Insights and investment solutions magazine

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Welcome

In this edition of Insights and Investment Solutions magazine, read the latest market update based on the highlights across the Australian market over the past month.

We look at how to manage your debt and how debt can help you build long term wealth.

Until next time – happy reading.

Grasso Financial Services
John Grasso AFP®, DIP FS (FP), MFinPlan, SSA SMSF
Specialist Advisor™
07 4783 1767
admin@grassfs.com.au
www.grassofinancialservices.com.au

Market update

This month saw record COVID-19 infections across US and Europe with many countries heading back into physical lockdowns. November also saw mixed economic data and a new US President elect. Despite all, the strong hopes of a vaccine before Christmas led our local share market to have one of its strongest months since 1988.

COVID-19 Outlook

As the northern hemisphere heads into winter and with a predicted case numbers rise as a result, it is becoming increasingly evident that COVID-19 like its sibling, the flu, is seasonal.

In Australia, both Victoria and NSW experienced 26 and 24 days respectively of no community transmission over November. Melbourne, the most recent hotspot for infections in Australia was able to temporarily eradicate COVID-19 with no active cases in the state by the end of the month. Unfortunately, an outbreak in Adelaide put the city into an extreme 6-day lockdown that was cut short 3 days early.

In the US, daily infection rates hit all-time highs with more than 200,000 recorded infections with over 2,500 deaths per day reported over the month. As an indicator of the severity of the situation, we saw the New York City Public School system, the largest in the country, close as the percentage of positive tests over the 7 day rolling average hit a 3% circuit breaker level. Europe, like the US, faced a similar fate with most countries heading back into physical lockdowns in the hopes of flattening the curve and to remove stress across an overloaded healthcare system.

While this may have painted a very grim picture as we head into the holiday season – November saw strong hopes for the success of stage 3 vaccine trials. Most notably Pfizer, AstraZeneca and Moderna all reporting an effectiveness of more than 90%. This is in comparison to our normal annual flu jab that sits at 50-60%. Pfizer has submitted emergency approval to the US Food and Drug Authority (FDA), with Moderna not far behind. It is expected that the first round of COVID-19 vaccines will be issued before the end of the year.

US Election

On November 7 the US went to the polls for what was one of the most hotly contested and divided elections in history. The lead up to the election polling data indicated a potential 'blue wave' – with the Democrats taking both houses and the oval office. In the proceeding days after the election it became apparent that while Joe Biden would be the 46th US President (despite the Republicans efforts to overturn the result), Biden will contend with the House of Representatives and Senate most likely being divided - pending the outcome of 2 Senate races in Georgia due in early January.

A divided house means it will be a lot harder for Biden to get many of his campaign measures actioned, including raising of corporate taxes. Despite this outcome, markets welcomed the news of a new President as we saw the strongest post-election rally on record. While we waited to hear if the outgoing President Trump will concede and accept defeat, towards the end of the month The President reluctantly agreed to allow the transition of power to occur.

There are two key takeaways from the election outside of the noise surrounding alleged voter fraud and multiple state recounts. Firstly, this was the highest level of voter participation in the US at almost 70% (normally sub 60%). Secondly, Joe Biden and Donald Trump received the highest and second highest number of votes in US history, respectively.

How to manage your debt

Consolidating your debts, transferring your credit cards to a low or zero balance card and making sure you're paying the lowest possible rate on your mortgage are just some of the steps on how to manage debt and get on top of your loans.

Australia has the second highest household debt in the world , second only to Switzerland, with household debt running at about 125 per cent of gross domestic product (also known as GDP) . With stats like this, it's no wonder debt is something that keeps us up at night.

According to the ABC's 2019 survey, Australia Talks, debt is a problem for 90 per cent of the 55,000 people who responded to the research. Additionally, 37 per cent of respondents said they struggled to pay their debts, with almost half of millennials surveyed stating that debt is a problem for them.

But it's not all doom and gloom for those who are concerned. Here are three ways to manage debt.

1. Debt consolidation

This is a strategy that can help you reduce the interest you pay over time and the total amount you pay on your loans. It involves consolidating or combining higher-paying debts such as credit cards into a lower-paying facility such as a personal loan.

Consolidating your debts this way could give you savings over time, given Canstar research conducted in April 2020 shows the average interest rate a non-rewards credit card charges is 13.76 per cent, while the highest rate is 24.98 per cent. This compares with an average rate of 10.30 per cent for personal loans.

Another option for managing debt is if you have a home loan, you may be able to consolidate all your personal loans and credit cards into your home loan. According to Finder's figures from April 2020, the average variable home loan interest rate is 4.63 per cent. So, consolidating all your loans into your home loan means you'll save even more than consolidating your debts into your personal loan. If you consolidate your loans into your home loan, you are putting up your home as security. This means that if you are unable to make repayments, the lender can sell your home to get back the money you borrowed. You should consider which option is the right one for you.

Debt consolidation has other advantages. Moving your credit card balances to a lower-interest rate personal loan or to your home loan can also stop you from spending more on your credit card to help you get a firmer financial footing.

2. Take control of your credit cards

Research into credit card lending by the Australian Securities and Investments Commission (ASIC), which reviewed 21.4 million credit card accounts, shows 18.5 per cent of us struggle with credit card debt. If you're part of this statistic however, there are plenty of actions you can take to manage debt like this.

Take control

The first step is to take control by working out how long it will take you to pay off your credit card.

Let's say you have a $10,000 debt on which you are paying 18 per cent interest. It will take you 43 years and 11 months to pay off this debt by paying the minimum amount of $203 a month, and you will end up paying $36,332 in total. But, if you increase your monthly repayments to $492, you can have the debt paid off in two years and only pay $11,805. That's a saving of $24,528.

The message is: pay off as much as you can afford when it comes to high interest debt, such as credit cards to pay down your debt as fast as possible and significantly reduce the total amount you will pay in the long run.

Balance transfer

Arranging a balance transfer is another great way to get on top of your credit card debts. This is a strategy that involves transferring your credit card balance from a high-interest card to a low-interest or zero interest card and trying to pay off as much as possible during the special low-interest or zero-interest period.

It is important, however, to understand the terms and conditions of credit card products such as these, as the interest rate will increase to the standard variable rate applicable to the credit card after the special interest conditions end.

Pay in full during interest-free period

Another way to get on top of your credit card debt is to pay off the amount in full before the end of the card's interest-free period. Be aware that the interest-free period does not start from the time you make a purchase, but instead, at the start of each statement.

Many cards have an interest-free period of up to 55 days, so if you buy something at the start of each statement's interest-free period, you will enjoy 55 days interest-free. The interest-free period may not apply to cash advances and balance transfers.

3. Check you're on the lowest possible home loan rate

With interest rates at record lows, home loans have never been more affordable. Surprisingly, however, a large number of us don't check we're on the lower possible rate, or, ask our bank for the best rate it can give us.

If you have a mortgage, now is the time to contact your lender to reduce your interest rate, if possible. If you are able to drop the rate you pay, you could save thousands over time and pay off your home loan faster.

How debt can help you build long-term wealth

Contrary to what some people may think, debt can help you build your wealth – especially if the debt is used responsibly with a clear plan and objective. In this article, we look at three ways that may help you to better utilise debt to increase your wealth over the long-term.

'Efficient' debt verses 'inefficient' debt

It's important to outline the difference between efficient and inefficient debt.

Inefficient debt is generally associated with assets that depreciate in value and have no potential of producing income or offering tax benefits. This could include debt such as a car loan or using a credit card to pay for a holiday.

Efficient debt on the other hand is acquired to purchase assets that have the potential to grow in value and/or generate income that can be used to pay back the debt. Examples of such assets include property, shares and other securities such as managed funds. It's this type of debt that can help you build real wealth over the long term.

There are a number of ways to manage debt as a means to build wealth over the long-term.

1. Remove inefficient debt

Having inefficient debt is more than likely reducing your wealth due to the associated interest and fees. In some cases, it may be worthwhile focusing on paying down this debt first – starting with your highest interest/fee debt, and progressively paying this off.

For instance, if the interest on your credit card balance or personal loan is more than the interest on your home loan, depending on your circumstances, it may be better to pay off your credit card debt first given it has higher interest and fees than your home loan. By utilising this approach, you should be able to progressively reduce your overall interest payments.

2. Borrowing to invest

Borrowing to invest (e.g., in property or shares), or gearing, can be a powerful means to build wealth over time as it enables you to purchase more investments than would be otherwise possible.

If your investments increase in value over time, gearing can generate a higher overall return, after the interest and other costs associated with the debt have been factored in. Capital growth and income generated from the assets can also be used to pay back the debt plus interest and fees. The interest charged on the debt may also be tax deductable.

However, there is always a risk that your investments may decrease in value, resulting in owing more on the loan than the value of your investment. If you're unable to pay back the loan due to unexpected circumstances such as, an interest rate increases or you're out of work for an extended period, the lender may have the right to take ownership of your investments.

In a worst-case scenario, depending on the amount you've borrowed to invest, you could lose more than your initial capital.

Varying examples of how gearing may work, can be viewed from this article.

3. Debt Recycling

Debt recycling can be an effective strategy to accumulate wealth over time by converting some of your debt, which is inefficient (doesn't generate capital growth or income, or isn't tax-deductable) into debt that may be efficient (generates capital growth or income, or is tax-deductable).

One way to do this involves using a lump sum – possibly received from a bonus or an inheritance – to pay off your inefficient debt. If you then borrow the same amount and invest it, you're essentially replacing the inefficient debt with a debt that is tax-deductable and could potentially generate wealth.

There are other options for implementing a debt recycling strategy, with varying levels of risk. A financial adviser may be able to help you determine a strategy that is most suitable for your needs.

The risks associated with taking on debt

Using debt as part of your investment strategy can introduce substantial risk including:

- Borrowing could increase potential losses
- Your losses could exceed the amount initially invested
- The value of your investments purchased using debt may not increase, or if the value does increase, it may not be sufficient to cover the costs of the loan such as interest and fees
- You may need to sell your investments sooner than intended to cover your interest, fees and charges
- If you are unable to repay your loan, the lender may have the right to sell your assets to cover outstanding repayments, interest or fees
- You may be liable to pay more tax.

In summary

Given the level of risk associated with an investment strategy that incorporates debt, it's important to consider whether this approach is right for you. Speaking to a professional, such as a financial adviser, is highly recommended.

It's also important not to incur more debt than you can comfortably afford to pay back, regardless of whether it is efficient or inefficient.

Bottom line: when it comes to taking on debt, there is always risk, but if managed well, efficient debt can help you to build your wealth over time.

Grasso Financial Services P 07 4783 1767 W www.grassofinancialservices.com.au

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