Dangers lurking in the bank of mum and dad

A parental guarantee is one way to get in the market but it comes with its own set of risks

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A parental guarantee can be a risky strategy as it allows borrowers to buy property with no cash and no evidence of genuine savings

Average house prices in Australia fell by 0.5 per cent in the December quarter with Sydney suffering the largest decline of 3.1 per cent. So what does this mean for parents who have, or are thinking about guaranteeing their children's home loans?

With a peaking property market and deteriorating housing affordability, Ramon Mitchell, Director of Acquisitions at Performance Property Advisory, has noticed an increasing trend of parents helping their children enter the property market via family guarantees. "We're particularly noticing an increase in younger, first-home buyers who are making the most of this to get on to the increasingly difficult to reach first rung of the property ladder" says Mitchell.

Under normal lending circumstances, where a borrower does not have enough savings to meet a 20 per cent deposit plus stamp duty, the bank will either decline the loan or impose Lenders Mortgage Insurance, which can cost thousands of dollars. Sydney mortgage broker Elaine Lam explains "a family guarantee can be a useful tool that allows borrowers to finance property with little or no deposit, where their parents are willing to assist by providing a limited security guarantee secured against their home, an investment property or another financial assets such as a term deposit".

But the procedure can be a risky strategy as it allows borrowers to buy property with no cash and no evidence of genuine savings, as long as the bank is satisfied the borrower can meet the ongoing loan repayments, says Lam. In the event the borrower defaults on the loan, the bank will come after the parents for any losses and costs that the bank incurs.

The benefit of a family guarantee lie solely with the borrower, not the guarantor, says Joseph Alam, head of retail business at finance broker Lendfin. "It can take upwards of 10 years to save for a deposit in some areas of Australia and during this time the property market is likely to have lifted substantially, meaning the borrower keeps chasing ever shifting goalposts".

Mitchell has also witnessed the use of family guarantees to help children "buy into aspirational suburbs and avoid having to buy at a lower price then sell and upgrade a few years later, triggering a round of real estate agent fees, stamp duty and legal costs".

Sydney couple Daniel and Alyssa James recently bought a house-and-land package in Sydney's northwest with the help of a family guarantee from Alyssa's parent. The couple noted that "the family guarantee meant that we could upgrade homes sooner and allow us to be closer to Sydney then we currently are".

For parents who already have a guarantee in place, Alam suggests a few pointers:

- The property is revalued every two years. If there is enough equity, the bank will release the parents from any liability of the original loan.
- If there isn't enough equity to release the parents, Alam advises the parents and children have a frank talk on how long the guarantee is to remain in place and agree on an increased loan repayment schedule so that the children can reduce the debt to the point where the parents can exit the guarantee arrangement with the bank.
- For parents looking to provide a family guarantee to their children for a property purchase, Lam advises that each party understand their obligations under the contract, and in particular, the parents should seek legal advice on the repercussions if the children's marriage dissolves.

North Shore Property Sales principal Trevor Chan recommends "that an agreement should be drawn up between the parents and children to handle any potential situations that could arise in the future to avoid future disputes". Alam of Lendfin adds that "parents should speak with their children about the large responsibilities involved and ask how stable their employment situation is."

Not all banks allow parental guarantees, while others have strict rules. Lam recommends that prospective borrowers thinking about a family guarantee first seek advice from a mortgage broker to find out their options and then discuss the potential scenarios with their parents.

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Energy market fears feed into bonds, equities

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It has become clear over this summer that markets desire clarity and some degree of certainty surrounding the future of the global economy.

Traditionally, when it becomes apparent that events are more significant than a shorter-term correction, the key conversation among professionals in Australia's ultra-high-net-worth wealth advisory sector quickly shifts to fixed-income investing, seen by most as the prudent and defensive place to turn.

This time around, though, the global investor appears to be caught on the horns of a dilemma because both Australian and international fixed-income favourites, such as government or corporate bonds, are both expensive and unduly volatile. And there is little point turning to a volatile asset class that presents risks equivalent to those found in equities (which also undeniably offer lower longer-term returns).

Since August 2015's so-called "Rates Riot", when markets revolted against the idea of a US interest rate "lift-off" and also when Chinese equity markets peaked and then fell, Australian Government Bonds have led a global fixed-income rally that has left benchmark yields at dangerous levels. This, in part, reflects the three well justified concerns of global investors at this time:

- Attention on Chinese, US, eurozone and Australian interest rate disparities
- Global Energy price patterns
- Questions surrounding the depth of liquidity in the most important fixed income benchmark, the US 10-year Treasury Bill market.

Diverging interest rate policies are not unprecedented but the combination of all three is. What's more, with so much continued uncertainty UHNW global investors have been reappraising core, investment grade and also high yielding bond investments.

Even though the US 10-year Treasury Bill market is the deepest of all international markets across any asset class, news reports of Chinese, Saudi and Russian Sovereign Wealth Funds selling large parcels of US 10-year Treasury holdings to support currencies pegged to either the US dollar or energy prices have raised eyebrows even in quarters such as the International Monetary Fund.

When it comes to global energy, Ibe Kachikwu, Nigeria's Petroleum Resources Minister last month at Davos astutely reminded us that, "Everyone emphasises price but (oil) price is really not the issue, it is the future of the oil industry that is the issue ... It is a whole lot more than price".

And he was right.

As bond markets in effect reflect the industry's broad composition, what these statements mean for fixed income and specifically bond investors focusing on energy markets is determining which players will ultimately win and what are their probabilities of succeeding. The historically high levels of volatility are also reflecting a concern about this predicament, as after all, it is typically the role of equity not bond markets to separate the wheat from the chaff.

Also remembering that fixed-income investments are traditionally seen as a shelter during volatile times, it has become unsettling to many to now accept that this asset class, in particular, is the actual eye of the global storm.

As the graph highlights, the changes to energy markets seen since the "Oil Wars" began in late 2014 have immediately and directly affected US (and other) high yielding fixed-income markets.

But they have also by extension, transmitted to interbank credit markets, which now has the result of shifting the corporate creditworthiness of large Australian mining and energy businesses, such as BHP and Origin.

Despite these concerns, Deutsche Bank (Australia) this week extended their buy recommendation on both Origin and BHP Hybrids based on these companies' underlying credit fundamentals and valuation.

What the "credit crunch" of 2008 taught Australian local investors is that it is always important to keep a close eye on volatile credit markets and ensure that those levels of volatility do not infect the equity portion of related businesses, in this instance a company such as BHP.

Larkin Group is an ultra high net wealth adviser focusing on high-yielding global investments. www.larkingroup.com.au

Colour of money: blue chips end in the red

ROGER MONTGOMERY

As we begin 2016 you may be hoping for a better year than last year.

If so, it's time to take a hard, long look at your portfolio.

Probability suggests that it is full of blue chips like the big banks, Telstra, Woolworths and perhaps BHP and Rio Tinto. As an aside, of course you've never sold them because you'd have "to pay tax".

Now take a look at the return they achieved for you last year. It wasn't very impressive was it? After all, the ASX finished the last calendar year virtually unchanged.

But step back a little further and you will find that the returns from many of these companies have been modest at best, even over a longer period.

Look at Telstra: its share price today is lower than where it was 15 years ago.

How about Woolworth? Well, the hare price is lower than where it was eight years ago.

Not to mention BHP and NAB, where the share prices are lower than many, many years ago.

What if the problem isn't anything but the very stocks you consider blue chips themselves?

May I suggest that conventional or traditional blue-chip companies — those big stalwarts that have been around forever and are believed to have reliable dividends — aren't blue-chip companies at all.

Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily understandable business where earnings are virtually certain to be materially higher five, 10 and 20 years from now. If you put together a portfolio of companies where aggregate earnings march upward over the years, then so also will the portfolio's market value.

Back in 2014 the income recession — investors' cash was earning zilch in term deposits — forced investors to chase higher-yielding dividend shares. Their efforts appeared to be self-reinforcing, as the buying of those who followed in 2015 rewarded early adopters.

Unsurprisingly, with share prices elevated but unsupported by "aggregate earnings marching upwards", they eventually collapsed, causing investors to lose valuable retirement buying power.

All of this can be avoided if investors understand how a company increases in value.

Over the long run, the share price will follow the underlying or intrinsic value of a company, so instead of trying to predict prices, you can turn your attention away from the so called "stockmarket" and simply spend your time identifying businesses that will increase in value. Think of a special bank account with $10 million deposited and ready to earn its owner 20 per cent per annum in interest forever.

Assume this obviously special bank account retains all of its interest and is allowed to compound for a decade or more.

If we auctioned it today, I suspect that 20 per cent interest would be too mouth-watering to ignore and frenzied bidding may see the $10m account sell for double, triple or even quadruple the amount of money deposited. If it sold for $40m, or four times the equity at the time of purchase, would the buyer have purchased a blue-chip investment?

> Turn your attention away from the stockmarket and identify businesses that will increase in value

In 10 year's time, the account will have over $60m deposited and it would still be earning 20 per cent.

A great deal of value has been created simply by the passing of time and the ability of the bank account to retain its earnings and redeploy them at a high rate of return.

If we auction the account after 10 years, it may still trade for quadruple the amount deposited ($240m) and the buyer who paid $40m would be satisfied with their return.

We can replace the bank account analogy with a company and by renaming the money in the account "equity" and the interest rate "return on equity" we have the ingredients for a true blue-chip company.

A true blue-chip is a company able to retain a large portion of its profits and redeploy those retained profits at a very high rate of return.

True blue chips aren't always big; in fact often they're small and mid-cap companies.

So now take another look at each of the stocks in your portfolio and find out what percentage of their earnings they have paid out to you as dividends.

If the percentage is very high, it might mean you've enjoyed some satisfying income but that income has been at the expense of future earnings growth.

Importantly, it's earnings growth that will drive the market value of your portfolio.

If thus far you have been chasing dividend yields from traditional blue chips thinking your wealth will be protected, 2016 may just be the year to start afresh with a "rational" approach.

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