

4 key wealth building strategies for income rich, asset poor professionals

It is no secret that the younger generations are living life differently to the baby boomers. Things like marrying later in life, taking a career break for travel, spending more on "lifestyle" items and not being shy about borrowing have all been debated and discussed in the media. A consequence of these changes is that we find a lot of professionals in their late 20's to early 30's who have a significant earning capacity, but few assets to their name. Far be it for me to cast judgement. When I was younger, I couldn't spend my money fast enough! Inevitably, a time comes when people start to think, "I need to start managing my money better" – but this can happen later in life for some.

This month's newsletter will look at some common investment strategies for high income earning professionals to employ, to get the most bang for their investment buck. However, this comes with a caution. Some people feel they need to accept a higher risk to try and achieve a higher return to "make up for lost time". This is often not appropriate and a core investment strategy should be inherently low risk. Therefore, always consider and mitigate your downside risks.

Strategy 1: Invest pre-tax dollars (side effect is you also reduce tax!)

The late Kerry Parker once said during a government inquiry, "Of course I am minimising my tax. And if anybody in this country doesn't minimise their tax, they want their heads read, because as a government, I can tell you you're not spending it that well that we should be donating extra!" I can't think of a better way to put it. The problem with earning a high income is that it can trigger a high tax bill. However, if you are keen to generate wealth, you should try and invest your income pre-tax rather than post-tax. There are two main ways of investing pre-tax:

1. Gearing essentially allows you to forego pre-tax income now for capital growth later – gearing involves borrowing money to invest. As long as you are investing in an income producing asset (like property or shares), the interest in respect of an investment loan should be tax deductible. This essentially allows you to use pre-tax dollars to fund investment loans. For income rich investors, the strategy is best utilised when you invest in high growth, but low income investments. The example below compares someone who has no gearing and someone who borrows \$750,000 to invest in an asset that generates a 2.5% income return net of any other costs and deductions.

This \$750,000 investment costs the investor \$1,505 per month after tax to maintain (i.e. after tax income reduced from \$12,060 to \$10,555). Assuming an 8% per annum capital growth rate, the investment's value would increase to \$1.62 million after 10 years creating \$870,000 in equity – well worth

forgoing the \$180,600 of income over that period (i.e. \$1,505 p/month for 10 years).

	No gearing	Gearing
Total remuneration	\$250,000	\$250,000
Superannuation guarantee (employers 9%)	\$22,500	\$22,500
Deduction for interest expense (\$750k loan @ 7%)	-	\$52,500
Taxable income from investment (@ 2.5% net)	-	\$18,750
Taxable income	\$227,500	\$193,750
Tax payable	\$82,790	\$67,095
Tax saving		\$15,695
After tax monthly income	\$12,060	\$10,555

2. Salary sacrifice super contributions – an employee can direct their employer to make pre-tax contributions into a superannuation fund (called "concessional contributions"). This will reduce the employees taxable income and therefore, the amount of income tax payable. The super fund will be taxed on the amount of contributions it receives at a concessional tax rate of 15%. However, this concession is capped at a maximum of \$50,000 per annum for people under 50 years of age (i.e. if someone makes concessional contributions of more than \$50,000 in one year the excessive contributions are taxed at the highest marginal rate of 46.5%). Therefore, it doesn't make sense to contribute anymore than \$50,000 per year. Let's look at an example:

	No additional super contributions	Additional super contributions
Total remuneration	\$250,000	\$250,000
Superannuation guarantee (employers 9%)	\$22,500	\$22,500
Additional concessional contributions	-	\$27,500
Taxable income	\$227,500	\$200,000
Tax payable	\$82,790	\$70,000
Tax saving		\$12,790
After tax monthly income	\$12,060	\$10,833

The employee who contributes up to \$50,000 into superannuation saves \$12,790 in tax. Also, he has invested an additional \$27,500 into super thereby increase his assets. The cost of doing this is he will receive \$1,225 less per month in after tax income. However, the true value rests in the long term value of super. After 20 years, for the person who hasn't made additional contributions, their super will be worth \$443,000 in today's dollars. The person who has made additional contributions up to \$50,000 in total per annum will find their super is worth \$985,000 in today's dollars (assuming an average 8% return which might be a dream in today's market). That's a staggering additional \$542,000 in wealth!

The downside to this strategy is that it locks the investment inside the super system until age 60. This may not be appropriate, as a relatively young person may need to access investment funds in certain situations. For example, someone who holds investments outside super can liquidate the investments and reduce their home loan (for example). Also, this strategy will not assist funding early retirement. However, some level of salary sacrifice contributions may be

appropriate – particularly for high income earners.

Strategy 2: Invest in assets which can be improved

Of course, you don't need to be a genius to recognise that investing in high growth assets is better than low growth assets. However, achieving capital growth earlier in the investment ownership period is even more critical for asset poor investors. The reason is that the sooner you can generate equity in an investment, the sooner you can leverage that equity and invest more.

Investing in direct residential property is excellent in this regard, because it has the ability to be "improved". For example, a perfect solution is to acquire a well located property (i.e. don't compromise on the location, architectural style, floor plan, etc.) that needs a face lift – i.e. new kitchen, bathrooms and carpet. The *rule of thumb* to use for cosmetic improvements is that your property's value should increase by \$1.50 for every \$1.00 you spend on improving the property (in a strong market, maybe even \$2.00). Also, you should try and limit expenditure on cosmetics to 10% or less of the property's purchase price. For example, if you could purchase an apartment for \$400,000 and spend \$35,000 on renovations, you should only undertake this project if the property will be worth over \$450,000 after the renovation is completed. In this example, you have "created" \$15,000 of equity in the property and thereby given your investment a kick start. Also, the side effect is that it's likely that you will also improve the rental return on the investment, which doesn't hurt. In a normal property market, it is not uncommon for an investor who employs this strategy to generate sufficient equity in their property to allow them to acquire another investment in 6 to 9 months.

Strategy 3: Greater leverage – but do it safely

I understand that borrowing might be a dirty word at the moment. Who would suggest borrowing in the middle of a credit crisis? Well, borrowing so that you can invest a greater amount of money than you currently have (i.e. referred to as a gearing strategy) is a time-tested and fundamentally sound strategy. The market gets a bit carried away at times. Reading the papers lately makes you think if borrowing for any purpose is a good idea. Don't get too distracted by the hysteria, because it's often unfounded. For example, it was only less than 6 months ago when the "geniuses" were suggesting petrol prices would hit \$2.50 per litre. I drove past a petrol station this morning and I'm pretty sure the price was about \$1.10. In 1 to 2 years time, we'll probably be reading how borrowing to invest is in fashion again.

Anyway, the laws of leverage are unbeatable. If you are asset poor, then the more you can leverage (borrow against) your equity, the better. Consider a simple example of a investor who has \$50,000 in cash. If she invests in an asset that provides a 10% growth rate, then her investment will increase by \$5,000. However, if she uses the \$50,000 as a deposit and borrows an extra \$100,000, her total investment will grow by \$15,000. As long as the holding costs (interest) are less than \$10,000, she will be better off.

Of course, borrowing money doesn't come without risk. You must do it safely and cover your downside. For example, in my opinion anyone who borrows money must consider obtaining income protection insurance.

A gearing strategy is probably best implemented when investing in property, because banks will (at least as I write this newsletter!) lend up to 100% of a property's value. As long as you are borrowing well within your capacity and you can always meet the repayments, then borrowing a larger percentage of a property's value is relatively safe. It is only if you default on your loan repayments when the percentage borrowed comes into play. Generally, if you borrow more than 80% of a property's value, you will have to pay for Lenders Mortgage Insurance (a once off up-front fee paid to the bank's mortgage insurance company to cover the lenders risk). Some people shy away from paying for mortgage insurance, but it can be well worth paying for. Consider the example below where an investor has \$90,000 of cash as a deposit. He can either purchase a property for approximately \$360,000 and borrow 80% or spend up to \$550,000 and borrow 90% (and pay for mortgage insurance).

	\$360,000 investment at 80%	\$550,000 investment at 90%
Increase in value after 5 years (@ 10% growth)	\$220,000	\$335,000
Negative cash flow over 5 years (rent less interest)	(22,800)	(\$47,000)
Cost of mortgage insurance	-	(\$8,000)
Net improvement in wealth	\$197,200	\$280,000

Even after a relatively short period of 5 years, the difference in wealth is over \$80,000. It is well worth paying the mortgage insurance fee of \$8,000 to make an extra \$80,000, isn't it? The conclusion is that it is well worthwhile for an income rich investor to pay for mortgage insurance, as it gives them greater leverage (assuming it's safe to borrow of course). Also, spending more might allow you to purchase a superior quality investment property.

When it comes to shares, the current stock market teaches us a very good lesson – beware of margin calls. I would not suggest leveraging shares to anywhere near the same level using a margin loan, because of the risk of margin calls. That is a nice lead into the next strategy...

Strategy 4: Capital guaranteed investments

Some banks and fund managers offer capital guaranteed investments. This means that the initial amount of your investment (and sometimes even any growth in the investment) is guaranteed – so you can't lose the money you put into the investment. The primary benefit of these investments is that your downside is minimised. Also, as a consequence of this, banks and fund managers may allow you to borrow 100%, thereby not requiring any cash invested. As the investment is capital guaranteed, there is no risk of margin calls on the loan. Of course, you need to finance the interest in respect of the loan used to fund the initial investment.

Whilst capital guaranteed investments sound attractive on the face of it, there are two key things you must check out.

Firstly, the underlying investment must be sound. Sometimes poorer quality investments are "dressed up" with fancy bells and whistles. Don't ever invest in something because it is convenient (i.e. just because it has a capital guarantee). First and foremost, you must invest because you believe the investment is fundamentally a good investment, with or without the bells and whistles such as the capital guarantee and 100% loan. For example, we have a strong belief in the index fund methodology. Therefore, a capital guaranteed investment which is invested in an index fund can be a great solution in our opinion.

Secondly, check all the fees. Some products have quite high fees in terms of entry fees, exit fees, and ongoing fees. Also, with respect to the loan's interest rate, check into the tax treatment. Changes announced in the 2008 Federal Budget mean that it is likely that not all the interest paid in respect to the loan used to acquire the investment will be tax deductible. In fact, only interest up to the Reserve Bank of Australia (RBA) Indicator Variable Rate for Standard Housing Loans will be deductible. Any interest in excess of this rate will not be tax deductible.

Only some of the ideas

Income rich, asset poor professionals have plenty of opportunities to accumulate wealth. Given their low asset base, they cannot afford to make any mistakes. They must be well advised and invest in good quality assets. The above four strategies are only just the beginning. Each person's individual situation might give rise to further opportunities that can be explored. ProSolution Wealth Advisory's commission-free, fee-for-service financial planning solution is experienced in developing intelligent solutions for income rich, asset poor professionals.

ProSolution Wealth Advisory is a fully licensed financial planning firm specialising in preparing Property Investment Strategies for investors that desire to accumulate wealth through investing in direct residential property. Go to www.prosolution.com.au for more information.

Happy Holidays

From all the staff at ProSolution, please accept our best wishes for a happy, relaxing and safe holiday season. We hope you get to spend some well deserved relaxation time with family and friends. We look forward to working with you again in 2009.

2008... an interesting year!

Hasn't it been an "interesting" year in the world of finance? It certainly hasn't been boring and has made the year fly by. We have had another fantastic year at ProSolution and haven't really felt too many negative effects from the credit crisis. In 2009, we released our first book ([Smart Borrowers Handbook](#)), moved offices in Melbourne, launched a very unique financial planning service and were ranked number 2 nationally in terms of lending volumes. I would like to publicly thank all of the team at ProSolution for all their hard work and dedication.

I am optimistic that the property market will pick up early next year, with significantly lower interest rates, first home buyer initiatives and the economy possibly buoyed by government spending. 2009 will be another great year for us as well. We will be hosting more seminars and possibly even releasing a second book!

Thank you: \$400 donated to the Cerebral Palsy Foundation

Thank you to all the people who participated in our recent survey in regards to our seminars in 2009. Your feedback was very useful and will assist us in developing some fantastic seminars next year. We received 361 responses and as promised, we will donate \$1 for every response. In fact, we rounded it up to \$400. This is a lovely end-of-year gift for the Foundation and will hopefully help them become one step further towards a prevention and cure for cerebral palsy.

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