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YAMAN Coach™

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When is a loan expensive?

A personal loan is a non-collateralized one. Be aware that such loans bear interest that is much higher than regular collateralized debt like housing and car loans. Why? Because the lender is taking greater risks in lending without fallback collateral.

Loans come with different terms. To level the playing field between loans and know which is more expensive, we need to know their effective annual compound interest rate (ACIR). But to put things into perspective, let us first break down the two other common ways of quoting interest.

Simple interest is the total Peso interest for the duration of the loan divided by the loan principal and divided by the term of the loan. A Php10,000 loan payable over a term of 60 months at a monthly amortization of Php311.37 will have a simple interest of 17.36% p.a. This was arrived at by subtracting the original loan amount from the product of the monthly amortization and the term. The answer is then divided by the original loan amount and then further divided by 5, the equivalent term of the loan in years. The answer is converted to percentage format to arrive at the simple interest.

Personal loans, however, typically use the add-on-rate (A-O-R) method when quoting their interest rates. A Php10,000 loan payable over a term of 60 months at a monthly amortization of Php311.37 will have an A-O-R of 1.447% per month. Each periodic Peso amortization is comprised of the original loan amount divided by the term of the loan plus a fixed Peso interest equivalent to the A-O-R multiplied to the original loan. On an annual basis, the A-O-R per month translates also to 17.36% or 1.447% multiplied by 12.

Both simple interest rate and A-O-R are also called nominal interest rates.

Now, a loan that is quoted using effective ACIR will equate to a fixed periodic Peso amortization comprised of increasing principal and decreasing interest payments as amortizations are made and the original loan is paid down. The same Php10,000 loan whose monthly amortizations were computed earlier at a 17.36% p.a. simple interest and 1.447% A-O-R per month actually translates to an effective ACIR of 28%.

The effective ACIR is the only one among the three methods mentioned that reflects the equitable way of paying interest, that interest is paid only on the principal that is left unpaid. Given the foregoing assumptions, a lender can quote a more expensive level of simple interest or A-O-R on an annual basis of 25% and still appear cheaper on the surface level than the loan that is quoted on an effective ACIR of 28%.

But what about compounding? Compounding simply means that the lender will actually earn his interest income, say 28% effective p.a. as in the example given, if he relends all of what he collects at the same 28% effective ACIR as and when he makes a collection.

So, always ask for the effective ACIR when shopping for loans. Lenders have the obligation of disclosing all of the attendant costs of a loan under the Truth in Lending Act.

How to buy in a bull run

When will you know when stock prices have bottomed out? Put another way, how do you know that your middle finger is the longest among your fingers in one hand? You know by comparing the middle finger's length to the other fingers close to it.

In a similar way, you will know when a stock's price has bottomed out when you compare that price to those that immediately precede and succeed it. That means it will be impossible to buy at the bottom because you will only know one of the bases for comparison (i.e. the immediately succeeding price) "after the fact."

Jesse Livermore, the world's greatest stock trader says that you should not buy when falling stock prices start to reverse direction, which is called the pivotal point. You should buy when stock prices continue to rise after the pivotal point and are supported by increased volumes. You need not be the first out of the proverbial gate.

Now, when the market recovers, and it most definitely will, you can ride the recovery by "buying" the index as NO portfolio can outperform the index in a recovery or bull run. Outperformance is measured against a benchmark like the PSEi. But if you are just after absolute returns, measure yourself against that return level.

You buy the index by creating a portfolio with stock exposure weights equal to those of index component stocks.

If you believe that you are a great stock picker, buy more of the index component stocks that have a prospective beta to the PSEi higher than 1. If a stock's beta is 1.5x, when the PSEi moves up by 1%, the stock will move up by 1% x 1.5 or 1.5%.

Conversely, if the stock moves down by 1%, that stock will drop in price by 1% x 1.5 or 1.5%. High return equates to high risk. And to check if you are truly a good stock picker, you can track your performance through performance attribution analysis.

Now if you are starting to fall asleep by reading this piece, wake up to know that direct investing is indeed complicated as you will need to be all S.E.T.

"S" stands for sizeable funds. You will need to manage huge amounts for those stockbrokers with excellent research to service you; and you will need more than one of them to cover all grounds. "E" means you will need not only expertise to understand the excellent research but also the experience to understand the psychology of investors. And "T" stands for the ability to manage your investment portfolio full time, especially during these times when volatility is the new normal.

Now if you lack even in just one of the S, E or T and you want the easy way to invest, do indirect investing just by leaving your money with the professionals. This can be done buying either an index mutual fund or index unit investment trust fund (UITF). And if you want life insurance to come with your investments, especially when you know you still need life insurance but want to shell out more for investing, get a single pay variable unit-linked insurance policy. These products are called pooled funds and are meant for the retail market.

If you have at least Php5 million in cash to invest, open a full discretion investment management account (IMA) where the Trust Department will structure a portfolio just for you.

Here's to a successful recovery/bull run investing for you.

Editor's Note

Efren Ll. Cruz, RFP®
Editor-in-Chief

The Intelligent Investor

The intelligent investor will not invest blindly and just listen to Marites, Marife or Marisol (free tips) for that is gambling.

He will study for himself the historical performance of an investment and from there make his own projections of future performance.

And while good past performance is not an absolute guarantee of future good return, there is substantially much less to expect from past bad performance.

He will use technical charting to see which investment is the most beaten down in value without much justification so that he benefits immensely when that investment recovers.

Are you an intelligent investor?