Six steps for managing rising household debt

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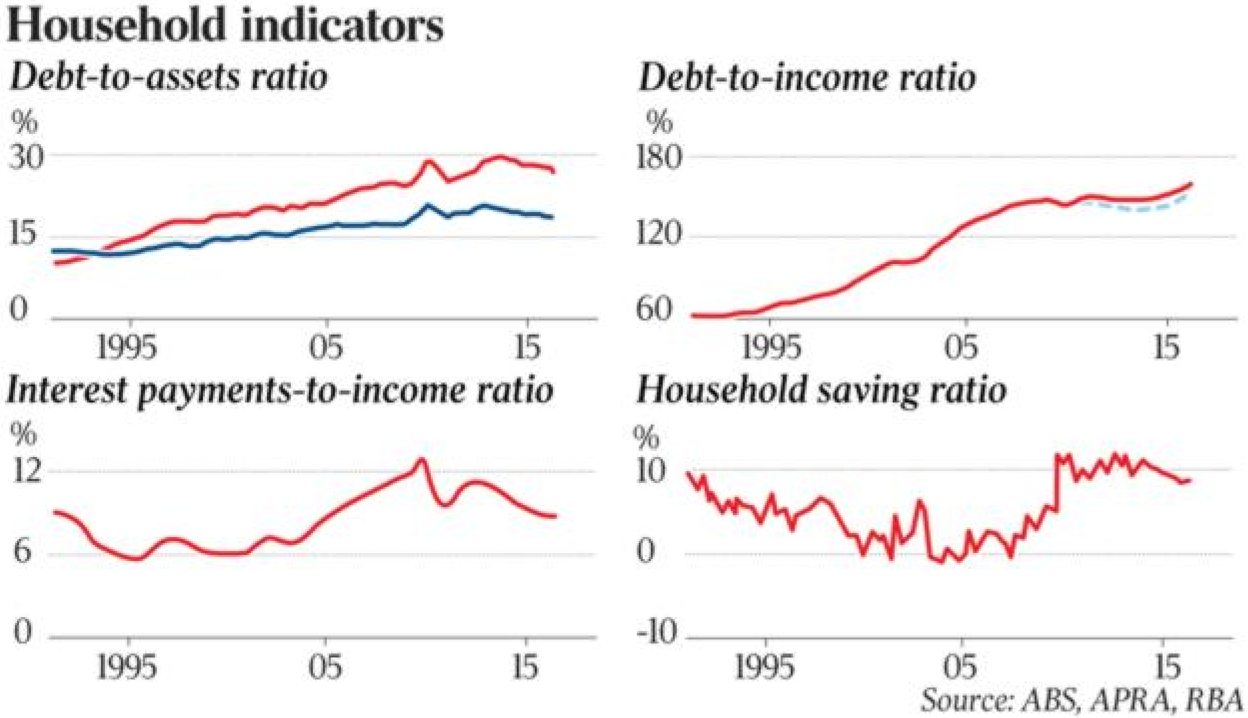
- DON STAMMER



Household indicators. *Source:* TheAustralian

Most of the time and effort spent on investment advice is devoted to asset selection. How to manage any debts the investor has, or will soon acquire, is generally given little attention.

That ranking of priorities is understandable: the choice of investments is wide, the risks of the various asset classes and of individual investments need to be understood, and an appropriate diversification has to be planned.

But for many Australian investors, debt matters a lot. Our household debt, as a percentage of household income, is the highest in the world. It plateaued for a time after the global financial crisis; recently, it's been creeping up again to a record high a little above 150 per cent.

Managed wisely, debt enables investors to build up larger holdings of wealth than they otherwise could. But excessive debt and debt managed badly are the easy ways to wealth contraction or destruction.

The level and structure of debt of Australian households debt are more complex than is generally recognised. As the Reserve Bank pointed out in its Financial Stability Report, household financial stress “remains fairly benign”. In part, that’s because the low interest rates we’ve had in recent years make it easier for borrowers to service their debts. Indeed, the average household with a mortgage is 28 months ahead on scheduled repayments.

Households have further strengthened their balance sheets, in aggregate, in recent years by saving almost 10 per cent of disposable income, compared with zero saving in the decade to 2006. Households’ debt-to-assets ratio has continued on a mild downward trend in recent years. Also, the share of housing loans that banks classify as non-performing is low, at 0.6 per cent of total housing loans by value.

What, then, are the worries? The macro concerns from the high level of household debt are these: strongly rising housing prices in some regions could bring on a housing bust; and, in the RBA’s words, the “high levels of investor activity have raised concerns about banks’ housing loan portfolios”.

More generally, there’s recognition that a minority of households is repeating long-familiar mistakes in taking on too much debt, leaving them vulnerable to shocks like higher interest rates, job loss, ill health, or falling asset values. Here are six commonsense rules for investors to think about and manage the high level of debt.

1. Each household should maintain, and regularly update, information on its indebtedness — including not just what is owed on the mortgage, but also any personal loans, credit cards, taxes to be paid, HECS, and so on.

2. It’s also a good idea to list debts under two headings: “Good debt” and “bad debt”. Good debt would include — at least within reasonable limits — borrowings for the family home, investments and education. Generally, “bad debt” would include debt to pay for living expenses and holidays.

3. High-cost borrowings such as advances on credit cards are a debt trap and should be avoided.

4. Most loans for investment purposes carry variable interest rates. When the RBA raises its cash rate, the resulting increases in monthly repayments on existing loans can be painful for borrowers. Particularly while the general structure of interest rates is low — as it is today — borrowers should consider having a part of their loan carry a fixed interest rate.

5. Too often, people borrowing for investment purposes do so when markets are booming. But the truth is that investors seeking the additional “leverage” or “gearing” that debt provides will generally do better by making their move in gloomy times, when quality investments can be purchased at reasonable prices. Investors should allow also that from time to time their investments will fall in value; that taxable incomes that support “negative gearing” can disappear in difficult years; and that tax rules can change.

6. In many investments, investors acquire debt indirectly; they don’t have to borrow in order to have a geared portfolio. For example, the average (non-financial) listed company has debt equal to 55 per cent of its equity value.

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund and Altius Asset Management Limited. The views expressed are his alone.