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Creating wealth through property PART II

Terry Sofra.

YOU'VE HEARD THE OLD CLICHÉ "YOU DON'T HAVE TO BE WEALTHY TO INVEST, BUT YOU DO NEED TO INVEST TO BE WEALTHY". YET IN MY 20 YEARS AS A WEALTH PLANNER, I'VE HEARD EVERY EXCUSE UNDER THE SUN AS TO WHY "THE TIMING" WAS NOT RIGHT TO INVEST.

Interest rates are too high, it is too risky, we don't understand it, cash flow is too tight, property is too expensive, my neighbour lost money on property… I could go on all day with endless excuses **that most people are using** to hold themselves back.

The case for mediocrity

Most people let the weakest excuse (or what they call "a good reason") stop them from taking the step they most desperately need to take. And that's why, sadly, most people live ordinary, or dare I say it … mediocre lives.

Instead of spreading their risk by diversifying into quality investments, most spend their money on things that they understand (comfort spend), usually depreciating items in their business or assets that they will need to work to produce income (grinding assets) or toys that provide "instant gratification" (gizmos).

BUT … I've realised that you can't help these "self victims" or people who are too afraid to leave their comfort zone. Unfortunately, most people keep doing what they're been doing for years and never realize their true potential — or a financially free retirement for that matter.

One thing I can almost guarantee is: doing the same thing will never, ever, give you a different result.

A bit harsh? Well, I've realised that my job as a financial planner is to try and wake people up and help them stop making excuses (by taking positive action), before it's too late. Sort of like a "business bully" I guess.

Get positive! Plan for phases

I believe we have two separate phases or stages in life — the accumulation phase and the spending phase. Of course, the length of each stage is different for everyone, but for the purpose of illustration let's say the accumulation phase is between the ages 20- 55 and the spending phase begins at about age 55-60 onwards, depending on when you decide to hang up the boots.

Phase 1

Accumulation

Throughout the accumulation phase it is critical that we actively take part in investing in capital growth assets (property, shares, superannuation, etc). Throughout this stage of our lives it is necessary that we take risk (calculated risk of course) and try to use capital growth to our advantage.

The alternative is saving for retirement — which is probably not impossible, but the odds are definitely against you as your hard-earned-and-saved dollars will be pretty much eroded by the taxman and inflation costs.

Inflation tends to result in a lower real rate of returns, where as growth assets (such as property and shares) tend to offer better inflation protection because they also rise in price. To use an analogy: the interest from cash in the bank gives you the fruit from the tree only, while property and shares provide both the fruit from the tree as well as the tree's growth.

Saving is not the answer…

So saving is not the answer, what about earning more money? Well that doesn't work either. Usually, the increased earnings result in an ever-increasing "want list". Typically, as the earnings increase so does quality of life.

So what is the answer then?

The greatest mind of all time, Albert Einstein, when asked what was the most exciting thing he had learnt in his life time he said the **law of "compound interest".**

So intrigued was Einstein with this theory, that he came up with his own formula – what we know now as the **"Rule of 72":** basically, the formula of 72/i = DM. That is: 72 divided by the interest rate return will give you the number of years to double your original investment. So if, for example, your investment provides a 7.2% return, it will take 10 years to double your money.

…it's property

The good news is that property has returned an average growth of 11% over the past 20 years (way better than 7.2%). So while there is no crystal ball, it would be safe to assume that with the present demand for housing, a fair return will continue into the future, and this would be a sensible strategy to create wealth. If it's good enough for the greatest mind to be impressed with this strategy, then who am I to argue? Perhaps we should all be adopting this new-found knowledge as part of our investment strategies.

Real-life example

Let me give you a real live example on how it works. Some years ago (2004) a dairy farmer client of mine (for the purpose of this, let's call her Sue) reluctantly agreed to adopt our wealth-planning strategy to diversify off-farm into bricks and mortar by buying a three-bedroom apartment in Melbourne for $345,000. Now I say "reluctantly" because in 2005, $345,000 was a lot of money and it could have been used many times over in the family farm. As we all know farming (like most businesses) can be a capital-hungry operation.

Over the years, the rent helped with the serviceability of the loan interest and, with some extra focused contributions, the loan was reduced to less than $50,000. But the good news for Sue was that she was offered $650,000 for that property some seven years later. Now let me ask the question: how long would it take to save $600,000?

Spending

Circumstances have now changed: Sue has now sold the family farm and has moved to the second phase — spending — where cash flow is critical. The resulting capital growth, along with the forced saving in loan reduction ($600,000), combined to form an important base for Sue's retirement. In fact, in this case we were able to amalgamate these funds with other surplus assets to form the magical million dollar goal.

In the spending phase, the most important things are cash flow, independence and low risk. With that level of investment base ($1m) we were able to adopt an allocated pension strategy, whereby we invested the $1m in term-deposit (property is no longer important in this phase, cash flow is). Invested in a low-risk term deposit at 6.5%, this was able to provide a $65,000 tax free pension to Sue (while leaving the capital $1m untouched).

I realised early in my career that I could use the advantage of **leverage through capital growth** to help fund my future retirement. This was probably one of the most incredible "a-ha" moments of my life.

The critical problem most people have is that they never even get into the property race for the fear of risk or failure. And that is the biggest risk of all. The truth is, most people wouldn't drive across town to attend a seminar or pick up a book to learn a little more about investing, never mind put themselves in a position where they are taking on some extra risk.

Simply put, leverage allows you to minimise your own money (by using other people's money) and your own time (as a few hours a month may be all that's required to manage a property portfolio) to possibly maximise a capital gain. As property usually doubles every 10 years while the loan amount reduces or at best stays constant, any realising gain will help toward a comfortable retirement.

Challenge and education

As tax consultants and financial planners, our role is predominately to save tax, protect assets and create wealth for people. Yet part of that is to challenge people to BE more, DO more and live to the potential that they were blessed with.

By educating people about the advantage of leverage and the absolute necessity of taking risk in growth assets to have a chance of reaching a secure and financially free retirement, we help people take the step they most desperately need to take.

If our message resonates with you somewhat, and you'd like to know more, we have a number of informative (and no obligation) property workshops that may further help you, your family and friends to create wealth through property.

We hope you can come on board with us on the property investment journey. Register on line www.sofrapartners.com.au or call 03 5831 3499. I am great believer that simply earning more money won't solve your money problems. I have a client who earns $400,000 a year but he spends $420,000 on expenses and liabilities. Is he happy? You bet, but for the rest of his days he will be reliant on working with his hands to service that lifestyle. We all know that as we get older that physical commitment is not always possible.

The reality is that as we get more income our tastes tend to get more expensive. So earning more money is no guarantee you will be financially free in retirement.

What is clear to me now, is that in our accumulation phase of life (probably between 20 and 55 years of age) we need to have a structured plan that is leveraged for capital growth if we want to have a fair quality of life in our spending phase (55 years and onwards). The biggest risk is not taking a risk during the accumulation phase in your life.

A percentage of your business income (or wage for that matter) needs to be sacrificed into bricks and mortar to have a chance of reaching that golden target of $1million in assets – which is the level of assets I believe needs to be achieved to sustain a good quality of life when you have heaps of time on your hands.

The problem is there are so many reasons we can come up with to convince ourselves not to do this:

It's too risky;

- I need the capital to buy more depreciating assets;
- Interest rates are too high;
- I heard a horror story about renting to tenants; or
- The property market is too high.

If you want to find reasons why you should not invest, I'm sure you can.

There is no doubt that fear of risk is somewhat subdued by the tax relief that the taxman provides in our leap of faith into the property market.

And let's face it, as business owners we do not get very many incentives to take on risk.

Despite the normal deductions of claiming interest, repairs and outgoings, if the property is purchased after 1985 you can claim the write-off on the building for the next 40 years. Getting a tax depreciation deduction on an appreciating asset sounds too good to be true, but that is the reality.

We can also quell a number of other fears of property investment. What if the property is untenanted, the tenant trashes the property or interest rates go up? The first two concerns can easily be covered by insurance and the problem of interest rates is partially offset by inflation increases in rent, which are usually easily hedged by fixing your rate for a long term.

I am frequently asked what a good investment is and while everyone's circumstances are different, it remains hard to go past property, which has provided a secure investment and performed better than the inflation rate (more than 11 per cent in the past 20 years). It also provides a tax relief.

The risk of ploughing your hard earned capital back into the same business year after year is, in my opinion, the greatest risk of all. This is investing in more work (and usually for little additional return).

My three golden questions I ask before I invest money (in an investment or my business) are:

- How secure is my capital (never unnessarily risk your hard-earned capital)?
- What return will I get on my money (this is very rarely asked by business owners)?
- When can I get my capital back?

Asking these three simple questions has changed the way I invest money and it has provided significantly positive results.

So, before you go out and sign up for a new gizmo that you could probably do without, consider the opportunity cost of the capital instead being put to work for you into bricks and mortar.

Consider if you are investing in work or cashflow.

Find someone who has the right investment mentality, and study, copy and capitalise on their behaviour.

For more information call Sofra Partners on (03) 5831 3499.
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