

### Consolidate debt

Mortgages aren't the only debt people carry, and interest rates on credit cards and personal loans are also rising. These forms of credit have higher interest rates to begin with, so they can be difficult to get under control.

Debt consolidation is the process of rolling together all your loans into one loan with the lowest interest rate. This will usually be the home loan.

If you have a redraw facility on your mortgage, use it to pay off any personal loans and credit card balances. Don't treat it as a magic pudding, though. All debt has to be repaid eventually, and the sooner the better.

If you're not a home-owner and you are paying interest on your credit cards, talk to your bank about a personal loan. It may provide a lower interest rate, and make it easier to repay the debt.

### Editorial

The two big themes on the Australian financial scene at present are rising interest rates and turmoil on our share market. The signs tell us that the United States has slipped into recession, and whilst the Australian economy continues to benefit from the mining boom, we may not be immune to the flow-on effects of the American slow-down.

The sub-prime lending crisis lies behind much of the share market upheaval. Ironically, despite our strong economy and our companies having relatively low exposure to sub-prime loans, the Australian share market has fallen more than the US market. It's a difficult time for investors, so in this edition we review some fundamentals of share market investing.

The sub-prime crisis is also exerting some pressure on domestic interest rates. Though it is inflation, driven by our strong economy and the shortage of housing, that is having the biggest influence. We examine this in more detail on page 3, but given the pressure on household budgets caused by higher interest rates, we start with some tips on managing debt.

We live in challenging economic times, and the outlook is uncertain. However there are some tried and true strategies that can help you to reduce risk and position you to take full advantage of the recovery, when it occurs.

As always, the right advice is crucial. An IFFP planner can help, so call us on 1300 138 848 to make an appointment.

**David Haynes**  
*General Manager*

### Repay loans as quickly as possible

Using your surplus savings to pay off loans is one of the most effective wealth creation strategies there is.

If you're in a 30% tax bracket, and the interest rate on your mortgage is over 9%, you'd need to achieve more than 13% return on an investment, before tax, for it to be a better deal than paying down the home loan. For people in higher tax brackets, the required return is even greater.

*continued page 4...*

#### THIS ISSUE...

Profiting from turbulent times

Why are interest rates going up?

Funeral bond limits

# Profiting from turbulent times

When share markets take a dive it's worth reminding ourselves of a few market fundamentals:

1. **Shares are volatile.** Shares go up and down in value. Since November last year, many shares have been falling in price, as they do from time to time. Some companies with weak financial structures may not survive in their current form. However sound, well-managed companies will weather the storm.
2. **Share markets have always recovered.** In the entire history of share markets, they have never collapsed and failed to recover. In fact, after every fall, markets go on to set new highs.
3. **No one rings a bell at the bottom.** The recovery could begin next month or next year. It could be slow and protracted, or large movements could occur over a few days of trading. Investors who are out of the market at the wrong time miss out on substantial gains when the market moves quickly.
4. **Patience is often rewarded.** Investors with well-diversified portfolios of quality investments are usually rewarded for sitting tight and being patient.
5. **Downturns create opportunities.** Another way to look at share market downturns is that the market is having a sale. The true bargains may be difficult to identify in the midst of the storm, but they'll be there.
6. **Investors can profit from the turbulent times.** One way to take advantage of share market volatility is through dollar cost averaging. This is simply the process of making regular asset purchases, as opposed to placing a large sum of money in one hit.

Below is an example of investing \$1,000 a month into a hypothetical managed share fund.

Month	Unit price	Units purchased
1	\$3.00	333.33
2	\$2.80	357.14
3	\$2.50	400.00
4	\$2.60	384.62
5	\$2.10	476.19
6	\$1.98	505.05
7	\$2.30	434.78
8	\$2.45	408.16
9	\$2.80	357.14
10	\$3.00	333.33
<b>Total</b>		<b>3989.74</b>

At the end of the investment period, \$10,000 has been added to the portfolio, but because more units were purchased when the market was down, the investor has bought 656 units more than they would have if they had invested everything on Day 1.

At the end of the process the value of the investment stands at \$11,969.22 – a 19.7% return, even though the unit price has only come back to its starting point.

If you are receiving employer superannuation contributions, you're probably taking advantage of dollar cost averaging without knowing it.

Each time a contribution is made, it will be adding to your investments at the current, lower prices.

Even though it's an enforced approach to dollar cost averaging, it provides exactly the same benefit as illustrated below.

Dollar cost averaging doesn't always provide the best outcome or generate a positive return. It works best in a declining to flat market.

Given that share markets spend more time rising than falling, there will often be long periods when dollar cost averaging doesn't pay off.

But in turbulent times like we're experiencing at the moment, dollar cost averaging into a well diversified managed share fund may well be the sensible way to unearth those hidden bargains.





## Why are interest rates going up?

This question must be on the minds of anyone with a mortgage at the moment. At the heart of the answer is the fact that the Reserve Bank of Australia (RBA) has been given the job of keeping inflation within the range of 2–3% pa. Their main tool for doing this is adjusting interest rates. This is called monetary policy.

As inflation has popped its head above the 3% line in recent times, the RBA has increased official interest rates to try to knock it down again.

Mind you, rates have risen 12 times since the last cut in December 2001. They've increased from 4.25% to 7.25%, so it's proving quite difficult to reign in the galloping economy.

Higher interest rates reduce inflation by increasing mortgage repayments, thus reducing the amount of money people have available to spend on consumer goods and services.

This reduces demand, and when demand is lower, prices should fall, or at least be less inclined to rise. Higher interest rates don't just affect people with mortgages. Most companies borrow money to help grow their businesses. Higher interest rates reduce their profits.

This makes them more reluctant to invest in new equipment and to take on new staff, and economic growth is further dampened.

Unfortunately, raising interest rates is a bit of a blunt instrument, and inevitably creates winners and losers. Around 35% of households have a mortgage<sup>1</sup>, and they take on a disproportionate burden when interest rates are used as the only tool for an attack of inflation.

People without debt may actually benefit from rising interest rates, with interest-bearing investments now looking more attractive than at any time in the last decade. Many of the banks have been increasing their mortgage rates by more than the official rises lately, so what's going on?

The problem is that Australians love to spend, and we don't like to save. In fact, as a nation, we have been spending more than we earn for decades. The only way we can fund that gap is by borrowing from overseas.

In recent years, that has been relatively cheap to do, but as a result of the sub-prime lending crisis triggered in the United States, the cost of overseas money has gone up substantially. The banks pass on this higher cost of money to borrowers, in the form of increased interest rates.

Fiscal policy can also be used in the fight against inflation. Fiscal policy is the balance between tax collection and government spending, and it's controlled by the federal government. Increasing taxes and decreasing spending help to reduce inflationary pressures.

The federal government has promised substantial tax cuts over the next three years. This will put more money into people's pockets and stimulate inflation.

To counteract this, the government has indicated it will reduce government spending. We'll have to wait for the May budget to see exactly what they have in mind.

The Reserve Bank has hinted that recent interest rate rises may be sufficient to bring inflation back under control. However many economists are tipping another rise in May, so there may be some more pain in the pipeline yet.

<sup>1</sup> Source: Australian Bureau of Statistics

***“As a nation, we have been spending more than we earn for decades.”***



## New limits on funeral bonds

Funeral bonds are a form of insurance policy specifically designed to allow people to save for their funeral expenses. Proceeds are only payable upon death, and no prior withdrawals can be made.

Funeral bonds may provide tax benefits, but aside from making provision for life's last expense, their main attraction is that they are one of the few ways in which it is possible to legitimately 'hide' assets from Centrelink's Age Pension means tests.

On January 1, 2008 the limit on the amount that can be contributed to a funeral bond was increased from \$5,000 to \$10,000.

Thus, a couple purchasing two funeral bonds can reduce the level of assets counted by Centrelink by up to \$20,000. This could lead to an increase in the level of Age Pension of up to \$30 per fortnight per couple.

If you are over Age Pension age and would like to know more about funeral bonds, call 1300 138 848 to arrange an appointment with an IFFP financial planner.

***"...they are one of the few ways in which it is possible to legitimately 'hide' assets"***

### ***Managing debt in the face of rising interest rates...continued from page 1***

Switching from monthly to fortnightly payments is one way to pay off the mortgage more quickly. This step alone could cut around six years off the term of a standard loan, and save tens of thousands of dollars in interest.

Opening a mortgage offset account is another great way to reduce your interest bill. Any money in the offset account is subtracted from your mortgage balance when calculating interest payable. This means every dollar in the bank is working as hard as possible for you.

### **Review spending**

It's important to remember that a major reason for raising interest rates is to reduce consumer spending. The Reserve Bank's aim is to dampen economic activity a little, to try to correct some of the imbalances that arise in a hot economy. So, to some extent, the pain being felt by borrowers is intentional.

Therefore, any debt management strategy needs to look at spending. If you don't already

have one, draw up a household budget. It will help you keep track of where the money is going, and make it easier to see where you might be able to cut back.

Credit cards make it easy to give into temptation. If you're in control of your credit cards and pay off the balance every month before interest is incurred, they are a great convenience. But if plastic has control of you and you're forever trying to get the balance down, it might be time to get the scissors out and show your credit cards who's boss.

### **For intending borrowers**

If you plan to take out a mortgage soon, borrow conservatively and allow for higher rates. The people facing the biggest problem at the moment are the ones who borrowed up to their limit at lower interest rates. They now find that they don't have the capacity to cope with higher repayments.

IFFP can help you work out a debt management program. Phone 1300 138 848 to make an appointment, without obligation, with one of our experienced advisers.

For more information  
**1300 138 848**

Website  
**iffp.com.au**

Email  
**iffp@industryfundservices.com.au**

### **HEAD OFFICE**

Casselden Place, Level 31

2 Lonsdale Street

Melbourne VIC 3000

ABN 54 007 016 195

AFSL No. 232514

FP\_N\_0408