Doom and Gloom... Or Opportunity Knocking?

By David Bradley, Chartered Accountant

What's your view of the economy?

Do you feel we're journeying down the inevitable path of deep recession, perhaps even a worldwide depression? Or are we at the dawn of the biggest financial opportunity to grip the world in the past 70 years?

The state of the economy is the talk of the nation's press. Election fever has served to only further pressurise the cauldron of economic uncertainty evidenced by low interest rates and plummeting business confidence. Pessimists forecast impending certain recession while the best that optimists concede is that we are in uncertain times.

My aim in this Hot Topic is to express my opinion about what the recession will mean to investors, while also sharing my thoughts on how you can position yourself to take maximum advantage of the opportunities that you may find in the upcoming months.

What's A Recession?

In order to understand what a recession is, you must first understand how an economy's progress is measured.

The general term allocated by economists to measure a Country's productivity is 'GDP' - which stands for Gross Domestic Product.

In layman's terms, GDP is a reflection of either the expansion (if it is positive) or contraction (if it is negative) of economic output. It makes sense that if the Country is prospering, then productivity will increase. For more information about GDP and how it is measured please click here

Recession is a term used to reflect two consecutive periods of negative GDP or, a situation where the Country's productivity falls for two periods in a row. What a recession really means is the economy is reducing in size.

Other economic indicators are said to be correlated (connected or related) to GDP, such as business and consumer confidence and unemployment.

Talk of a recession certainly seems to affect consumer confidence.

People start hearing the term recession and begin to fear for the future because they can still remember the stagnant times of the last recession about ten years ago. One prominent memory still vivid in my mind is the massive number of 'for lease' signs up and down St. Kilda Road (an area of concentrated business premises that has now been somewhat converted in to trendy city apartments).

At the time I was working as an accountant in a firm that employed over 100 people.

On one bleak and sorry afternoon, 23 staff were called one by one into a Partner's office and told 'not to come back on Monday'. Imagine how the workers felt every time their phone rang that afternoon! At the pub on the Friday after the sackings, the mood was like a wake as we all pondered life in a recession.

The sombre mood transgressed business confidence and flowed into consumer confidence, as everyone knew a family member, friend or workmate who had been retrenched or simply lost his/her job. Recession equated to uncertainty and uncertainty meant less optimistic spending.
Why Does A Recession Occur
And Why Did All Those People Lose Their Jobs?

The uncertain times of a recession cause people to become fearful of change and generally insecure.

For most individuals the major source of income is a salary or wage. In times of recession there is fear that your job may no longer be secure. The fear that one could lose his/her job results in cutting back spending and becoming wiser (or tighter) with money management matters. Trips to the movies, take-away dinners and extra clothes are now all considered luxuries that can be put off.

This in turn has a direct effect on suppliers of products deemed 'non-essential'. The drop in demand causes business owners to drop production, but inevitably operating costs must also be cut to remain competitive... even alive. Staff are laid off, decisions about buying new equipment are deferred and every area of spending is squeezed to save money wherever possible.

In a recession, it's those who consumed too much in the good times and borrowed large slabs of 'bad debt' that hit the hardest. Previously relying on continual pay increases to fund a better lifestyle, these consumers are shocked into realising that unless they can find some other source of income, a lifestyle cut is inevitable.

Also affected are those who lose their job. Welfare payments are not enough to sustain the lifestyle they were accustomed to, which can lead to a major redistribution of wealth. Pilots around the world who are now working much fewer hours are one such class of previous high-income earner that may need to adopt a much less extravagant lifestyle to survive. It's probably no longer possible to fund a private school education, house in the suburbs, two cars, a dog and a negatively geared investment property portfolio.

If they can't get another job, then they will have to consider downsizing by selling some assets - otherwise the bank may make the decision for them.

2001 Recession vs 1990 Recession

I can still remember the then Treasurer of Australia, Mr. Paul Keating, describing our last recession as "...the recession we had to have".

So, are the economic conditions the same now as they were back then? Must we again have another recession?

I believe that the economic outlook today is a lot different to back then.

The economy overheating and concerns about rising inflation caused the economic gloom associated with the late 1980's and early 1990's.

Interest rates on standard variable mortgages peaked at 17% per annum between June 1989 and May 1990, interest on business overdrafts during the same period was charged at over 20% per annum (RBA figures).

Inflation (CPI) was measured at between 7% and 8% over the same period, far above the figures that are currently being published, even allowing for the impact of GST (for more information, click here).

Today the problem seems to be the exact reverse of the economic conditions experienced during the 'recession we had to have.'

Housing interest rates are lower than they have been for 30 years and inflation is also historically low too.

Yet despite these indicators, productivity continues to fall - together with business and consumer confidence.

The Reserve Bank policy is to lower interest rates to stimulate spending, but rate cuts alone aren't having the desired impact to keep the economy growing at sufficient levels to ward off a contraction in productivity. My guess is that people are not spending the savings from rate reductions. Instead, they are using them as extra debt repayments.
Economies have moved in boom-bust cycles for as long as history has been recorded. In that time man has attempted (where possible) to limit the impact, but as yet no successful solution for stability has been found. Based on this alone I think that it's safe to say that avoiding a recession (or even a depression) is nearly impossible.

The weight of global corporate shrinking (or collapse) has also begun... the airline industries have put off 30,000 staff. Here in Australia retail stores are hurting with the Coles Myer profit figure halved from the previous year and Diamaru closing up shop. The second biggest airline carrier in the country has gone broke and even if it is rescued by Administrators, it will only be a shell of its former self with a skeleton staff.

It seems to me the tide of economic doom and gloom, alluded to in Steve's March Hot Topic, will need to run its full course and there will be many more casualties until the good times return.

What can YOU do?

At the recent Inner Circle get together, everyone was asked to ponder the following question:

If the opportunity of a lifetime crossed your path today, would you be primed to take action?

I've been investing a lot of time discussing this question with Steve (about our business) and also accounting clients who have called and sought my advice about how the recession will impact them.

I think it's important to remember that opportunity occurs during both boom and bust cycles. In many ways I'm excited by the times ahead because during the last recession, I stood with the 'Chicken Littles' of the world and was busy worrying about saving my job. With my head down, I don't like to ponder exactly how many 'chances of a lifetime' passed me by!

Here's an overview of the advice I have been providing my accounting clients at around $200 per hour.

In preparing for the times ahead, you need to concentrate on only two things:

- Are you in sufficient financial shape to weather the impending global economic slowdown? and
- Are you in a position to expand while others are contracting (thus applying the theory of doing the reverse of what the masses are doing)?

Here's a short checklist of considerations that I have been encouraging my accounting clients to work through in multiple choice format:

1. If your current wealth creation situation were to be characterised according to dietary terms, how would you rate?
   a. Underweight
   b. Lean
   c. Fit
   d. Overweight
   e. Obese

The first step in any plan is to determine your current situation. In order to do this you need to create an expression of financial performance. I recommend you work through the following fundamental questions or issues:

- Am I earning more than I spend?
- How am I funding / saving the shortfall?
• In percentage terms, what proportion of my cashflow (wage / salary) is devoted to:
  i. living expenses
  ii. savings
  iii. investing
  iv. unknown

• What items of expenditure could be avoided if my income was halved tomorrow?

• How many months could I survive if a crisis occurred and I earned no income?

• How has your strategy changed over the last six months?

At the same time as considering these issues, I strongly encourage all businesses to review their client base (or investment portfolio if you are an investor). Now is the time to be providing additional value to your best clients.

Also be mindful of the possible impact of major clients reducing or cancelling orders at this sensitive time. It may pay to have a contingency plan to ensure there is a steady stream of reliable sales rather than income that is reliant on a strong economy.

A good example is one of my accounting clients who operates a cookie / muffin franchise in a major shopping centre. Although his products could be seen as a luxury item, his location (right outside a supermarket) will mean that he will still get enough foot traffic to generate sales.

While his sales for catering and corporate events may suffer, he will continue to receive steady sales from reliable customers who walk past his store on their periodic grocery run. I've advised him not to be complacent in terms of relying on the passing trade though. Instead, it is time to provide additional value to the better ‘off the street’ regular clients as well as continuing to attract passing trade in the form of better point of sale advertising and ‘combo’ offers.

2. When was the last time you sat back and allocated more than half an hour to reflect on the critical success factors in your business or wealth creation plan?
   a. Today
   b. Yesterday
   c. Last Week
   d. Last Month
   e. I Can’t Remember

Documenting your critical success factors and then monitoring trends that impact upon them is very important.

Once again in a business context it comes to looking at who are your clients at the same time as determining who are the clients of your clients. This philosophy can also be applied to shares (by examining who are the major clients of the company you invest in) and real estate (who supplies the income to the tenants you rent to and what happens if this income stops).

Your ongoing success is largely a matter of planning and being prepared by considering various ‘what if’ circumstances.

Another of my accounting clients operates in the aviation field and had Ansett as one of its customers.

Even before Ansett was placed into administration, I had discussed the impact of what would happen if the company folded, since the warning signs had been obvious in the industry for some time. By adopting some firm credit control procedures, the exposure of the company was limited to $5,000 when ordinarily it
would have been about $20,000.

Be sure to have a plan documented and be very wary when you depart from the rules that you impose upon yourself - especially if they relate to offering flexible credit terms to attract business.

3. Your biggest investment announces it is now broke. How do you react?
   a. Immediately blame management and wait for the class action lawsuit.
   b. Feel sick, because you've lost money and now have to start again.
   c. Kick yourself that you didn't see it coming.
   d. Instigate another plan that you had in the event of this collapse.
   e. Don't want to think about it because you're too busy.

How reliant is your business or wealth creation plan on any one client or investment?

Now is an excellent time to diversify your client base or investments, thus reducing your exposure to a previous asset that may turn out to be a liability. If you are owed a large amount of money or are promised work by a major client then begin formulating alternative strategies.

If you are a share trader then I urge you to go back and consider how each stock you own fits into your investment portfolio and at what point your exit strategy is triggered. Many traders invest for the good times, but when bad times occur then they start saying they're in it for the long-term.

I suggest that you avoid having only one plan. When Steve, Tim and I were due to fly to Sydney recently, we were booked on Ansett flight 12 leaving the morning that it closed down. The night before, well before the planes were grounded, Steve and I were already formulating a course of action should we not be able to fly.

So when it came time to instigate the emergency plan, while thousands of angry travellers marched to the Qantas terminal, I casually walked down to the car hire desk and secured a vehicle to drive us to Sydney in luxury. An inconvenience? Yes. A disaster? No.

If you are an employee working for a company that is experiencing problems, now might be the time to put out the feelers and test the water. Once again, businesses are advised to return to core activities in an effort to secure a reliable steady income stream. The last thing you want to face is the prospect of wondering how you are going to earn enough money to put food on the table.

The Opportunity Of A Lifetime...

4. How would you react if the opportunity of a lifetime came across your desk tomorrow?
   a. I don't know because I'm too busy to think about it.
   b. Hang on Dave, you've just said that I should concentrate on consolidating my business, so I'm not looking for any opportunities.
   c. Consider how it fits in with your overall documented wealth accumulation plan.
   d. Not take action because your credit is already maxed out.

Whenever there is a crisis, there is also an opportunity.

If we enter into a recession, then there is sure to be many people who will lose a lot of money - but in the same token there will be many others who make their fortune.

Opportunities will present themselves in every area. For example, you may come across a chance to buy a business for a fraction of what it is worth.

Astute property investors will be able to take advantage of bargains, as those who paid too much for their investments or have overcapitalised feel the pressure of high debt repayments. Sooner or later, it's
certain that the properties 'for sale' will exceed demand and prices will fall.

Even as I type this a deal has come through on the fax for 2 * 3 bedroom, 1 * 1 bedroom and 2 * 2 bedroom apartment block at a yield of over 13%... someone needs to sell.

What will happen to the stock market? I can't be sure, but last time money flowed to businesses that were considered recession proof. For example, people still needed to buy groceries and use the telephone.

Prices for these stocks firmed while those companies that were highly speculative experienced even more volatile times. As someone with limited share market experience, my strategy will be to watch with interest and look for an opportunity to pick up cheaper 'recession proof' stocks when the market over-sells them.

**When Is It Time To Act?**

When will you know that it's time to take advantage? How do you find the bargain deals?

Unfortunately, it's unlikely you'll wake up and see the news headlines heralding that the time is right to take advantage of the prevailing economic conditions. And I doubt you'll find the great deals without searching for them in business papers, magazines and at business brokers.

The only warning you'll see from the press are either articles of despair (meaning that the best bargain deals have already been snapped up) or that the economy is recovering (indicating you have missed the boat altogether).

Now is the time to ready yourself by learning how to complete a due diligence over every asset you are offered - whether business, stock or property. Attend seminars, read books, post questions and seek advice where necessary - don't put off investing in yourself, as it's going to take some skill to make money from now on.

**What Are We Doing?**

Without predicting the world is about to end, Steve and I have been ready for a recession for the past 6 months.

Our strategy is to still purchase quality investment properties, provided we can secure them on our terms (right price and meeting our due diligence criteria).

We have critically reviewed EVERY one of our assets and if it is under performing, we have either taken steps to make it perform or alternatively sold it.

A question I'm asked a lot is "Can you still make money in property at the moment?"

The answer is absolutely, but now more than ever you must complete your due diligence. Make sure you use the PATTERN templates in the online tools area and have an exit strategy in place before you purchase.

All that has happened in the past few years is that the market has "covered up" a lot of errors that people have made by buying on hype rather than on substance. The adage 'all ships float on a rising tide' is accurate for what happened yesterday, but the tide is no longer rising.

If the market is flat or going backwards, there will not be the same chance to make errors and survive.

**Final Thoughts**

If the slump in business confidence continues and the world remains fearful of the possibility of a protracted war, then I believe we will enter into a recession sooner rather than later.

But there is still enough evidence to indicate that the recession may be shallow and short and not necessarily long and deep. At this stage, my advice is to do the following:

1. Strengthen your financial position by repaying as much personal consumption debt (credit cards, personal loans etc.) as possible. If you avoid doing this then you will not be primed to take action
when an opportunity presents itself.

2. Consider each asset you own and compare its performance to your long-term wealth creation plan. If it is under performing then you should create an exit strategy that outlines what has to happen for you to sell. If you run a business then look to secure a steady and secure income stream by focusing on smaller clients rather than seeking massive accounts.

3. Begin / continue to build cash reserves. Although the return will be low, your buying power will be great, as cash will be in short supply and there will be many who will be desperate to have it. If you operate a business then now is the time to start enforcing strict credit control procedures and payment terms.

4. Continue to look for the investment opportunity, but be extra sure to complete a thorough due diligence review before buying and be certain your finance sources have not experienced a change in lending policy. Make all your offers 'subject to finance'.

The bottom line is this... whether or not you believe we are about to head into recession, depression or a new period of unsurpassed economic bliss, it would be prudent to have a plan for all possibilities.

Please place your questions and comments on the General Wealth Creation forum.

Best regards,

David Bradley