mikephippsfinance

Financial Literacy and the Assumption of Ignorance

There are lots of quotes on the internet regarding financial literacy. Here's the one that jumps out at me:

"Financial illiteracy is not an issue unique to any one population. It affects everyone: men and women, young and old, across all racial and socioeconomic lines. No longer can we stand by and ignore this problem. The economic future of the United States depends on it."

President's Advisory Council on Financial Literacy

Here in Oz we have an interesting way of dealing with the problem of the financially illiterate. It's a lot like the way we deal with dangerous roads. The problem is identified, usually by numerous accidents, and then we erect a sign warning of dangerous conditions ahead. We don't invest in fixing the two obvious problems, being the dangerous road and the poor driver. Then we compel everyone to walk as slow as our slowest person by introducing draconian enforcement measures, fines and speed limits. It's brilliant, just brilliant!

In the financial services sector, we do the same thing. A number of accidents and close calls results in a review of the system. This is followed by a raft of new rules and regulations, monumental amounts of paperwork and increased regulation. The whole farce culminates in a thing called The Banking Code of Practice. This inspired piece of nonsense not only compels lenders to treat clients like inexperienced drivers on dangerous roads but to also assume that the driver is impaired and incapable of making any kind of sensible decision. Best of all it places responsibility on the lender while giving the borrower any number of avenues to escape responsibility. There is no Opt Out provision for long suffering bank clients who simple don't want mountains of paper every time they want to do something. We all walk as slow as our slowest and that's a snail's pace to be sure.

Needless to say, we are already seeing the outcome of all this new compliance and to date none of it is good for the economy. Slower loan approval turnaround times, lower credit approval volumes and very fragile consumer confidence. Sure, a few aggrieved bank clients are probably feeling pretty good about the whole mess but for the average quiet Australian in the 'burbs it's hard to see any positives coming out of the current situation. Even if we get real about financial education right now, we are at least one generation away from a population that doesn't need government rules and regulations in order to make informed financial decisions. In the meantime, the job will be left to people like us who spend an incredible amount of unpaid time explaining to clients how things work.

Which leads me (at last you say) to a very brief summary of the most misunderstood finance related ratios and concepts that we see. Remember, we deal mostly in business finance so these will be somewhat tilted that way. Having said that understanding the rational involved in each concept will help anyone who wants to better understand finance.

Equity

Simply the proportionate value of an asset that you own. If your house is worth $800,000 and you owe the bank $300,000 then your equity is $500,000. That's fine in theory but it's important to understand that if you go to the bank, you can't borrow an extra $500,000. For business and many investment purposes the maximum lending (or gearing) will be 80% of the house value. As such the calculation is:

- $800,000 x 80% = $640,000 less current debt $300,000 leaves $340,000

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A lot of potential buyers of management rights and motels make this fundamental mistake and assume a higher level of equity than what is actually available. The only way to access all the equity in a property is to sell it.

Loan to Valuation Ratio (LVR)

Simply an outcome of asset value and lending. Sometimes referred to as gearing.

- Loan $300,000 divided by asset value $750,000 x 100 = 40% LVR

It's important not to add purchase costs to the asset value when calculating LVR. It's also important to understand that banks lend on purchase price or valuation, whichever is the lesser. If you pay more than valuation for an asset while needing to maintain an acceptable LVR you will need to contribute additional equity. That gets important later on, as you will see.

Interest

Lenders charge interest when you borrow money. The longer you take to pay down the debt the more interest you pay. If the net value of the financed asset or venture (after tax planning and deductions) does not appreciate faster than the cost of the debt you are behind the eight ball. It's that simple. So, how to shorten the odds in your favour? Pay the debt off fast.

Incurring an interest cost with a tax deduction being the primary motivation is, of itself, a flawed strategy. Who in their right mind spends $1 to save 30 cents? There are good reasons to carry business and investment debt and tax deductibility of interest costs just happens to be a happy side benefit.

I strongly recommend using an Amortisation Table to review the loan you are contemplating. Plenty are available via Google and they are great way see graphically what a difference accelerated debt reduction can make to your total interest costs.

One caveat…..there are some geared investment products for which cash flow generation is more appealing than debt amortisation. That's fine as long as the leveraged investor understands the nature of the risk and the future possibility of a need to introduce more capital should the asset value fall and/or bank lending tolerances change.

Return on Investment (ROI)

An outcome of comparing the price of an incoming producing asset with the raw profit it makes. Not a bad way of comparing like assets and other investment opportunities.

- Net profit $320,000 divided by management rights plus unit price $2,350,000 x 100 = 13.6% ROI

This simple ratio can be used for any investment opportunity or asset class and in my view is a better method of comparing opportunities than using multiples of net profit. I am sure the smarties out there will point out that there are far more sophisticated ways of comparing competing investment opportunities. I am happy to write about Net Present Value of Future Cash Flows once I am confident the average borrower understands the fundamentals.

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Return on Equity (ROE) and Leverage

You've got a certain amount of money to invest and the rest will come from the bank. Let's say the asset has a ROI of 14%, interest costs at 5% and gearing at 70%. The simple outcome is that the more 5% interest only money you can get your hands on the higher your return on equity. Of course, blind Freddie can see that if/when interest rates rise the ROE will erode unless the ROI has been driven up by improved business performance. With rates where they are right now and asset classes like management rights showing ROI numbers at nearly three times cost of debt the miracle of leverage can be clearly demonstrated. Just remember, it's only a miracle while rates are low, and ROI is high. Beware the miracle that turns out to be a mirage.

Here's the basics:

- Asset value $3,500,000
- Add costs to acquire $250,000
- Total required $3,750,000
- Less bank finance at 70% LVR $2,450,000
- Equity contribution required $1,300,000
- Net profit $475,000 less interest costs $122,500 = $352,500 divided by $1,300,000 x 100 = Return on equity 27%

Seems simple and wow, what a return! Problem is this calculation is flawed and reflects the way numbers can be presented to distort outcomes. The calculation reflects a profit net of a two-person team and net of any allowances for contingencies such as relief management. To get a real-world ROE these allowances must be made. As such the revised calculation looks like this:

- Net profit $475,000 less interest costs $122,500 = $352,500 less wages and contingencies allowance $130,000 = $222,500 divided by $1,300,000 x 100 = Return on equity 17%

Still pretty good but certainly not the 27% the raw numbers would suggest. The trick is to understand that ROE needs to be seen as a passive return. That is, a return after the personal labour and contingencies allowances of the business owner are deducted from the profit. My personal preference would be to take a lower return (still way better than my super fund for example) and pay off the debt.

We tend to use the ROE calculation when assessing a passive investment, but you can also use this when you are looking at the returns a husband & wife business is generating. To calculate your ROE, first you need to ask yourself what you would reasonably pay yourself to complete the work you are doing & deduct that from the net profit, then you can truly see what the return to you for your original investment would be.

If all these ratios are starting to give you a headache, remember….. we are always happy to run all the numbers for you and our services are fee free.

In closing I must stress that all this is very simplified, and every borrower will have a different set of circumstances. Clever tax planning and individual asset classes will also impact my observations. Borrowers should always consult their accountant before making any financial decision.

Let's hope that at some point we can all start walking at our own pace.

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