



MONEY DUE REWARDS:



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No Free Lunches

Just about everybody has heard the old saying: “There’s no such thing as a free lunch”. These are wise words and true, but one place where they are particularly applicable is in the realm of “fixed interest” or “income” investing, i.e. where you invest money, not for capital growth, but simply so to receive your money back, plus interest.

In this type of investing, there is a general expectation that you will, in fact get your money back at the end of the investment term, and as a result most people focus exclusively on the interest rate. After all, if you get your money back at the finish, all that really matters is the interest, so the higher the rate, the better it will be as an investment. Right?

Wrong! In fact it is that sort of thinking that has landed the noteholders of Westpoint, Fincorp and ACR well and truly in the soup. Many investors opted for the attractive interest rate, but didn’t look much further, and now the damage is done.

In fact, to invest wisely in the income markets, careful attention needs to be paid to the underlying investment which is supposed to be funding the return of your capital, as well as the promised interest payments. In all cases, we need to ask ourselves the question, “What would happen if the underlying venture didn’t perform to expectations?” Once we start to ask these sorts of questions, we find that the world suddenly becomes more complicated. To illustrate the range of options you might encounter in this asset class, let me give a few examples.

Investment 1 is a “high yield” mortgage fund which last year yielded 9.84%. Sounds pretty good, but in order to get that sort of return the manager had to restrict the underlying investments to 15 loans, all of which were financing the construction of retirement homes in Western Australia and Queensland. Pretty risky stuff, and not very diversified.

Investment 2, by contrast, is also a “high yield” mortgage fund and is expected to yield about 8%. Not as juicy as the first one, but in this case there is a much larger underlying loan book, with a wider range of underlying enterprises being financed. As a result, the risk of a substantial default is considerably less compared with the first investment.

Investment 3, on the other hand is an interest bearing security yielding 7.49% including franking credits and issued by a major Australian bank. Here, the issuer is pretty rock solid, so the risk is less again, but so is the return.

It is abundantly clear that there are very few “free lunches” in this market. In fact, debts tend to be quite finely priced according to the amount of risk involved. The question really becomes whether a greater or lesser level of credit risk is appropriate in your circumstances.

While appearing simple at first glance, the world of interest bearing investments is actually remarkably complex. A professional financial advisor can assist you in dealing with these complications and help you to find an investment approach which suits your preferences and circumstances.

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