

## Article

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### To spend or to save?

By Eddie Chung, Partner, BDO Kendalls

Following the Reserve Bank's latest dramatic interest rate cut and the Federal Government's planned additional cash handouts, a lot of people will have some spare cash in their wallets. But what should we be doing with the spare money? Should we spend it the way the Treasurer and Prime Minister want us to, or should we stash it away for a rainy day?

#### The big picture

We are in the middle of a global financial crisis. While the threat of inflation seems to have retreated somewhat, thanks to the drop in petrol prices, the ripples created by the financial crisis are still fresh and continual, which could cause further slow down of activities and transactions and therefore ultimately translate to job losses. In light of this environment, it makes sense to be conservative and use the money wisely.

#### Pay down existing debt

As most people would know, there are good debts and there are bad ones. Good debts are those that give rise to tax-deductible interest. In other words, they were loans originally drawn down to buy income producing assets such as property and share investments. They are good because the after-tax cost of these loans is much lower after a tax deduction has been claimed on the interest. In addition, the funds, which give rise to the debt, will either produce income, capital gain, or both.

In contrast, bad debts are dead money. This includes debts spent on holidays, cars and lifestyle purchases. What the debt was originally spent on rarely produces a return and every dollar of interest comes out of your hard earned after-tax monies.

Therefore, if you have spare money, it would make sense to use it to pay down bad debts. After all, you can always borrow again if you desperately need funds in future as you reduce your debt load, bearing in mind however that credit is generally harder to come by these days.

#### Save it in somewhere safe

If you are one of the lucky ones who are debt-free, it would both be responsible and sensible to put aside some money for a rainy day, which is where the spare money generated by the rate cut will come in handy.

There are many schools of thought out there when it comes to investing in our current market. It all depends on your personal risk appetite. If you are daring enough to invest, it pays to consult a financial planner, who can recommend investment options in light of your risk appetite and the prevailing market conditions.

However, if you are conservative at heart, putting the money in a high interest bearing cash deposit account ("high" being a relative term!) may not be a bad idea, especially when inflation is in check. Ultimately, this is one area where you need to play it by ear – the financial market is very dynamic and you need to act fairly quickly as it changes to stay ahead of the game.

### **Home loan**

The debate over whether spare money should be used to pay down a home loan as opposed to invest in shares or property continues and the answer will depend on who you speak to.

To come out ahead, you need to be able to use the funds that would otherwise be sunk into your home loan to generate an after-tax return that equates at least the interest rate on your home loan. In other words, if your home loan is at 6% and you are paying tax at 30%, you will need to be able to generate a pre-tax return of at least 8.6% to break even.

Don't forget that if investment opportunities are limited, paying down your home loan with a re-draw facility effectively boosts your borrowing power, which means that you will be able to redraw the funds if a sound investment opportunity crops up in the future.

### **Spend some for the country – but only some**

The current Government strategy of using spending to stimulate the economy is a text book solution. The idea is, the more we spend, the more demand created, which leads to increased employment and therefore increased spending. This is known as the "multiplier effect".

Having said that, the current climate can be likened to the situation of where two people are drowning. There is no point for either one of them to help each other. However, if one of them secures safety, he/she will be able to help the other. That is why flight safety procedures always tell you to help yourself first in case of a disaster before helping your children. In other words, provided that your financial position is reasonably secure, then do spend some to help the country.

### **Conventional wisdom**

As we have all seen in recent times, the businesses that are thriving in a subdued economy are those that are cash rich with minimum debt. The same principle translates and applies to the everyday person on the street. The interest rate cut is an opportunity for you to further secure your financial position in these volatile times.

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