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WEALTH MATTERS

Your personal guide to wealth creation

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The Amazing Power Of Compound Interest

If you were to ask a 25-year-old where their superannuation is invested, at least half of them would have no clue. They probably would not be able to tell you what fund it is in. If they do know the actual fund, try asking them about the portfolio they have within their fund. It is likely by now that you will find at least three-quarters of 25-year-olds have little to no engagement with their superannuation whatsoever. It is understandable though as it is money that they are not able to touch until they are 60 and are likely to be 65 or older by the time that they retire. Why worry about it now?

It is because now is the most important time for them to worry about their super – and the reason behind that is because of the impact of compound interest.

Take as an example Melissa, a 25-year-old that has $20,000 in her superannuation. The default product that she is invested in is the balanced product, but she also has options to choose more conservative or more aggressive portfolios.

The money will still be in her super fund for another 40 years. How important is a small increase in the rate of return to what she already has in her super?

$20,000 invested for 40 years at a rate of return of 5% will equal $140,899.80 in 40 years. At an inflation rate of 2% that is the equivalent of $63,767 in today's money. It is still a good result, but how could it be made better? Investing $20,000 for 40 years at 7% would net $299,489 or $135,636 in today's money. That is almost double the money that had been initially invested.

Now is a crucial time for everyone, young and old, to consider their superannuation portfolio to ensure that they are always receiving the best return possible. It will be far too late to do so when they hit retirement age after all.

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New Versus Old Property

The first thing to consider when purchasing a property is the location. Why is this important? Think about this – all property in the world started out at the same price, but now there are dramatically fluctuating prices, unachievable or unbelievable to the buyer. You want to buy the best property you can afford because that would suggest that it will continue to go up in value more than cheaper properties.

This comes back to compromising on what you can afford with what you want. For example, some people would love to buy an apartment block in the Eastern Suburbs of Sydney – but who can afford that? What these people need to do is buy the best property that they can afford.

It is important to note that the only part of the property that goes up in value is the land, but the only part of the property that can generate rent is the building. For example, an older, inner suburban property may be worth a lot of money but does not generate close to the same rental income as a percentage of a brand-new apartment in the same area

A $1.5 million house may only generate $40,000 in gross rent and will cost a lot more to maintain. Two $750,000 apartments in the same town will probably generate about $60,000 in gross rent and will not start incurring big maintenance costs for another decade or so. The new apartment also offers more tax advantages in that it will have more depreciation.

It is extremely likely that, over twenty years, the older property will grow in value a lot more than the apartments, and it is likely to be more desirable to have it than to not. But is it an affordable option? The rent and tax savings from the new apartment may be the difference between being able to buy or not.

What Is A Power Of Attorney?

A Power of Attorney is where one person (known as the "grantor") gives certain powers to another person to act on their behalf. The other person is known as the "attorney".

Powers of Attorney can be general and give wide-ranging powers to the attorney or can be specific to certain tasks.

Aging parents may wish to appoint their child as a power of attorney if they are concerned for their mental capacity so that their assets can be dealt with. A husband and wife may wish to grant each other a power of attorney for the same reason.

A person cannot grant someone power of attorney once they have lost their mental capacity, so it is important to always plan and appoint any attorneys early.

Powers of Attorney are extremely important documents, and a lawyer should always be involved when drafting them.

The lawyer will give good advice and can talk to you about other legal documents such as medical guardianship.

Who Is Left To Lend To SMSFs?

Borrowing to buy a property in your Self-Managed Super Fund is a relatively new and exciting wealth creation strategy. Though it is not suited for everyone, those that are suited to it should seriously consider the option.

When the law first changed to allow SMSFs to borrow, only a few specialist lenders went into the market. The four major banks took several years to follow suit, and only three of them had a publicly offered product with the fourth doing loans only for "special clients".

Recently the major banks have completely pulled out of lending to SMSFs to buy property, leaving only a few of the smaller banks or non-bank lenders to do so. Some specialists focus primarily on lending to SMSFs.

Another option to borrowing directly from a financial institution is that you yourself can lend the money to your SMSF. In many instances, this is the best course of action. Even if you do not have the funds easily at hand, you can borrow against your own home and lend the money to your SMSF.

If you already have an SMSF loan or are thinking about obtaining one, contact a reputable broker with experience in SMSF loans to ensure the best product is selected for your needs.

What Are Franking Credits?

When a company makes a profit, it must pay tax on that profit. In Australia, large companies pay 30% tax on their profit. With the profit left over after tax, they can then pay their profits to their shareholder, with payments known as dividends. Australian companies can pay dividends to overseas investors and overseas companies can pay dividends to Australian residents.

In Australia, the government has decided that an Australian shareholder of an Australian company will receive a credit for the tax paid by the Australian company in Australia. The shareholder will then pay tax on the full amount (with that credit).

Assuming that a share of the profit of a company is $100 and the company pays $30 in tax, the company then has $70 left over to pay a dividend and gives the shareholder the full $70. Under Australia's tax law, the shareholder then gets a credit for the $30 tax paid by the company, added to the dividend already received. The taxable income of the shareholder is $100, but $30 has already been paid in tax.

If they are on a lower tax rate than 30%, then they will receive a refund of the extra tax. If on a higher tax rate, they will then pay the top-up tax. Either way, Australian shares have a nice benefit over international shares in that shareholders can get a full credit for the tax paid by the company before receiving their dividend.

The Covid Property Boom

There were many predictions of doom and gloom that permeated the property market news due to COVID-19, with some occurring not that long ago. Experts last year predicted in some articles a price drop as high as 30% during the COVID-19 pandemic. Those who owned a million-dollar property, for instance, were warned that it may only be worth $700,000 in a year's time. With negative equity in their own homes a plausible potential result, many people were scared and concerned by the prospect and outcome of the market.

As a result of all this predicted doom and gloom, the government reduced interest rates to an all time low. Other prices fell as well, including petrol and rent. Australia as a country lives off the back of agriculture and mining sales, and our customers (other countries) did not stop eating our food or producing goods using our iron ore, so kept buying our products. As a result of Australians being unable to travel internationally, their money was spent back in Australia. The government also increased its domestic spending.

As a result of this, the economic position of Australia has been strengthened more than anyone expected. Looking back at other recoveries from economic disasters, and how well Australia rebounded from the Great Depression, WW2, the 1987 market crash, and the Global Financial Crisis could show a trend and predict yet another economic boom after the pandemic.

What is to come may be better than what was expected of the outcome.

The government however does not appear interested in quelling the current boom like they did in 2017, where they asked banks to reign in their lending which reduced demand and dropped prices.

There are a few reasons why the government is not preferring that course of action.

First and foremost, there is still concern over the performance of the global economy. As Australia is very much intertwined with the global economy and relies heavily on other countries for its prosperity, the government does not want policies that will slow the Australian economy just yet.

Second is what is called the "wealth effect". There is still concern over the state of the Australian economy. With JobKeeper now finished, there is still a strong chance that more businesses will fail, people will lose their jobs and there will be more bankruptcies. By allowing house prices to increase, people will feel wealthier. This leads to a positive attitude towards spending, and if as a nation spending is increased, more jobs can come about as a result. It's even better when that money is spent in Australia, as it means more local jobs.

This may seem like bad news to non-homeowners, but with rents lower than they have been for years and interest rates at their lowest ever, saving up for and buying the first home is now a lot easier.

How Much Do I Need To Retire On?

From a financial point of view, the most important question to ask when planning for retirement is “how much money do I need to retire on”. Here are the points that need to be considered when making a retirement plan.

1. **How long does the money need to last?** A person who is going to retire at 80 will certainly not need as much money as would be needed if retiring at 50. It is usual to not know how long exactly the money will be needed until, but it is easier to predict with a projected timeline. For example: If you retired at 65, and expect to need money until you are 90, your money needs to last for 25 years.

2. **How much money should be left over when I die?** Some people may want to make sure that they have as much money left over when they die to leave their kids, as they had when they retired. Others may be happy for their children to have the house, and there are those who may believe their children to have been well setup during their lives and therefore do not need anything extra. It is important to know that if money is to be left over to leave to anyone, it means that there will need to be more money to start with at retirement.

3. **How much money is needed to live on?** Though they may be happy to live on less money when they retire, often people start spending more than they ever did because they are no longer headed to work every day. From a planning perspective, start with a number that is the same as what is needed to spend in the current lifestyle. Filling out a detailed budget questionnaire can help with this, but most people often underestimate how much they spend. Often it is best to simply look at what is earned now, take away how much is used to pay off debts or save and what is left from that is what can be spent.

4. **What rate of return will the money get?** Upon retirement, we might like to think that our money has been put into a risk-free environment so that capital cannot be lost, and that makes sense. However risk-free investments pay the lowest rate of return, and as such, will require a lot more capital to fund retirement. For example, with current deposit rates situated at around 2%, $2.5 million would need to be invested to receive $50,000 per annum in interest. However, if there was a share portfolio giving a return of 7%, then only $714,000 would need to be invested to return that same amount per annum. Of course, shares come with a degree of risk, but how much risk are you willing to take?

After considering all the above information, it is possible to mathematically calculate how much capital will be required to pay a particular income for a specific period, and with just how much to have left over to leave as the inheritance.

What If I Cannot Reach My Retirement Savings Goal?

Often when people work with an adviser to find out how much they need to fund their retirement, they work out that they may not be able to get to where they need to be.

They might determine, for instance, that they need $1.6 million but with their current savings strategy be only able to reach $1.2 million. In this case, there is no magic bullet for figuring out a compromise (other than winning the lottery).

In the previous article, we discussed how long money needs to last, how much to spend, how much to leave the kids and how much risk to take with your money. By compromising on one or more of these aspects, obtaining those retirement goals will get a little closer.

For example, a person may decide to work for three more years. This has a double benefit – their savings grows for three more years, but they only need their money to last three fewer years, which can have a big impact on their retirement.

More risks may be taken where instead of investing all their money in term deposits, part of their portfolio can be put into riskier assets. This would therefore give a higher expected long-term rate of return.

It might also be worth accepting that the inheritance may not be as large as previously planned.

Finally, if all these compromises have been attempted in some way, it might be worth considering spending less.

It is very important to speak to someone to help ascertain where you are regarding meeting your retirement goals. We are always willing and ready to help you on your saving journey.