THE COMPLETE GUIDE TO

PROPERTY INVESTING

IN AUSTRALIA

LUCAS ROGERS, ACA, B. Comm, Dip. Fin.

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Read what they say about Lucas Rogers

"…getting started in investing in property was a big and scary step for us. We were lucky that Lucas showed us the correct way to go about things so we avoided the mistakes our friends had made. We now have a sizeable portfolio and are looking forward to an early retirement."

W and C Bateman – Gold Coast QLD

"…we already had our own home and one investment but it was all structured incorrectly and costing us a packet to keep. Lucas re-structured it correctly for us. The saving we made allowed us to go and get our second investment property."

T and M Fitzwilliam – Melbourne

"I first saw Lucas speak when he spoke on behalf of the Federal Government about property investment. Prior to that I had no goals and to be quite honest no idea about property. Since then I am focused on building a property portfolio and set my target of $2 million in net assets over the next 10 years and I am well on the way to achieving that."

J N Drake – Sydney

Olivia, Nikita, Tommy and Katia.
I love you guys to the moon and back. Xx

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Why I wrote the book

Welcome to the world of property investment.

I wrote this book because I felt that I had something to share with people. Through my work I have spoken to and educated thousands of Australians about investing in property. In my time, I have met many people who have just gone about investing the wrong way and lost money. Either they purchased the wrong type of property or purchased in a structure that was incorrect and very expensive to correct. Some people get some parts of the investment process right – like buying the right type of property – but then they will drop the ball in another area, such as tax or finance. This will hinder their ability to build a property portfolio of any size. Others just have the wrong mindset to build a property portfolio. They are not sure of what they want and therefore can never achieve it.

I have read many books on investment, as it has always been an interest of mine. Property, shares and business, you name it, I have read about it! I have come to the conclusion that most books on investment are too long, too complicated and generally too boring. I found there was a gap there that I thought I could fill. Truth is, the majority of people would rather be reading a Dan Brown thriller or a "Harry Potter" novel than reading about "Bull and Bear markets" or the "Population forecasts for 2050". Reading books on investment and investing itself is just a means to an end. If we could win the lotto and get back to having fun, who wouldn't – rather than spend their time studying and investing? But the unfortunate thing is the odds of winning lotto are 45,379,620 to 1. Not great! So therefore we must take it on our own shoulders to build wealth for both ourselves and our families so that we are able to live a comfortable life in retirement.

My intention in writing this book is three-fold.

- Firstly, it is to help you understand why it is so important to invest and build wealth and why everyone must do it no matter what their background. Hopefully this book motivates you to actually take that first step.
- Secondly, it is to try and pass as much knowledge as I can over to you in an easy-to-understand format.
- Thirdly, it is to not take up too much of your time in doing so, meaning you can get back to having fun, which in the end, is what life is all about.

I tried to cut out as much fluff and padding as possible when writing this book. I have tried not to dazzle anyone with technical terms that are difficult to understand. The one little indulgence I have in this book is the final section, "Teaching your kids how to build wealth". For those of you who don't have kids, that may seem like the fluff and padding that I was trying to cut out, but for me it is the most important section. Teaching the next generation the financial skills to invest is as important to me as teaching them to brush their teeth.

In today's competitive world, investing is an essential skill to learn. It is the sort of thing they should be teaching in schools. I think it's more important to a child's long-term happiness than learning about the gold rush of the 1800s. This is why I have implemented my Smarter Schools Program. My long-term goal is to be able to have investing taught as a senior subject in high school. I have kids now, three of them. Twin boy and girl and another little girl. I regard it as my duty to teach them about investing wisely and safely.

I feel very strongly about trying to teach the next generation how to invest wisely in property and understand some key concepts. The biggest asset that anyone has is time. We are all born with the same amount, whether we are rich or poor, there are still 24 hours in a day and seven days in a week. How you use that time is up to you.

With investing, the earlier you start, the better off you are going to be because investing is time in the market not timing of the market. So if we can get our kids to know the correct principles of investing and start them early enough, imagine the difference it will make to them. The great thing is, you don't have to earn a huge income to be wealthy through investment, as long as you start early and you know what you are doing with that income.

I once had a meeting with a guy in Perth named Jack. Jack ran a boat hire business in south Perth on the foreshore. He was quite old but was still very keen on property and wanted to get his daughter started in investing. He knew the power of property and time and he told me a story about when he was young. He used to work as a shearer. He explained to me that the life of a shearer was working in remote locations and after a big job had been done, the shearers would all go back to town and drink as much as they could with the money they had earned until they had to leave for the next job. One of Jack's mates was a little bit different from the rest and instead of coming back to town and getting on the grog, he would save his money. Every few years this guy would buy an investment property in Perth. In the end Jack was still doing the back-breaking work of a shearer and his friend had amassed a property portfolio consisting of no less than 30 properties in the Perth suburb of Subiaco. Those of you who know Perth, will have an idea of what that portfolio would be worth – tens of millions of dollars. So you see, it is important to get in early and start as time is the big compounding factor.

For those of you who don't have kids, feel free to skip that section on "Teaching your kids" although I still think it is a great read for everyone.

About Lucas Rogers

I thought it necessary to tell you a bit about myself, not to gloat but to answer the question: "What qualifies you to educate me on property investment?"

At present I am a Chartered Accountant and a qualified financial planner (RG146). I have a Bachelor of Commerce, a Certificate 4 in Mortgage Broking and I hold a full principal real estate licence in Queensland, New South Wales, Victoria and Western Australia.

I was born in Sydney and lived in Cronulla until the age of six, then I moved to a farm on Queensland's Sunshine coast where I suppose I grew up.

I went to school about an hour away from where I lived. I had no idea what I wanted to do for a career so Dad suggested that I start off by doing a business degree. When I left school, I left home and went to university. In between partying and playing sport, I managed to scrape through university with a Bachelor of Commerce. Then I went to work for an accounting firm in Brisbane, where I proceeded to start my professional year (or PY) to become a Chartered Accountant. (I don't know why they call it a "Professional Year" – it actually takes two years but that's accounting for you.)

It was a hard, hard slog but I got there. The main thing I learnt from my PY was how valuable time is. After working for four years in tax and business services, I left Australia to expand my horizons and went to work in London. I worked in some of the world's largest investment banks for the next seven years, including Morgan Stanley and Credit Suisse First Boston. Towards the end of my time in London, I came to the realisation that working in an investment bank was not for me and I needed to change my career path. So while still in London I studied to become a licensed real estate agent via correspondence. After seven years of cold weather and warm beer I moved home in 2004.

I had had enough of the investment bank life so I thought I would put my real estate licence to use and I got a job with the local real estate agent. I set my goal to be the best agent in Queensland and the job consumed me, I loved it. It wasn't work to me it was fun. Within six months of me starting work in real estate I was poached by a large property investment and development firm to set up their Western Australian operation. So after getting back from London, six months later, I was off to Perth. I set the Western Australian office up as the state manager and ran that for the next six years.

While running that office I was involved in hundreds of millions of dollars' worth of property development, sales, finance, and capital raisings. I lectured and helped thousands of Australians achieve their financial goals through investing in property.

The company I worked for eventually got too big, too focused on profits and I felt that the clients were not getting value for money. I was not happy with the way it was treating clients and I decided that I could do it better on my own. I left the company in 2010 to set up my own business, Rogers Property Group. At Rogers Property Group we educate and advise people in property investment strategies. We make sure that their portfolio is running efficiently from a tax perspective and above all that they are making money. We have helped hundreds of people achieve their financial goals.

So I have had a bit of experience and I am an investor myself, however in this business there is always something to learn.

LUCAS ROGERS
March 2015

Before we start…

Property investing should not be as difficult and scary as people believe. There are just a few basics that you need to follow that will set the foundation for a good and sizeable property portfolio.

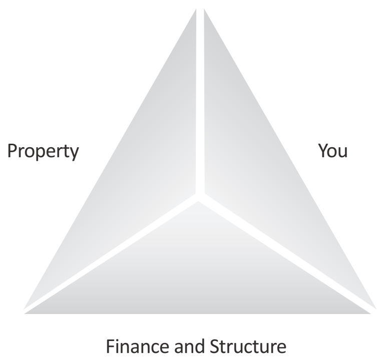
I want to ask you something before we start.

Why did you pick up this book?

I think that everything happens for a reason. Your action of picking up this book means there must be something going on somewhere inside you that says you want to change something. Great! Maybe you want to make a better life for you and your family, maybe you want to pay off your own home faster or maybe you just have a thirst for knowledge about the subject? Whatever your reasons, I sincerely hope you enjoy the book and find what you are looking for.

The book is divided into three parts: notice that I have represented this on an equilateral triangle in the diagram on the next page. This is significant because each of these parts holds equal importance to the serious property investor.

- You
- Finance and structure
- Property



Some of you may be thinking, “I just want to know about where to buy”. That’s fine and you can skip to that section if you choose, but each of the parts in the book is just as important as the others so I encourage you to read it in its entirety and not skip sections.

You

In this first part of the book, I will be talking about getting your mind right for property investing and becoming wealthy. We will look at what it takes to be successful both in life and in property investment. We will look at some traits that are common to all successful investors whom I have met. I will give you a few exercises and tools that you can use. I am not going to ask you to start meditating, rubbing your ears while standing on one foot, or anything crazy like that (don’t laugh – I have actually seen people do it!). We are just getting our head into the right mind-set to deal with investing and all of its up and downs.

Finance and structure

How you structure and finance your investments are the foundations on which everything else is built. If you want to build a 20-storey building, the foundations have to be planned, they have to be deep and strong. If you're building a 20-storey building on weak foundations, what happens when the earth shifts? The building crumbles! It is the same when building a property portfolio, if the foundation of finance is not planned and is not strong, then the first sign of trouble means that your property portfolio will crumble. Therefore, it has to be done right. You must be buying property in the correct structure in order to get the right tax benefits and asset protection.

Property

In the third part of the book, we will be looking at what sort of product (type of property) Australians want to live in and comparing which type of product will be the best from a capital growth perspective and why. Then we will be looking at where is the best place to put that property. We determine this by looking at the macros (big picture) of property growth. Then we break the market down even further by looking at the micros (little picture) on property growth.

As I have already said, I am an accountant. Therefore, by nature I am very analytical. I find it easier to take things in if they are just broken down in a simple bullet-point format and explained in a logical sequence. This will hopefully help you understand and follow better and also speed this process up.

PART I

YOU

Chapter 1
WHY BUILD WEALTH?

The fact that you have actually bothered to pick this book up and are reading it means that you are probably not asking yourself, "Why build wealth?" Good for you. To be honest, this is half the battle won right there. Unlike you, for most Australians that question, "Why build wealth?" has never entered their head because they have not even come to the realisation that they must build wealth for retirement and financial security. As retirement seems so far off, it does not get much of people's thought time. They have this idea that everything is going to be OK – "She'll be right mate!" – as the Aussie saying goes. I am here to tell you that in fact no it won't be OK. She won't be right.

You need to ask yourself these questions:

1. If you were to lose your job tomorrow and could not get another job, could you survive off your assets alone?

2. When retirement comes, will your assets provide you with an income at that stage?
3. If at retirement your assets won't pay for you, what will you live on?

If you answered "No" to either question one or two, then you need to start building up an asset base. If you answered "the pension" to question three, then you are in for a rude shock. We are going to have a closer look at the pension and see what that provides later in the book and it may change your opinion.

The fact of the matter is everyone must invest. Everyone.

It doesn't matter what income you are on, you must be putting something away for the future. If you are not investing, then you need to be getting yourself into a position where you can start investing, as soon as you can.

Let me repeat that.

If you are not investing, then you need to be getting yourself into a position where you can start investing, as soon as you can. No one is going to take responsibility for your financial future for you, only you can do this. Just as squirrels put nuts away for the winter so they don't starve, so do we have to put away investments for retirement so we don't go without. If you are on a very high income at the moment, and are under the impression that you won't need to invest, then you are mistaken. People who are on high incomes tend to have a higher expectation of lifestyle, and therefore need more assets to provide for their retirement.

Just how much you are going to need really comes down to what you want. We have a closer look at how Australians are retiring and a measure of what you may need in the next section.

When I mention retirement most people are thinking old, boring, pensioner-types hobbling around on Zimmer frames. But it doesn't have to be like that. What about if you were to retire in your forties? Or even your thirties? When you are still able to do all the things that you love – travel, play sports, spend more time with your family, or working in a job that you enjoy – for fun – rather than just having to work to make ends meet. It is possible. The dream of retiring early certainly is possible and I have seen people become financially free in their mid-thirties just from passively investing in property.

Being able to retire young just doesn't happen. You have to make it happen. You will need to start investing wisely as early as you can. You need to set a goal, set a plan to reach that goal and stick to it. Who knows, by doing and achieving, you may even be able to inspire others around you who have witnessed your success.

How people retire in Australia

People fall into one of these categories:

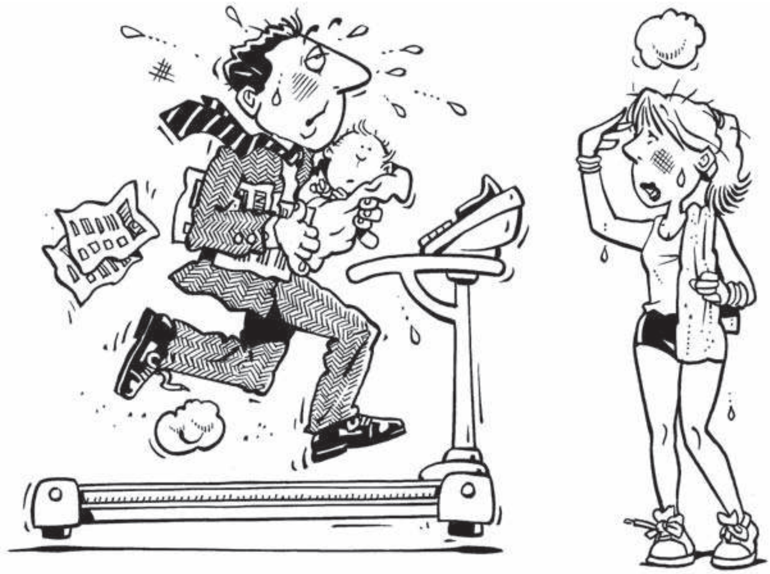
1. Those who have set financial goals and are taking steps to make those goals reality
2. Those who do not know that they need to build wealth for the future
3. Those who know that they need to build wealth but can't be bothered to do it

Which category do you fit into?

Here is a fact: only 2% of Australians are actually retiring on an income greater than $50,000 a year. That is not a lot is it? Most people earn more than $50,000 p.a. but few people retire on an income of this figure. Most Australians are retiring on well below the median wage and many are actually below the poverty line.

So the question has to be posed. Why? The reason that most people retire poor is that they don't know that they must build wealth. They get caught up in the day-to-day happenings of their life and don't think that far into the future. Most people fall into the following life pattern. I like to call it "The treadmill of life", and it goes like this:

- Get through school as best they can
- Try and get a job, apprenticeship or do a degree
- Party hard and have fun in the early years
- Meet a partner
- Have kids
- Try to progress their career to pay for those kids and buy a home
- Kids leave school
- Parents hit mid-fifties, kids leave home
- Late fifties, suddenly realise they may have to start accumulating some assets for retirement
- Realise there is not enough time
- Resign themselves to the fact they will be on the pension
- Retire and spend life watching TV and complaining about how the government doesn't do enough for pensioners even though "we've paid taxes all our lives".



See the pattern? It is an easy one to fall into. And why not? Investing is not something that we are taught in school. Unless you have parents who have managed to unlock the door to investment success, and can show you how to do it, how else are you ever going to learn?

For a lot of people, paying off their own home was the only thing they concentrated on and they thought that was the way to become wealthy. This could not be further from the truth. To pay off your own home is very commendable but unfortunately, when you retire, your own home does not give you any income. You will either need to sell it and downsize or take out a reverse mortgage on it. Neither solution is ideal. Wouldn't it be great to have flexibility? Wouldn't it be great to be able to make decisions not based on the necessity to survive but because that is what you want to do? Life should be about choices you want to make, not about being backed into a corner due to financial hardship and stress.

Not only do most people not realise that they need to build wealth, they don't realise how much wealth they actually need to build to retire comfortably.

I have educated thousands of people on how to build wealth through property. I give property training seminars to the public on behalf of the Federal Government and one of the first things that I ask my trainees is, "If you want to retire on a passive income from assets of $50,000 p.a. today, how many dollars' worth of net assets – excluding your own home – would you need?" Most people have no idea what the answer to that question is. If you don't know the answer to that question, how can you ever then plan what you need or set a goal? How can you set a goal of retiring on $80,000 p.a. if you don't know how many dollars' worth of assets you need to generate that income? The answer to the question is that most quality assets will give you a maximum of around a 5% yield. Therefore, you need around $1 million of net assets – excluding you own home – to provide an income of $50,000 p.a.

Remember: Net Assets = Asset Value – Debts

That is the equivalent of:

- $1 million in shares
- $1 million in superannuation
- $1 million in cash
- Approximately two or three averaged-priced Australian residential properties with no debt.

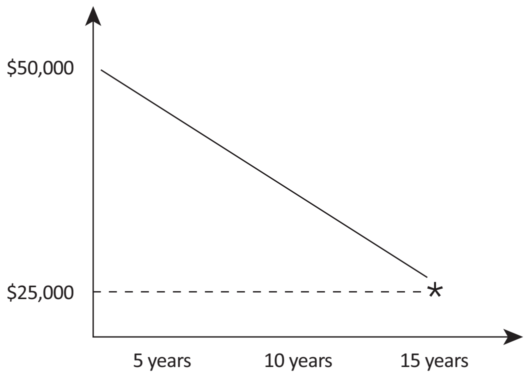
Remember, this does not include your own home!

Now, sit back and have a think. How many of your friends currently have that sort of asset base? No doubt, not many.

The effect of inflation

Consider this. Let's say that you had a goal that you wanted to retire on an income of $50,000 p.a. in 15 years' time. You must bear in mind that what you can buy for $50,000 today, you will not be able to buy for $50,000 in 15 years' time. The reason is that inflation eats away at the buying power of money. Inflation is the eroding power of money. Some people have described inflation as the poor man's tax.

The diminishing power of money (inflation)

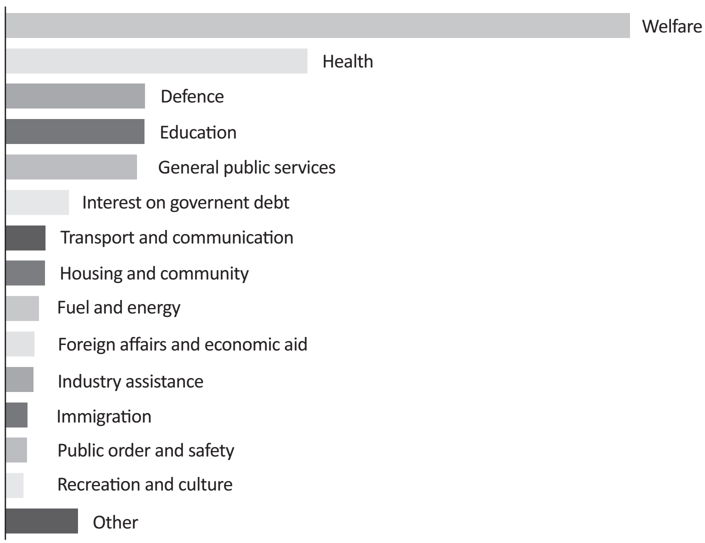


Why? Because if you do not hold investments, then you are not keeping up with the value increases in the overall market. The rich who do hold the assets, just keep getting richer. Those who don't, just get poorer. At current inflation rates, your $50,000 in 15 years' time will buy the same as about $25,000 in today's dollars. You can assume that money is going to halve in value every 15 years on average. So, taking into account this unforeseen devil called inflation, we are not going to need $50,000 in 15 years' time, we are going to need $100,000 p.a. to provide us with the same lifestyle. Working backwards further, at 5% yield we won't need $1 million in net assets but $2 million in net assets. It's getting even harder, isn't it? I hope I am making it clear to you the importance of starting to invest as early as you can. The more time you give yourself to allow your assets to grow in value, the better off you will be.

The ever-increasing retirement age

Unfortunately though, most people don't start early and many never even start at all. Most people are retiring poor on the pension. Here is an interesting exercise, take a look at your latest tax return. Go to the back page. One of the changes that the Liberal government has introduced is to show you, on a monetary basis, where your taxes are going.

Where taxes are paid to



You would think that the majority of your taxes would go to infrastructure such as roads and public transport, but this is not the case at all. The majority of our taxes are going to welfare. That's right. Around 40% of the tax you pay goes back to welfare recipients. Most of that goes to the aged pension. Broken down, that is about $55 billion or 14% of all tax goes back to people on the aged pension each year. It's a hell of a lot, isn't it? On top of that, this figure is set to grow even larger as Australia's population is ageing.

In the longer term, this is not sustainable. We now have fewer taxpayers for every pensioner. What is going to happen in the future? Well, people are going to be required to work longer. Gone are the days of retirement at age 55 and getting on the pension. That age limit has been moving upwards for some time and will continue to do so. As I write this book, there is a strong push to have the retirement age moved to 70 years old. This will happen. I absolutely guarantee it. It is only a matter of time. If you consider that the average life-expectancy of an Australian male is 79 years, if we are made to work until we are 70 then that does not leave us a lot of time in retirement to relax and enjoy the good life. Even if we do manage to make 70 and end up getting the pension, this is a measly existence anyway. You will just join the other pensioners watching TV, with life passing you by, complaining about how pensioners don't get a "fair go".

How do we avoid falling into this trap that so many others fall into? How do we avoid living well below our expectations? The answer is simple. Invest. Invest in low-risk, simple assets over the longer term to build an asset base and save tax. It is not incredibly difficult. It just takes some commitment, courage, a positive mental attitude and a very small amount of knowledge.

Chapter 2

HOW TO BE SUCCESSFUL

Have you ever wondered why some people are successful and some just are not? Some people seem to get all the "wins" and others just struggle through life the whole way. Is it just bad luck vs good luck? I am here to tell you that it certainly is not just a case of luck. All successful people tend to have the same characteristics, no matter what field they are in, and they make their own luck. What are these characteristics? What makes up the mindset of a successful person?

Investing in property, researching and making sure you get the right property is only half the battle. Getting your mindset right and having the ingredients to be successful is the other. Now this book is not a life-coaching book and I am not going to start telling you to watch your diet and meditate, etc. To be honest, I don't know one successful person who does actually meditate (contrary to what you read in a lot of success books) but I have known lots of successful people in my time and have always tried to determine what differentiates them from your not-so-successful person.

My father always used to try and test me out. I remember, he would ask me, “Luke, why do you think he is so successful?” “Why is he different?” So after a while I began to analyse these guys and discuss it with my Dad. I found that successful people were always confident, positive and willing to have a go. But as I got older, I realised it was not so much that it was just these qualities that successful people possessed but more so how they put them to use. These successful people always seemed to use the same formula or steps to achieve what they wanted – even the small things they wanted to achieve. Because, after all, overall success is really just a whole lot of small achievements bundled together.

It was these steps that separated these winners out. To be successful in anything you must:

1. Set goals
2. Get motivated
3. Act
4. Be confident/positive
5. Be tenacious.

I believe these are the five main things that successful people do, that others don’t and that is why most people fail. Let’s have a look at each of these in turn.

Set goals

I can’t stress to you the importance of setting goals. Not only in investing but in all parts of your life. It is of utmost importance that you start with a clearly-defined set of goals. This gives you a target, something to aim for. After all, how can you achieve something unless you clearly define what it is you want to achieve? There's no point in having the goal, "I want to be comfortable in retirement." That is wishy-washy and not clearly defined. What is "comfortable in retirement" anyway? What is comfortable to you may not be comfortable for James Packer or another person. You have to clearly define what comfortable is before you can attempt to get there and measure your progress.

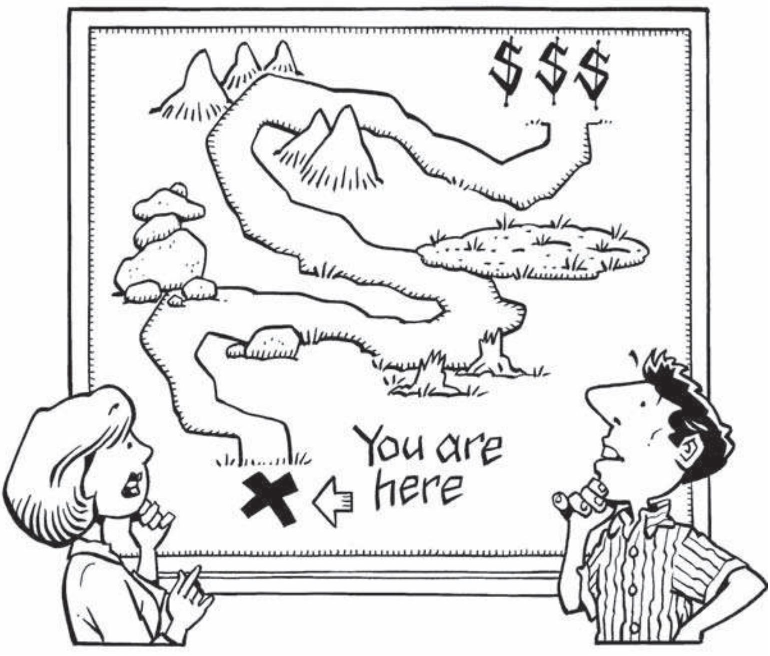
There are many different methods that people employ to help them define their goals. Writing them down will help, cutting pictures out of magazines of the lifestyle that you would like to be living, or the car that you would like to be driving, also helps define what it is that you would like. (We get into this further when we talk about setting a plan.)

One of the biggest benefits of setting goals, and what they have always allowed me to do, is they help you to make correct decisions easily and not procrastinate. If you don't start out with a clearly-defined goal of what it is you want to achieve, you could make the first step in the wrong direction.

Pretend for a moment you are in the car at Bondi Beach and you want to go to Manly. Assume that you do not have a GPS in your car, just a map. What is the first thing you do? You look at where Manly is on your map. That is your goal, your destination. Then what you do is you look at where you are, which is Bondi. Then you plan a way to get to your destination by the fastest and easiest route. Therefore, when you come to your first stop sign and you can either go left or right, you know exactly which way to turn and you can continue with confidence knowing that you have taken the correct way to get yourself closer to where you want to be. Goals are the same. You can equate "Manly," your destination, to your financial goal of where you want to be in 10 years' time. You can also equate your current location to your current financial position, and your route on how to get there is your financial plan. And that simply is pretty much how you should go about reaching your financial goals.

- Set goals
- Determine where you are
- Set a plan on how to get there.

Pretty simple, eh?



But unfortunately, very few people ever get around to doing this. Most don't even know that they need to do it. However, if you talk to any successful businessman or any successful sportsman they will tell you that they set goals. Guaranteed.

Successful people will set goals, then review those goals against performance and then reset those goals.

I am an avid goal-setter. I set goals every day. I set long-term goals of what I want to achieve in a calendar year, but also quarterly goals and even daily goals of things that I want to achieve that day. I love it when every time I have completed a task, I tick it off in my diary on a daily basis. My wife and I sit down every few months and write down our medium-to-long-term goals. When we go back to review our goals it is amazing to see what we have achieved and where we may have missed the target and where we need to improve. The great thing about goals is they can be somewhat flexible and they do not need to be set in stone. The things you want, where you want to live and what you want to get out of life, will change with your age, experience and financial status. What you may have wanted to achieve at age 20 will have more than likely changed by age 40. I remember when I was 20 years old my main goal in life was to drink as much beer with my mates as I could while still being able to pass my exams to become a Chartered Accountant! Now that I am over 40 years old my goals in life are far different. (Although I still like to have a few beers occasionally!)

Goals can be classed into two main categories:

1. Non-financial
2. Financial.

Although they are just as important as one another, as I said, I am not here to life-coach you. This book is about wealth-building through investment property so we will cover non-financial goals briefly but be concentrating on financial goals.

Non–financial goals

Obviously, these will be the things that you want to accomplish of a non-financial nature. Maybe you have always wanted to bungee jump or do a sky-dive. Maybe you have set yourself a goal to drop those unwanted Christmas kilos. These are all fantastic goals and you will find that once you become a goal-setter you will achieve so much more and get so much more out of life. One of my early non-financial goals was to learn how to speak Spanish. One day I thought to myself, "I am never going to achieve this unless I make it happen". So I made my decision. I quit my high-paying job at Morgan Stanley (Investment Bank) in London and moved to South America. I lived with a family in a tiny room and studied Spanish like crazy for a year. I remember the first night I arrived, the grandmother "Abuelita" cooked up a special welcoming dish of boiled pig skin. It was disgusting. It still had the pig hairs coming off the skin! Yuk! Anyway that did not deter me from my goal to study Spanish. I had a one-on-one tutor for six hours a day. Nothing was going to get in my way. I left South America and was able to speak Spanish fluently and read novels in Spanish. It was a great achievement for me and something I am very proud of.

A lot of people have a goal that they would like to buy a holiday home or a boat to go fishing in. These are goals that cannot be achieved without money. So these goals can also form part of your financial goals as well.

What I have learnt over the years is that you can achieve anything that you put your mind to. If you want to study and become a lawyer you can do it. If you want to learn a new trade, you can do it. Anything from learning a new sport or language to going on that holiday you have always wanted, you can do it if you put your mind to it.

Financial goals

This is really what it is all about. Financial goals can either be based on asset values or income levels.

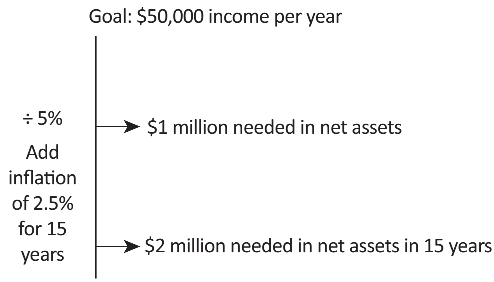
People will have different financial goals. Some people have a goal that they would like to own 10 houses, others want to have an asset base of $3 million. What I have found over my time is that when most people are thinking of a financial goal they are thinking about replacing their income from work with a passive income from their assets. "How much money am I going to need each year to live happily if I'm not working?" This can then be related back to how many houses you need or how many dollars you will need in the bank to provide that income.

I personally like my clients to set their financial goals based on the passive income level they would like to achieve. Then we can work out the value of the assets necessary to generate that passive income and we work back from there.

So in order to set the goal, think about how much passive income you would need to replace your current income. If you are wanting to replace income on retirement, think about how much income you will need on retirement. More or less than what you are currently on? Also, set this figure in today's dollars. Don't try and anticipate inflation just yet. Just say to yourself, "if I were to retire (or just stop work) tomorrow, what would I need to live on comfortably?" The figure that you come up with, that is your goal. That is your answer.

This is a great exercise that everyone should do. It can really be a brain-strainer and something that most people have never given any thought to. Most people would give more thought to who will win the footy this weekend than what they will be living off for the next 30 years after they stop work. Incredible isn't it?

Determining your goal with inflation



If you are not sure how much you will need, think about what you are earning at the moment. Assume that you do not have any debts – would you like the same amount of income passively without working? Would you be happy with less? They are your goals and the sky is the limit!

If you are still unsure on what you will need, the Australian Superannuation Funds Association (ASFA) and Westpac did a study on what people need to retire and they found that people need as a minimum 60% of the income that they were on. For example, if you were on $50,000 p.a., you would need $30,000 p.a. in retirement. If you are on $100,000 per year, you are going to need at least $60,000. Remember, to include your partner as well. If you are earning $60,000 and your partner is earning $40,000, then you will require an income of no less than $60,000 p.a. for both of you. Have you got enough in place to give you 60% of your current income?

Go ahead, take your time and have a think about it. When you have come up with a figure, write that number down in the box below. We are going to use that figure later on when we put a plan in place on how to get it.

What I want my passive income to be:

$

Get motivated

While wealth-building is not hard, it is not always beer and skittles either and it can be a little testing at times. Sometimes it can be frustrating. Sometimes it can be a bit scary but when you follow through and reach your goals, it is ALWAYS very satisfying.

For many people, the hardest thing is to actually get motivated to start investing. Most just keep putting it off and putting it off, never doing anything, just following a constant cycle of procrastination.

I have heard every excuse there is about why people can't invest and let me tell you there are lots of them. Everything from waiting for prices to drop to not having enough time to research. When you really look at it though, it boils down to two things: either being too scared or being too lazy. Nothing else.

The key thing here to get over this is to become motivated to do something. Motivation is a difficult thing to teach and it is an emotion that has to come from within you. What's more, it is not just getting motivated to start but to continue investing for the longer term, even when things get rough. Wealth-building through property investment is a journey. You are setting out down a well-worn path to success that many people have walked before you. Just like any journey that you set out on, you may have some ups and downs along the way but you need to stay focused and motivated to reach your final destination.

Although motivation can't be taught, there are some techniques that I have used personally that have kept me focused and enthused about what I want to achieve, even at times when I thought about packing it in.

Ask 'why?' and 'what for?'

Initially, when setting your goals, you need to ask yourself "Why?" Why are you really doing this and "What?" do you really want to get out of it? You may have to peel back a couple of layers of "Why?" but you need to find out what is really driving you.

Answers vary from person to person. I have sat down with hundreds and hundreds of people and asked them these two very same questions and I have heard lots of different answers, among them:

- "I want to provide a legacy for my kids"
- "I want a better retirement"
- "I want to be able to upgrade my home to the house of my dreams"
- "I am only going to be on a high income for a limited time. I want to get some assets under my belt while I am earning a good income".

I have one South African client who left everything he had in South Africa for a better and safer life here in Australia for his family. He had to give away almost everything he had and wanted to show people back home that he could get on top and do well again. These are all good answers that get right to the heart of why you are setting out on this journey.

The two most common answers that I hear are:

- "I don't believe in superannuation and I don't think there will be a pension when I retire so I need to start building some wealth somehow"
- "I saw how hard my parents did it in retirement and I don't want to be in that position".

This is a different driver. This is fear. Fear can be a very good motivator. Many successful entrepreneurs quote fear as a big driver to achieve and keep pushing themselves in the longer term.

I think it is good to have a little bit of fear. Not fear of actually getting started and investing, but fear of not getting started. It is very easy to determine how you are going to retire based on your current level of assets and current input into investment. The numbers will not lie to you. Nothing miraculous is going to happen so that you suddenly end up with all these assets and live this great lifestyle in retirement. If you do not do something, then your outcome and lifestyle is written in stone. This should be fear enough to drive you.

Whether it be fear of a poor retirement or a meagre existence or the desire to achieve something better for your family, work out what is your motivator and your driver, then harness its energy to push yourself forward and keep you motivated in the long term.

Seeing is believing

Another technique I use to motivate myself is visualisation.

This is a technique used a lot in sporting fields by the very best sports men and women in the world. This technique involves being able to visualise what you want to create and draw upon that image of what you desire; you then make the connection between you and that image.

Did you know that our brain works in pictures, not words? When we think of what we would like to do on the weekend we don't see it written down, we see it in images. It is the same for things that we desire. Let's test it out. OK – quickly think of something that you would like for dinner. Now when you thought of that type of food, did it come to you as an image or words? Let's try again. If I were to give you a million dollars and you had to spend it, what would you do with it? I'll bet a thousand to one that your answer to this question came to you as an image, a picture of what you wanted. Maybe it was car, boat, new home or even a holiday that you could see.

Imagine if you could use this to help you get want you want. Well you can. There was a movie, based on a best-selling book, that came out a while ago called "The Secret". It was all about the power of the mind and how if you thought about something long enough, with enough focus, over a period of time, it would manifest itself to you. You may have read this book or seen or heard of this movie. I personally don't believe this to be true. I don't believe just by thinking about a Ferrari constantly it is going to all of a sudden land on your doorstep. What I am suggesting is that being able to draw on this image of what you want will give you extra motivation, focus and drive to get it. And it will happen.

NASA has actually researched this by having their astronauts think and visualise certain space manoeuvres while being attached to muscle electrode pads. They determined that the same muscles that were used in the actual manoeuvre were stimulated during the thought and visualisation process. The brain is a very powerful thing.

A lot of people, when they are trying to lose weight, will cut pictures out of magazines of fabulous bodies and put them on their desk at work or even on the fridge. So whenever they open the fridge to get some rubbish to eat, they will see the picture and it will encourage them to stop and think, "Is this taking me closer to the body I want? If not, then I won't eat it or else I won't have the body that I want." It is giving them some extra drive to achieve their goals. This is another form of using visual data to stimulate motivation.

As I said, this is used a lot in sporting fields. I am sure Cadel Evans saw himself a thousand times in his own mind riding into Paris with the yellow jersey on winning the Tour de France. It would have been exactly as he had pictured it in his mind all those times as he actually won and became the first Australian ever to win the Tour de France and make history.

This all may seem a little strange to you, so I challenge you to try it.

Have you ever had to save for a holiday, been to the travel agent or looked on line at somewhere you and your friends or family would like to go? Then you work out how much it is going to cost and you start to budget and save. You find saving tough. You see something that you want (but don't need) in the shops. It takes a great deal of determination not to buy that item so that you have the money to put towards your trip. Every now and again, when things really get tough, you pull out a copy of the travel brochure and remind yourself just how great the holiday is going to be. This is motivation. This is the little bit of help you need – just pulling out the travel brochure – to remind yourself just how good it is going to be. Finally, you save enough and buy your ticket to go. You have the holiday of a lifetime with your friends and create memories that will last forever. It was all worth it.

I would, at a bare minimum, write my goals out and have them somewhere where I can view them regularly. Goals in your mind are only dreams. It is not until they are on paper they become goals. If you can cut some pictures out of magazines or download them from the internet, of the lifestyle that you would like to live or things that you would like to own, then paste them on the page next to your goals. I think that would be of great benefit. Sit down with your partner and really have a good think about what you want. List everything. Not everything will be of a material nature. Your goals might include things such as having the body that you dreamed of, or spending more quality time with the kids or friends, but the list will also include material things as well – the house that you would like to live in, the holiday that you would like to go on and maybe the car you would like to drive. Whatever it is you want, write it down. You will be surprised at the extra motivation you will get from this.

Act

Successful people don't just talk, they do.

Goal-setting is one thing, it gives you a great feeling, it gives you something to look forward to and it is fun cutting pictures out of magazines of things you would like to own. But unless you actually act on those goals they are not really goals at all, they are just dreams.

So many people out there like to talk about property investment and give advice yet they have never done anything about it. Let's face it, the majority of people would love to be wealthy but very few are. To be honest, the majority of people never do anything to improve their financial well-being. They like to read the property section of the newspaper, keep up to date with interest rates and tell everyone what they should and shouldn't be doing in their opinion but they never actually take the step and start investing. Ten years down the track, when property has doubled in value and they haven't made any money, they wonder why. Then they start blaming everyone around them but themselves. "The agent tried to do this", or "property was too expensive" or "the accountant said this or that." The bottom line is that everyone has to take control of their own destiny and financial future; no one else will do it for you.

I will say this now – ***everyone has to be investing. No matter what***

income they are on, they need to be investing. If you are not investing for some reason or another then you need to get yourself in a position where you are investing as soon as possible.

Just as the squirrel puts away nuts for winter – you need to be putting a bit away for retirement.

I find that people who aren't investing are generally procrastinators – people who just try and string things along for as long as they can because deep down they are too frightened to pick up the bat and have a swing at the ball. It is really all just based on fear of the unknown. They come up with all different types of excuses but it just boils down to procrastination based on fear. I like to sub-categorise these people based on the actions that mask that fear. See if you fit into one of these categories:

The researchers

They research and research and then do even more research. By researching, they feel as though they are doing something productive to move forward in the right direction, but in reality they are just chasing their own tail going nowhere. The researchers often come from technical type jobs, such as engineering, where everything has to be 100% right. When I first started in real estate, a guy said to me, "Never mix up activity with productivity" and I think that is one of the best sayings that I have ever heard. There's no point in looking busy, you need to be productive. The researchers should take this advice.

A woman at a property speaking event came up to me once and said she had been researching a particular area for four years! When I asked her how many properties she owned she said that she didn't own any as she had not yet finished researching. This is crazy. That suburb had probably changed so much in four years anyway. She was a classic researcher who used that as an excuse not to get into the market because in reality she was just too scared.

The big-hitters

Big-hitters are people waiting for the big hit – the home run hit out of the ballpark. In property terms, they are waiting for the one big deal where they can make millions in one go and never have to work again. They give the impression to everyone that a big deal is "just around the corner" and they are waiting for that one. In reality, it never is. What would they do if it was? Probably nothing anyway because they don't have the experience to pull it off because they haven't been working their way up with smaller investments first. This category is typical of someone who may have a high-paying job. The advice I give to these people is get into the market and gain some experience. Get four or five properties under your belt first then spread your wings after that. Rather than look for the big hit all the time, take small chunks and don't risk so much. At least you are in the market, having a go, and building wealth at the same time.

The nose-thumbers

Nose-thumbers are the people who think every deal they see is not good enough and there is not enough profit in it. They think they are either paying too much or can get into a better location. They think there is always a better deal around the corner so they never end up doing anything. Nothing is ever perfect for them. This is just a way of putting off having a go. What I would say to these people is that no deal is ever perfect! There is always going to be something that is not 100%. These are things that we just have to work with. But it is better to be in the market than not in at all.

The savers

Savers are people who just want to keep saving and saving for a bigger and bigger deposit. These types are, once again, just trying to put off the big step to have a go. Generally, they are too scared to use the equity in another asset to leverage into an investment property. My advice is that once you have enough for a deposit, whether it be from equity or saving, then it is time to start looking to buy a property. It is never too early to get into the market but it can be too late.

The family guys

I have actually heard people say, "I don't think investing is in the best interests of my family". What they are trying to do is pass the blame for fear onto someone else and look as if they are doing them a favour. This is crazy. The best thing you can do for your family is to intelligently invest in safe, growth-focused assets. Not only are you teaching your family by setting a great example, but later in life when you have no money and the kids have to look after you, they won't think it is in their best interests then!

The "she'll be right" crew

These people feel that because they have been paying taxes they are entitled to a pension to fund a comfortable retirement. My advice to these people is not to rely on anyone else – especially not the government and the pension. They should be reading the chapter regarding pensions in this book. Due to our aging population, there are less and less taxpayers to every pensioner now. This number will continue to diminish over time.

As well as the personality-types discussed above, there are myriad excuses – I've heard them all a hundred times. Let's cover off these, while we're at it too.

Building wealth is only for rich people

This is rubbish. Everyone needs to invest and build wealth and everyone can do it. It doesn't matter whether you are a high-income earner or a low-income earner, 85% of the world's millionaires are self-made, meaning they started off with next to nothing. I think it is important to start off small and grow over the longer term anyway.

I am waiting for the market to crash

This is also another bad idea. Waiting for some unforeseen event that may not even happen is just another excuse for being too scared to get started. If you come up with this excuse, it means you will probably never start. What's more, the property market (as a whole) has never crashed. Sure, property growth rates have flat-lined for a while but the median house price has never crashed. The most it has come down is around 5% in total. The only bracket of the market where property prices have come right down is at the very top end of the market, or in some regional locations where there is just such a small market for these properties. Property is probably the safest asset class and that is why the banks lend so much on it – up to 97% of its value.

I am too scared to invest

I do admire people who actually admit that they are scared. It is good to admit this and I think being a little scared is good as it will mean you do your homework. However, don't let fear stop you from getting started. Everybody is scared when they first start investing. Just like you were scared as a kid riding a bicycle for the first time. You get the wobbles up but you manage to overcome them. Once you are up and away there is no greater feeling as a kid. It is freedom at its best. It is just the same with investing. It is nerve-wracking. It is scary. But these are just emotions that you need to overcome. What can help is finding yourself a good mentor who has been there, done it, and succeeded. This will give you the confidence to move forward knowing that someone else has been down the same path as you and not only survived but has really succeeded.

I could go on and on. As I have stated – you must be investing or getting yourself into a position to be investing. If not you are just wasting time. I heard a saying once, “the definition of insanity is doing the same thing, the same way, over and over again and hoping that things will change.” This really rings true when it comes to investing. How can you ever expect to make money through investing if you never actually invest?! You can’t.

Be confident and positive

Successful people are confident and positive. This does not equate to arrogance but it means that they are confident in their actions. They don’t let fear get the better of them and hold them back. Successful people are not so susceptible to the “post-buyer blues” because they believe that the decisions they have made have been correct.

Once you have made the decision to invest, you need to run with it and be positive about it, because I guarantee there will be people who will tell you that you have done the wrong thing. You know the types I am talking about, the dinner-party or BBQ experts. Generally these people have no property themselves but they are self-proclaimed experts because they watch the business channel or read the paper. They will tell you that you have either purchased the wrong thing, paid too much, invested in a bad area or a stack of other negative things. This can then translate into post-buyer depression for you, the investor. It can bring on mixed negative emotions of depression and vulnerability.

To avoid this, be confident and positive in the fact that what you have done has been the right move for you. At the end of the day, that is who you are investing for. Only you know your circumstances and the limits that you have had to deal with, so believe that you have made the correct decision for you. After all, it is you who will be grinning further down the track once you have reached your financial goals and are living the life that you had only dreamed about.

You must also be confident that you have done your homework and you know that what you have purchased is a great investment. This can only be achieved if you have done your research and not just bought something because it is close to where you live so you can drive past and admire it on your way home from work each night.

As with anything, the more experience you have in investing, the better you will be able to control your fears and emotions and trust in what you are doing. That is why I always advise my clients to start off small and grow over time. There's no point in risking everything to start off with. You are best taking it slowly, building your portfolio on a solid foundation, brick by brick, so it lasts. This will grow your confidence.

Be tenacious

Property investing is not a get-rich-quick scheme. I am not going to pretend to you that it is and don't let anyone else tell you that it is. All those ads that you see in the paper or maybe on the internet where someone states that they made enough money from property to retire on in 18 months are nonsense. And now out of the goodness of their heart they want to share their secret with you? Come on! What a load of rubbish. These people don't want to help you make money, they want to take it from you and line their own pockets. I'll let you in on a little secret and that is that there are no secrets! There are no get-rich-quick schemes that work. Property is all about the long-term if you want to invest safely. If you start looking at short-term, get-rich-quick schemes, you will be in for a fall. You will lose money. I see it time and time again. People get bitten by the sharks in suits. It is really unfortunate.

As a property investor, you need to understand that the property investment journey is a long one. It is going to take at least five to ten years to build up a decent enough portfolio of property to be able to get any serious benefit from it. After all, we are talking about giving up work altogether and just living off income from our assets. Forget the get-rich-quick schemes. They are very risky and generally don't work (unless you are very, very lucky!). What you want to do is build wealth slowly and steadily. With this is mind, there are going to be some bumps and challenges along the road to wealth. This is where you need to be tenacious.

Let me share some of the challenges that you may face as a property investor: tenants not paying rent; tenants wrecking your house; maintenance issues and council issues, to name just a few! If, at the first sign of problems, you decide to bail out because it is "all too hard" then you can forget about being a property investor. You'll need to be able to face issues head on, solve them as best you can, then move on. Keep your eye focused on what you want to achieve, stay positive and confident and you will glide over the bumps.

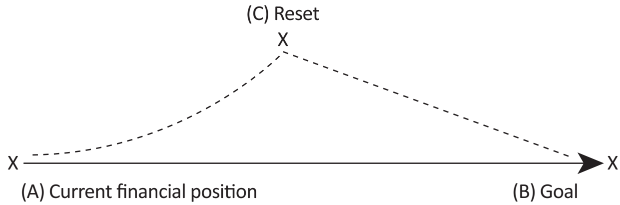
Hang in there. If you are feeling as if you want to give up, then go back to the start. Get motivated. Think about "why" you are doing this and "what" you want to achieve by doing it. Have another look at your goals and the pictures that you have cut out and pasted next to them. This may re-kindle the flame and get you back on track. Things won't happen overnight, but they will happen. You just have to be in there for the long term.

Chapter 3

WHERE ARE YOU NOW?

The analogy that wealth-building through property is a journey is such a good one. You start out with a clearly-defined destination, a target, your goal. You then determine where you are at present – your current financial position. Then you can just plot the shortest and most direct path to get from where you are to where you want to be. Have a look at the diagram below.

Setting your goals



This shows how to set out financial goals. Let me explain to you how the graph works.

Firstly, you set your financial goal which is point B, then you determine your current financial position which is point A. You then draw a straight line between A and B. That is the most direct route from your current financial position to your financial goal. But what happens in reality is somewhat different. Often, you have unforeseen expenditure on the way to your financial goal. You may have to buy a new car, the kids may have to take a school excursion you didn't know about or the house needs repairs. This expenditure will take you off track from where you want to be on your financial journey. That is why line A to C is not straight. But just as sports teams and business people review their performance against their goals and then reset their goals and plans, you must do the same. Your performance must be constantly reviewed and adjusted to make sure you are on track to be where you want to be and that your goals are met.

On the graph above, you reset your goals and review your current position – point C. Then you work out the best strategy on how to reach your financial goals – which will always be the most direct route – the straight line from point C to B. You repeat this process until you reach your goals and this will be done continually and will evolve over time. In fact, once you have got into the frame of mind to set financial goals, review your performance against those and then reset, then even when you have reached your current financial goals, you will more than likely reset and extend those out further. You will be amazed by what you can achieve, when you know what it is that you actually want to achieve and you focus in it.

Calculating your current asset value

As previously discussed, you start by setting the financial goal of what you want to achieve, then you assess where you are financially at the moment, only then can you put a plan in place on how to get there. Remember? It's just like using a map to get from your starting point to your destination.

This will mean that you must calculate the current value of your assets, plus your current levels of investment. Things to note in your calculations include:

- How many investment properties do you own at the moment?
- What is the value of your share portfolio less any debts associated with that?
- How much super do you have?
- How much extra above the Superannuation Guarantee are you contributing?
- Do you have any personal loans? When will these be paid off?
- Any on-going car leases?
- How fast are you paying off your own home? How much extra above the minimum monthly repayments are you paying?

Remember to exclude your own home from the total value of your assets. It cannot be included in the calculation because your home will not provide you with any income. This calculation is solely for investment (i.e. income-producing) assets.

Once you have added up all your assets and taken away your liabilities you will have your net current position. Write that figure in the box below. This is your CURRENT net worth excluding your home:

$

The next step requires you to now extrapolate that net figure forward to when you have set your goal of being financially independent. Write that figure in the box below. This is your FUTURE net worth excluding your home:

$

Great, you are halfway there. You can now say that you can expect to be worth $X (figure above) when you plan to retire. Do you think it is enough?

Calculating future income

Once you know what your assets will be worth to you at that point in time, you can then calculate how much income you can expect to receive from those assets. A basic rule of thumb is you can expect around a 4% to 5% yield off your assets.

An easy way to work this out is to take the future net value of your assets and divide that figure by 20. This is the equivalent of a 5% yield from your net assets. Write that NET INCOME figure in the box below.

Net income = Future net assets/20

$

Now that you have calculated your net income off your assets in retirement, the figure may not look too bad. Don't rest yet. There is one final thing left for you to do in this calculation and that is to take into account the eroding power of money – that's right, the dreaded inflation, that little "Pac Man" that eats into your savings and cash and reduces its power to purchase over time. Inflation currently is running at around 2.5% (which is not high).This figure is well within the Reserve Bank of Australia (RBA) guidelines. An inflation rate of 2.5% means that in 15 years, your money will halve in buying power. For example, $50,000 today will buy twice as much as $50,000 in 15 years' time. So if a new Holden costs $40,000 now, it will cost $80,000 in 15 years. A better example is if a shopping trolley of groceries costs $300 today, it will cost at least $600 in 15 years' time. However, a property that you pay $500,000 for today will be worth more than $1 million in 15' years' time. Why? Because it is increasing faster than inflation. This is why the best protection against inflation is to invest in growth assets such a property (more on that later!).

So take your future level of predicted passive income from above, and halve it for every 15 years into the future, until you reach the date you have set to retire. If you do not have a full 15 years to halve the number, then you must reduce it proportionally for every part of 15 years that you have.

Calculating your future financial position, based on your current financial position, then accounting for growth and levels of input at present can be tricky. However, it is a very important part of the puzzle and it has to be done with some accuracy if you want to be able to set a realistic and achievable plan. In order to do this exercise accurately, it is a good idea to call on the help of a qualified professional who can calculate this accurately rather than rely on your "guestimate". Whether you calculate it yourself or whether you use the help of a trained professional, take the net value of your current assets, extrapolate that out to your required timeframe, then work out what level of passive income it will give you at that time. Then you need to discount that income back for inflation to today's values.

EXAMPLE

Phil and Barbara are 45 years old. Their home is worth $650,000 and they owe $250,000 on that. Phil's income is $80,000 and Barbara's income is $30,000. Their combined superannuation is $150,000 and they are each putting in an extra 1% to bring the total contribution to 10.25%. Their share portfolio is worth $80,000.

They have set a goal that they would like to retire on a combined income of $70,000 p.a. in the equivalent of today's dollars when Phil turns 60 years old.

Let's have a look at how they are tracking towards reaching that goal.

Firstly, we need to work out what their current assets plus current levels of investment will be worth in 15 years. Remember – we cannot include their home because that will not provide them with any income.

	Current value	**Future value**
Superannuation*	$150,000	$450,000
Superannuation contribution @10.25% over the next 15 years		
Phil		$369,000
Barbara		$138,375
Shares**	$80,000	$240,000
Total future value of assets		$1,197,375
Future income @ 5%		$59,869
Today's equivalent value of future income after taking into account inflation	$29,934	
When Phil and Barbara compare this to their goal of $70,000 they realise they are very short of where they want to be		
Shortfall		$40,066

*This assumes that superannuation will double in value every 10 years

**This assumes that shares will double in value every 10 years

Write that figure in the box below.

$

Congratulations! You have now calculated what income you will be living on in today's dollars at your financial goal date.

You can now compare that against your goal.

I am going to have a stab in the dark to say that your actual figure above is far less than the figure you had set your goal at? Am I right? The truth is that 98% of times it will be. There is no magic trick in this, just statistics. The Australian Bureau of Statistics (ABS) tells us that only two out of every hundred Australians are retiring on an income of $50,000 per year or above. Most people have financial goals of more than $50,000 of passive income per year but the facts show that very few are achieving it.

I can back up these statistics with my own personal experience. I have gone through this calculation with thousands of Australians over the years and I can vouch for the figures from the ABS, that only two out of every hundred Australians are retiring on an income of $50,000 per year or above. It is scary. Most people are retiring on an income of far less.

According to BT Funds management, "Only 12% of retired Australians receive a gross weekly income of $500 or more ($25,000 p.a.). Approximately 70% of Australians aged 65 or over currently live on a gross weekly income of less than $300".

It is frightening to think that more than seven out of ten Australians are living on an income of less than $15,000 per year. When you have an income of $15,000 per year life is very limited. Holidays are minimal, going out to dinner is a rarity, gifts are greatly reduced. You are really just surviving. If you don't own your own home on top of that, then you have real problems because at least half of your $300 per week will go on rent.

Take a moment to consider your retirement figure. Is it enough for you to be able to live life on your terms and do the things you want? If not then you need to act now!

I have coached thousands of Australians on how to build wealth through property. I have sat down with many of them and calculated what they will retire on, based on their current level of assets. I find very few people are going to retire with any sort of decent income. Why? The answer is most people don't actually know that they need to invest and build wealth. They don't really know how many dollars of asset-base they need to provide a decent income. Very, very few people have gone through the exercise that you have just been through, of deciding on some financial goals, then calculating what they are actually going to retire on and seeing if there is a shortfall.

Let's recap. If you were going to retire tomorrow, approximately your investments need to be worth around $1 million. That is using a generous yield of 5%*. As we said earlier in the book, it means you need to have $1 million in superannuation or $1 million in shares with no debt, or approximately two to three averaged-priced investment properties owned outright with no debt.

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* To return $45,000 p.a. it is anticipated that an investor will need $ 1,052,080 funds under management. (BT Funds Management)

Remember, this is all excluding your own home! That's quite a lot, isn't it? Is it any wonder people are retiring poor? How many people do you know who have this sort of asset base? Not many – only around two in every 100.

This part of the book, in my personal view, is one of the most important. So many people go through life with a great income, a nice home and great lifestyle but they are totally unaware of what looms ahead of them in retirement. It can be a big, deep, dark hole if you have not prepared for it. I hope that by reading this book you are at least now forewarned. "Forewarned is forearmed" they say. At least you are ahead of most people and have actually identified that you do not have enough in place at the moment to be able to retire and you do actually need to start investing.

Setting a plan

Now you have identified that there is a shortfall in your assets, we come to the next step. You need to answer the following questions:

- How hard will I have to invest?
- How many properties am I going to need?

And the answers depend on two things:

- How much of a shortfall you have
- How much time you have until you want to reach your goals.

As we have discussed, property is not a get-rich-quick scheme. It takes a while to build up a portfolio of properties that is going to give you enough passive income to replace the income from your employment. You will need to accumulate a portfolio of several properties at least. If you have a short timeframe in which to build up this portfolio then you may have to work harder at it than someone else who is starting to invest when they are relatively young and have a lot more time. These people do not have to push themselves as hard or sacrifice as much.

Likewise, if you have set high goals and have a big shortfall currently between what you have and what you want to have, then even though you may have a long timeframe, you will still have to work hard and sacrifice over the long term. However, if you have relatively low goals and a long timeframe, then you may not have to work as hard or risk as much as your counterpart with the high goals.

Below is a work matrix to show how hard you will have to work to achieve your goals.

	Long Timeframe	Short Timeframe
Small Shortfall	Easy	Mid to Hard
High Shortfall	Mid to Hard	Hard

The bottom line is that if you have a short timeframe and you are well short of your goals, then you are going to have to work very hard to build your portfolio and really push yourself to accumulate properties in that short period of time. I would call a short timeframe anything less than a 10-year period.

Now that you have determined that you are not on track to meet your goals in the required timeframe, the next step in your plan is going to get you from where you are to where you want to be.

First, let's recap. Already, you have:

1. Set goals that show where you would like to be financially by a certain date.
2. Calculated what your actual level of passive income will be at that time, if you continue on the way you are.
3. Determined that there is a shortfall between what your goals are and what you are actually going to receive in retirement.

Putting together a plan is, funnily enough, relatively simple. It is a case of determining how many properties you will need to own without debt. I have an easy way for you to set up your own plan – it is what I do with clients.

When setting up a plan for a client, I like to plan out how many properties they are going to need to own outright (with no debt) in order to meet their goals. This is an easy way to gauge the client's progress and also it gives the client something tangible to work towards. If you need to own five properties outright in the next 15 years then you know you will need to buy at least one property every three years. If you are not doing that, then you will not meet your goals. It's as easy as that!

A simple way to work out how many properties you will need to meet your goals is to divide your shortfall by the return of an average-priced property. In order to do this, you need to know what an average-priced property would yield each year after expenses if it was owned outright. My calculations show that an average-priced Australian property would return around $300 per week after expenses if it was debt free. This equates to $15,000 per year.

So taking this figure and dividing it into your shortfall would give you the number of properties you need to own outright with no debt.

EXAMPLE

David wants to retire on $80,000 per year. He is aged 35 now and would like to be financially independent at 55. Based on his current levels of superannuation and investment, David has determined that he will only retire on $20,000 per year. David has a large shortfall of $60,000 between what he has set his financial goal at and where he is currently. He needs to build up an asset-base over the next 20 years that will provide him with a passive income of $60,000 per year on top of what his super will give him.

How many properties does David need to own?

Goal	$80,000
Actual	$20,000
Shortfall	$60,000
Timeframe	20 years

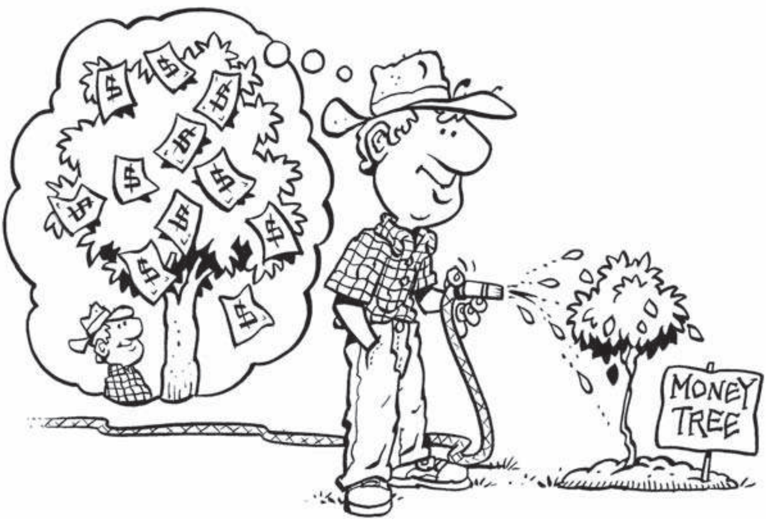
Shortfall/average property return = number of properties needed
$60,000/$15,000 = 4 properties

Simply, this tells us that David needs to own four properties outright over the next 20 years. David should know that unless he is buying a property at least every three to four years, he will not reach his goals. Although David has 20 years to build up his portfolio, there is no point in him buying all of his properties in the last three years of that 20-year timeframe. They would not have enough time to grow in value. In fact, they would just be a burden in retirement.

This is why it is important to understand the three different phases of an investment plan:

Think of your portfolio like an orchard and you are the farmer. In the early days, the farmer gets the soil ready for planting. He makes sure that he has the right soil with enough nutrients in it so that he will grow good, strong trees. He tills the soil, fertilises it and makes sure that he has enough water in storage so that he can water his crop when it is time to plant. Next, the farmer has to plant the seedlings. He plants many seedlings over time. He may even spread them out into different paddocks so he can spread his risk a bit in case the soil in one paddock is not good. Once he is sure that he has enough seedlings planted, he waits. Although he waits, he does not just forget about his seedlings. He continues to water them and fertilise them so that they have strong roots and a solid base. That way he knows that if the orchard is hit by a storm it won't be wiped out. It takes quite a few seasons of just waiting, watering and fertilising the orchard and the farmer is tempted to give up but he is patient and remains focused. He knows that if he sticks to his plan, he will have an enviable orchard which will supply him with fruit for many, many years to come.

Finally, after seasons of tending his orchard through droughts, cold snaps and pests, the fruit is now ready to be picked. It was all worthwhile. The farmer now has an orchard that is robust and fruit is plentiful.



As an investor, you are a lot like the farmer of the orchard. You must go through the different phases of investment.

Firstly, just as the farmer gets his soil ready to plant, you must get your finances in a position that allow you to invest. This is a step prior to actually investing itself, but it is just as important. You must make sure that you have consulted with a professional to determine the right financial structure to purchase your properties in (e.g. a trust, company, self managed super fund, etc.). This allows your portfolio to be grown from a strong base and become robust and stand the test of time. At the same time, at this stage, you are indentifying the goals that you want to achieve and taking stock of where you are now in relation to those goals. Then finally you put a plan in place to reach those goals in your given timeframe. Once your "soil is ready", so to speak, you are ready to enter the first phase of investing.

Accumulation

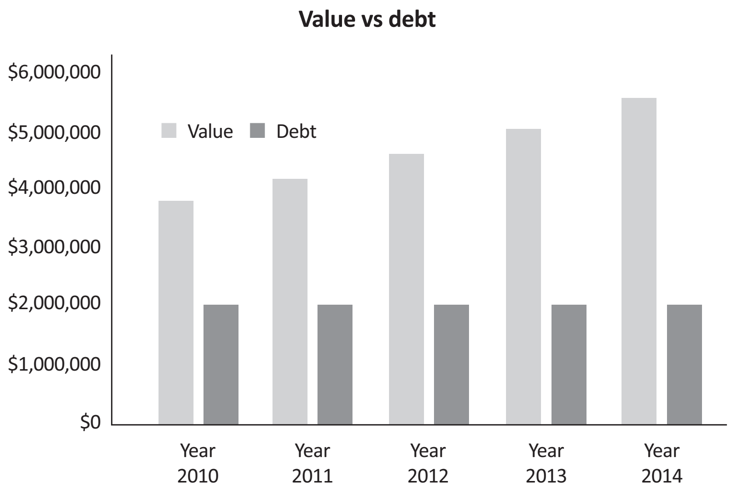
In this phase you will be accumulating quality, growth-focused assets and concentrating solely on that. This is without a doubt the hardest part of the investment lifecycle. During this phase it might feel as if you are accumulating all of these assets but there does not appear to be any reward for your efforts initially. Remember to be patient like the farmer. You cannot have a holding or a harvesting phase unless you have first accumulated your assets. Also, a very important point to note is this: the longer a property is held in the holding phase before harvest, the better the asset will be for you as it gives the equity in the property time to grow. Therefore, the more properties that you can accumulate early on in your investment lifecycle, the better off you are going to be.

The best time to buy is yesterday. The second best time is today.

The point is, start as early as you can. Don't delay. Be determined to acquire as many properties as you can as soon as you can. What I have noticed over the years is that most investors starting out tend to buy two or three properties in quick succession, then they slow down after that when their borrowing capacity ceiling has been met. Once their borrowing capacity increases, they then start to accumulate again. When setting your plan, make sure that you have all your purchases in the accumulation phase. There is no point in buying property during the final phase of your property investment lifecycle. A negatively-geared property purchased in the year of retirement will just be a burden. It is all too late at that stage. Best to pre-plan and set your accumulation period and stick to it.

Holding

As suggested, the holding phase is simply when you hold your assets and let them grow. Through this phase you probably will not accumulate too many more properties. You should be more focused on debt reduction. Assuming that all of your personal debts have been paid off, then you should now be concentrating on reducing debt across your entire portfolio. It may mean that you change the interest-only loans over to principal-and-interest loans or focus on putting more money into offset accounts. If you have not paid off all of your personal debt then this is a perfect time to start really focusing on that. At a minimum, you should aim to be in a position where the value of your properties is going up and your debt is remaining constant or reducing. This way, your net wealth is increasing, see the diagram overleaf.



Harvesting

The final phase of the lifecycle is the harvest. Like the farmer, you are reaping the fruit from your orchard that you have nurtured over time. If you have set goals, planned and acted to follow that plan, there is no reason why you should not be living the life you have always wanted. At this phase, your property portfolio should not only be self-sustaining, but it should be providing you with a strong passive income that you can live off without the need for employment.

During the harvesting phase, it may be necessary to reduce debt further if you have not done this through your holding phase. This may mean selling off some of your portfolio to reduce the debt that is outstanding, to bring the portfolio to a point where it is paying you the right amount of passive income.

Find a mentor

You are now able to set goals, work out your financial position and put a plan in place to achieve what it is you want. But the road to implementing your financial plan can at times be bumpy. You can feel alone. You may get to a crossroads where you are unsure of what decision to make. Having someone to talk to who has already had to make that decision and has succeeded is invaluable. They will be able to point you in the right direction and help you make the correct decision when needed. Property investing does have its ups and downs. Sometimes when you are on a down, a mentor will inspire you to carry on or inspire you just to get started if you are in the very early stages of investing. When I first started in property, I had a few mentors who were extremely successful people. They really inspired me to get motivated because I could see that it was possible. Also, by using their knowledge that they had gained over time, I was able to accelerate my wealth-building by avoiding mistakes I would have otherwise made. It is a bit like a coach of an athlete. The coach is able to guide the athlete to a winning performance. The coach is able to see things that the athlete may not, things that can be used to improve performance.

Most successful people have a mentor who they use as a sounding board for ideas – someone who is going to give them the right advice when they need it. One thing to remember when selecting a mentor is to make sure you use someone who has been there and done it. Don't choose someone who just talks the talk. There are a lot of people out there giving advice to investors who have neither the experience nor the qualifications to do so.

One group of people, whose advice you need to be wary of, is real estate agents. They are in the role to sell property not advise you on your investing. They are very good at talking you into buying a property and pointing out all the nice features, but generally don't own any real estate themselves and have no idea. Select someone who you trust and put faith in them that they will show you the correct way to do things. This will be someone who has been down the same path as you previously.

PART II

FINANCE AND STRUCTURE

Chapter 4
FINANCING YOUR INVESTMENT

Finance is the next point of the triangle that we need to cover. Finance tends to be the thing that most investors don't like and don't really understand. To be quite honest, it is easy to get confused or even scared by it as well. If that is you, then that is about to change. My goal in this chapter is to ensure that you totally understand finance and all the tricky acronyms and jargon that finance people and agents like to dazzle you with. It is extremely important to understand how to finance your investment property and the financial structures that you can buy property in. Finance can make or break your investment success in the long run, so you need to understand it.

Debt – a four letter word?

A lot of people have been brought up to think that debt is a four letter word, a bad thing. They have been taught that owing money is bad. Most parents teach their kids that they need to buy a home and concentrate on paying that off. Once that is done, then they are set for life.

Nothing could be further from the truth. Debt is not something to be scared of but something that you must understand and be able to control. Debt is a little bit like fire, it is damn useful but you need to be able to contain it and only use it in the right ways. If you don't, then your fingers get burnt. One of the first things in understanding debt is knowing the difference between good debt and bad debt.

Bad debt

Bad debt is simply debt incurred through discretionary spending, on something that is not an investment. The bottom line is that if you have borrowed to buy an item that is not making you money or going up in value, then it is a bad debt. This includes:

- Credit card debt on personal items such as clothes, holidays, nights out, etc.
- Personal loans for cars, boats, jet skis, motor bikes
- Lines of credit to buy new lounges or household items
- Equity loans for other personal items.

You get the gist? All of the above plus much more is considered bad debt. Interest payments on these items is wasted money and is not tax-deductible. Probably the worst part about these purchases is that they are depreciating and not increasing in value. That means that not only are you getting hit with interest expenses, you are also left with the value of item going backwards.

If you want to get ahead, it is very important to limit your spending on these items. In fact, cut out borrowing for this type of spending altogether. If you can't afford to pay cash for these things, then maybe it's not worth having them.

A lot of advisers class your own home as a bad debt. Their reasoning behind this is that it does not produce any income. I don't agree that the home is a bad debt. It can be a great way of spring-boarding you into investing. However, I think it is important not to go overboard on home expenditure and live in a house beyond your means. If you are earning $100,000 p.a. as a family income, I don't think it is necessary to stretch yourself and buy a $2 million house under the guise that it is "an investment". Spend within your means.

Your bad debt that is non-tax deductible must be the first debt to be paid back.

Good debt

Good debt is debt that you have incurred buying assets that are either providing income or going up in value (growth-focused).

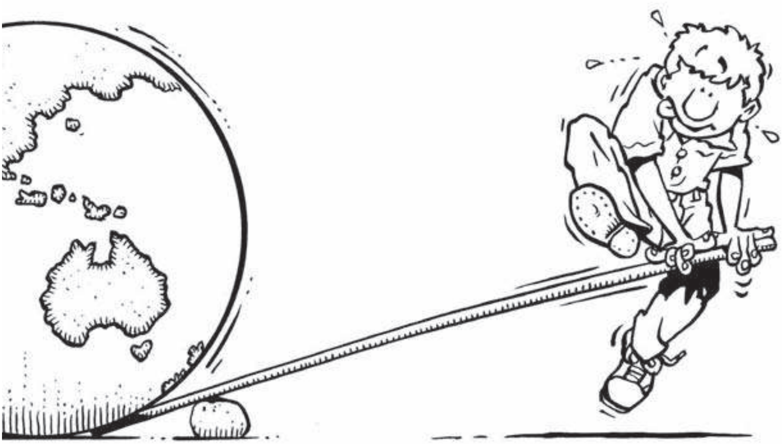
Good debt includes:

- Investment property loans
- Loans for business
- Loans for shares and other investments
- Loans for plant and equipment for work.

The interest repayments on these debts are tax-deductible. These are the types of debts that are OK to have because they are either producing income or capital or hopefully both. If you want to get ahead and invest for the future, you are going to need to take on some debt. Make that 'good' debt and you can use it as 'leverage'.

Leverage

Leverage by definition is **'doing more by using less'**. It was once said, "Give me a lever long enough and I can move the world." That is the power of leverage. Leverage in property is using good debt, or as some like to say Other People's Money (OPM), to purchase and control assets. If you want to build a property portfolio, leverage is essential.



You hear older people say that they only like to pay cash for everything. Well the median house price in Australia is now well over $500,000, so unless you have about that amount of cash in the bank then you are going to have to borrow or use leverage to buy a property and get started.

Below is an example of leverage.

You have $40,000 cash saved up and you want to enter the property market. You have a quick look around and come to the obvious conclusion that you are not going to be able to buy a property with $40,000.

You now have two options.

1. **Stay out of the market** and keep madly saving until you have enough to buy your first investment. This is not a good option. The market will generally rise faster than you can save. For example, the median house price in Brisbane is currently rising by $1,532 per week. Can you save that much?
2. **Use leverage.** You take your $40,000 and go to a mortgage broker or bank that will lend you another $360,000 on top of your $40,000 to give you a total of $400,000 to buy a property. Now you are in the market and building wealth.

Let's look at an example that shows the power of leverage.

	Investor 1 (no leverage)	Investor 2 (leverage)
Cash	$40,000	$40,000
Debt level	0	$360,000
Leverage	0%	90%
Growth at 10%	$4,000	$40,000
Less – interest 5%	0	-$18,000
Net gain	$4,000	$22,000
Rate of return	10%	55%

The numbers speak for themselves. The investor who has not used leverage has returned only $4,000 and a rate of return of only 10%. Investor 2 has used leverage and has returned $22,000 and a whopping rate of return of 55% on his original investment. Which would you rather? This is all done with no extra work, just using the power of leverage which, remember, is "doing more by using less". Leverage can be very powerful and make you very wealthy but, like fire, it must be used correctly.

The above example is at 90% leverage. Is this an acceptable percentage? To find out the answer to this question, you need to understand Loan to Value Ratios or LVRs.

LVR – Loan to Value Ratio

Your LVR or Loan to Value Ratio is how much leverage you are using. In other words, how much you are borrowing as a percentage.

There are no set percentages that you have to borrow but there are some more common numbers that people and banks use. The general LVRs are 70%, 80%, 90% and 95%. The greater the LVR, the less you are using of your own money. Obviously, if you are using a 95% LVR then you only have to come up with a 5% deposit. If you are using 80% it means you need a 20% deposit and so on.

Below is an example of leverage at different percentages.

	Investor 1 (80% LVR)	Investor 2 (95% LVR)
Cash	$40,000	$40,000
Debt level	$160,000	$760,000
LVR – (Leverage)	80%	95%
Total property purchase	$200,000	$800,000
Growth at 10%	$20,000	$80,000
Less – interest 5%	$8,000	-$38,000
Net gain	$12,000	$42,000
Rate of return	30%	105%

Here you can see how raising the LVR from 80% to 95% allows you to hold more assets, i.e. purchase more property. With the same growth rate that higher LVR (extra leverage) goes a long way and gives you an incredible increase in rate of return on your original capital of $40,000. It goes from 30% to a whopping 105% rate of return!

This is what leverage is all about. Using less to do more. This is why people who understand the power of leverage (using other people's money), understand that using leverage and not being scared of good debt is the only way to build wealth. It gives you the power to spread what you have further, hold more assets and make more money.

You may be thinking now, so why not push the LVR right out to 95% every time? That way you can borrow more and use greater leverage, right? Well, there is one more thing to consider here and that is Lenders Mortgage Insurance (LMI)

Lenders Mortgage Insurance or LMI

LMI is a one-off insurance payment that has to be made when your LVR goes above 80%. The reason for this is that as you provide less of a deposit, your loan becomes a greater risk to the bank. If for some reason you were to default and not pay your interest repayments, the bank would need to repossess the house and sell it. Because you have less of a deposit on the property, there is a higher chance, if they sell it fast, that they may not recover the full amount of the loan, after selling costs and charges have been taken into consideration. That poses a risk to the bank and therefore, they want to insure against it. And you have the privilege of paying for that insurance! That's right, the insurance that YOU pay does not keep you covered;

it is solely to keep the bank covered and safe. If you do default on your loan, the property is sold and the banks costs are not covered, the mortgage insurers will cover the bank for their loss, and then the insurers will come after you to cover their loss.

Having said all of that, don't let me frighten you off LMI. It is a cost of doing business and allows you to push your leverage out and borrow more. This can be a lifeline at times and a real necessity to either just getting started in the market or allowing you to extend your portfolio when you see the market rising. Also, bear in mind that LMI is tax-deductible.

So when is it right to use LMI and what is the correct LVR?

What is the correct LVR?

It is very difficult to advise you what the best LVR is and whether it is right for you to get into LMI territory with your loan. It is something that I get asked about all the time by my clients and it needs to be answered on an individual level. There is no blanket answer. Everyone has different circumstances and I would need to know your personal details, income, assets and liabilities, etc., before I could advise you.

Generally, I think it is wise to push your leverage out as much as you are comfortable with and this can only be determined by looking at your risk profile. There are a few pointers that I can give you, though, that you may apply to your own set of circumstances. However, this cannot be substituted for advice from a qualified mortgage broker, your banker or accountant.

If you are a high-income earner (earning above $180,000) and you do not have many tax deductions but have enough money saved for a 20% deposit, I would not use the whole 20% on one property and burn all of my deposit on one deal. I would advise splitting that deposit in two and using two 10% deposits and paying LMI. This will allow you to expand your portfolio faster and control more assets. You don't have many tax deductions so you can handle the increased negative gearing and the LMI is tax-deductible to you.

Under the reverse circumstances, if you are a low-income-earner, you will not have the capacity to soak up as many tax deductions from negative gearing and extra LMI so it may be better to use a lower LVR. It will lower your risk and not expose you to the LMI expense.

Borrowing capacity (BC)

Here comes another finance acronym: BC that stands for borrowing capacity. BC is quite simply how much you can borrow to buy property. As an investor it is imperative that you know what your borrowing capacity is and the basics behind how to calculate it and adjust it.

I will let you in on a little secret. Property investing is really just like one giant game of Monopoly. However, you are playing with real money and real property. Just like Monopoly, everyone is fighting to get the same properties in their portfolio. If a good deal comes up, someone is going to grab it. If you believe you can sit around, have a think about it, talk to your broker or bank and find out how much you can spend, then go back and make an offer, you are mistaken. Good property will sell fast. This is why, if you are a serious property investor, you need to know exactly what your BC is at any one time. That way you know exactly how much you can spend, so if a good deal comes up, you can pounce on it before someone else does. You need to be on first-name terms with your broker and be regularly checking to see what your BC is and looking for ways to improve it.

It amazes me how many people come into my office not knowing anything about borrowing capacity. They were under the impression that you just went to a bank and asked for money and if they thought the property you were buying was OK they gave you the money! Nothing could be further from the truth – read on.

Borrowing capacity comprises two parts:

1. Serviceability
2. Equity or deposit.

Both of these are just as important as the other. You won't get a loan if you have great serviceability and no deposit; and vice versa you won't get a loan just with a deposit and no income. I will now explain each of these in detail and show you ways you can improve them.

Serviceability

This is your ability to pay the loan back. It really boils down to how much you earn vs how much you spend. In the old days, banks used to allow one-third of your income to pay back your loan. These days serviceability is much more complex and each bank will have its own 'serviceability calculator'. It is important that your broker is experienced and knows the different serviceability calculators. For example, ANZ's serviceability calculator adds a big margin on all of your current expenses thus reducing your ability to borrow. If you are tight on servicing, your broker would not put you with ANZ.

There are ways to improve serviceability. Reducing your debt or getting a pay increase are the obvious ones but it's not always that easy! Another way that you can increase serviceability is to take a look at your credit cards. A lot of people assume that their credit cards don't affect their servicing because they pay them off each month and therefore have no credit card debt. What people don't realise is that it is not the debt that the bank is concerned with but more the credit card limit. The reason for this is if you had a credit card limit of say $60,000, and the bank gave you a loan for $400,000 to buy an investment property, you could go straight out the next day and incur a debt of $60,000 on your credit card. The limits are treated like debts. If your serviceability is not up to scratch, reduce your credit card limits while you are putting the loan through, then put them up again at a later stage if needs be.

Deposit or equity

This is the second part of getting a loan. This is your hurt money to the bank. If you default and the lender sells the property for less than the loan, they take your hurt money – your deposit. The greater the amount of deposit that you put into a deal, the less of a risk you become to the bank. That is why customers with loans that have an LVR lower than 80% are the best customers to a lender and they also receive the best interest rates.

You may be getting a little confused at this stage and thinking, "What is all this talk about LVRs? My friends borrowed 100% to buy their investment property." This may well be true – let me explain how this can be and why the banks are still applying LVRs.

The best way to explain this is with another example:

EXAMPLE

Phil owns his home which is worth $550,000 and he owes $100,000 on that. He wants to buy an investment property for $450,000. 20% of the value of the investment property is $90,000. So he is going to need $90,000 as a deposit, but he does not have any spare cash. How does he buy the property?

There are two different ways Phil can structure his deal.

Option 1

Phil can go back to the bank that has the mortgage on his home and ask them to lend him 100% for the property that he is about to buy. This is the option that most people will take. You can be tricked into thinking that you have not used a "deposit" or any equity and haven't needed the 20%. This is not true. What happens with this option is that the bank will take that $90,000 from the equity that Phil has in his home.

So rather than Phil having $450,000 equity in his home ($550,000 – $100,000 = $450,000) he now has $450,000 – $90,000 (equity used for investment purchase) = $360,000.

So for option 1, while it appears that Phil didn't have to put down any deposit, the bank is taking the equity from his home to use as security. It is important to understand this concept. It is called 'cross-collateralisation' or 'cross-securitisation'.

It also needs to be noted, if Phil owed a lot more on his home, say $500,000 instead of $100,000 he would not have had enough equity for an 80% LVR on the investment property.

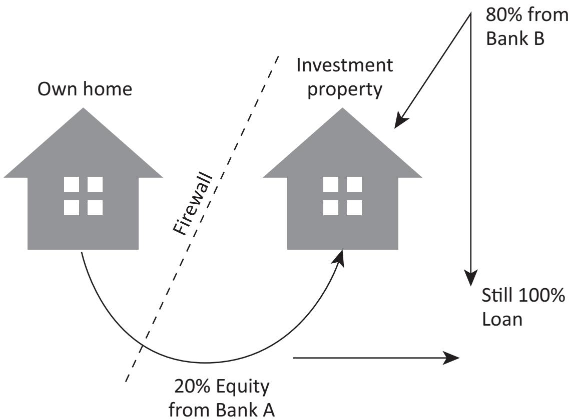
Option 2

This option is a little more complex than Option 1. In this option you only use the bank that has the mortgage on your own home to provide the deposit for the investment property, not the entire finance amount.

In Phil's case, he applies to his original bank that has the mortgage on his own home, (let's call this Bank A) for an equity loan of $90,000 which is the 20% deposit for the investment property. Provided that Phil has enough equity in his home, he should be approved with Bank A. Bank A pays that cash into Phil's working or savings account. Phil then takes that $90,000 in cash and goes to a second lender (let's call them Bank B) and applies for the rest of the loan needed to purchase the investment property. This will be 80% of the purchase price or $360,000.

Phil now has enough to buy the house. Bank A has supplied $90,000 which is the 20% deposit and Bank B has supplied the other $360,000 or 80%. Phil can now settle and buy the house as he has his full amount of $450,000.

Structuring your borrowing



Why set it up this way?

Well, a lot of people are under the false impression that by setting your finances up this way, it keeps your own home safe and out of the picture. So if you were to default on the investment property, Bank B only has the investment property and the 20% as security. They have no right to the other equity in your home. This is not exactly the case. It is true that it does create a firewall between Bank B and your home, meaning that if you default, you will get a little bit of breathing space because it is harder for Bank B to come and take the equity out of your home. However, you have to be well aware that if you do default on the investment, and in the highly unlikely case that Bank B does sell your investment for less than $360,000, then they can chase you and will chase you for any outstanding money that you owe. This means selling up your home to recover that money.

The best way to avoid any of this is to be well aware of the repayments you need to make, have your insurances in place and budget accordingly.

Chapter 5

STRUCTURING YOUR INVESTMENTS

Knowing what financial structure to buy your properties in can be a minefield when you start off investing. Even as you grow your portfolio, things can change and the structure that you use may evolve with you. It is important to get it right first time and get the right advice that is going to suit your circumstances, from both a taxation and asset protection perspective.

The structures that are generally used are:

1. Trust
2. Company
3. Self managed super fund (SMSF)
4. Your own name(s).

In this chapter, I outline the different basic structures that you can use to buy property and the pros and cons of each. I can't recommend which structure you should be using because I don't know your individual circumstances. By knowing the pros and cons of each different structure, you may be able to apply them to your own set of circumstances and work out what is best for you. Better still, get advice from a suitably-qualified professional.

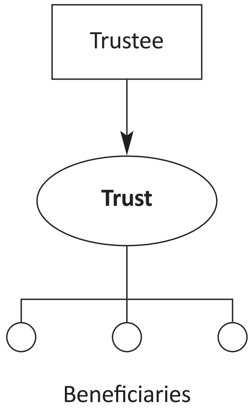
Trust structures

A trust is a structure that separates the control of an asset from the ownership of the asset. A trust is a separate legal entity to the owner. It is controlled by a trustee which can be a person but in many circumstances it will be company (also known as a corporate trustee). The trustee's job is to control the trust and therefore the assets held within that trust for the benefit of the beneficiaries. The trustee is governed by the "rules" of the trust which are contained in the trust deed.

You could almost liken a trust to a private courier truck. The courier driver takes possession of the cargo from the owners (beneficiaries) and he is now in control of those goods and expected to make the correct decisions regarding the wellbeing of these goods (just like the trustee). The courier truck is put under the control of the courier driver (the trustee) to drive the truck while carrying the cargo to a destination (when the trust ends or is 'vested') where the cargo or luggage (assets and property) is unloaded and given back to the owners. During the trip, the cargo is maintained in the best condition possible.

See diagram below for the workings of a trust.

Trust structure



Why use a trust?

There are two reasons why investors and business-owners choose to use a trust structure, for:

1. Asset protection
2. Income distribution.

As you don't actually own the assets (you just control them and receive the benefits of that control through being a beneficiary), if you were to get sued personally, your assets would be much safer from creditors if they were held in a trust.

The ability to disperse income across several beneficiaries to reduce tax payable is also very attractive. If you make $250,000 through your business, and could split that income across two or three beneficiaries, you would pay tax at a much lower rate.

What is the drawback of a trust?

If the focus of the property is capital growth then there is a high likelihood that the property will create a tax loss. When owning property in your own names, if it creates a tax loss you are able to use that tax loss against your taxable income – this is called negative gearing (more on this later). If a property is purchased in the name of a trust and the property is negatively geared, the negative gearing (or tax loss) cannot be passed down to the beneficiaries. This means that the property can potentially cost you two to three times more in weekly cash flow than it would if you had purchased it in your own name.

There are several types of trusts and I examine these below.

Fixed trust or unit trust

In a fixed trust, the share that beneficiaries have in assets and income (which may be proportional or absolute) is predetermined and 'fixed', leaving no room for the trustee to vary income distribution. Unit trusts are typically fixed trusts as each unit held in the trust represents an entitlement to a certain proportion of the income and/or capital.

Discretionary trust

A discretionary trust provides the trustee with 'discretion', as the name implies, over who receives distributions from the trust. It allows the trustee to distribute income and capital in amounts that allow the reduction in tax payable. The discretion must be exercised in accordance with the terms of the trust deed.

Hybrid trusts

A hybrid trust has characteristics of both fixed and discretionary trusts, and can be a unit trust with discretionary distribution options, or a discretionary trust but with certain entitlements that are fixed by the trust deed. This type of trust has received a lot of exposure lately, not all of it good. The ATO is not very keen on this type of trust so you must be very careful in its application.

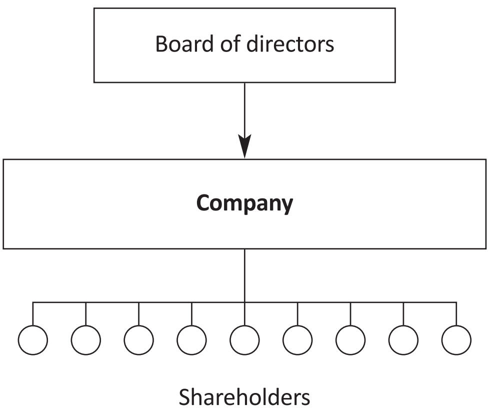
Family trusts

A discretionary or hybrid trust can generally be a 'family trust' for tax purposes, if the trustee so elects, but distributions need to be restricted to members of a particular 'family group'. Distributions outside this group will attract tax at the highest marginal rate (including Medicare levy).

Company structure

A company is made up of many small parts called shares. A company is owned by its shareholders and it is managed by its directors. It is a separate legal entity to you.

Company structure



Why use a company?

Due to the fact that a company is a separate legal entity to its owners (shareholders), the shareholders have only a limited liability. This is generally limited to the value of the shares. This can change, however, if a personal guarantee is given. Because of this limited liability, a company structure does provide asset protection to the shareholders. It can also be a more flexible tax structure to run a business.

What is the drawback of a company?

Where I see most people come unstuck is when they buy their properties in the same company that they are running their business through. This is fraught with danger. The danger is if you get sued, it is generally your business that gets sued. By holding your properties in that same company, it will mean that all your asset protection is lost. So be cautious about running your business and buying your assets in the same company name.

Also, there are certain tax benefits that an individual and trust are entitled to that a company is not, such as the 50% capital gains tax (CGT) discount.

SMSFs – Self Managed Super Funds

An SMSF is an excellent structure to buy property and has become very popular in recent years. People have seen their super balances drop dramatically over the last few years and have lost faith in the managed funds that they have been invested in. Only in recent years, have the laws actually allowed people to borrow to buy property through superannuation. A lot of people think that to buy property through an SMSF means you just take the cash out and use it as a deposit. This could not be further from the truth. It is a reasonably complex structure that gives you the ability to borrow and I highly advise that you seek the advice of a suitably qualified and experienced professional who knows the correct setup before you take this approach. I have seen a few loans set up incorrectly and it has been a costly nightmare to correct. Trustees of a non-compliant SMSF can lose tax benefits and receive fines.

An SMSF is very much like a trust structure. Like a trust, an SMSF is a separate legal entity to its owner. Also like a trust, it has to have a trustee to manage it. The trustee will generally be a company that has the owners as directors. The banks prefer this to individual trustees, particularly if the fund plans to borrow.

Why use an SMSF?

An SMSF has great tax advantages. Contributions going into the fund are only taxed at 15%. Capital gains tax and income tax generated from the fund is also greatly reduced. When you reach a certain age and you start drawing an income from the fund, the fund then becomes tax free. That means no income tax or CGT is payable.

What are the drawbacks of SMSFs?

SMSFs are reasonably expensive to set up and have extra accounting fees to be paid each year. You need to have a reasonable amount in super to be able to set up an SMSF and secure finance to invest in property. An opening SMSF balance is generally no less than $100,000, (depending on how much you want to spend on your property). Because SMSFs are so heavily regulated, the banks won't lend as much through superannuation as they would to you personally. The maximum your SMSF would be able to borrow is 80%, with most banks preferring an LVR of 70%. Thus it can make it hard to build up a decent portfolio through super alone.

Investing in your own name

Although not technically an entity, you can certainly buy property in your own name and the majority of people do. Buying property in your own name is exactly that: you own it, are responsible for it and get all the income and benefits from it.

Buying in your own name suits most people who do not need the added protection of buying through a trust. It also means they do not lose negative gearing benefits that go with investing in some property. You can buy property together with someone 50/50 (as joint tenants) or you can own it in whatever percentage split you want (as tenants in common). When buying with a partner, it is important that the percentage split of ownership is correct. If this is incorrect, it can be an expensive fix, with both stamp duty and CGT implications. I would advise that you get a suitably qualified person, in this case a Chartered Accountant, to advise you on what is the correct split to have the property in.

Why use own names?

It is definitely the simplest way to buy in your own names. There is no new entity that needs to be set up and no extra accounting fees. The tax benefits of buying in your own name are great. You can use negative gearing and you also get a 50% discount on CGT, if you have owned the property for more than a year before you sell it. There will also be less ongoing accounting fees when you hold property in your own name.

What are the drawbacks of buying in your own name?

The main drawback is that you actually do have to pay tax on the profits from the sale of that asset, albeit discounted by 50% if owned for over one year. Also, the income gained from the property is taxed. Another drawback is if you get sued your property may be at risk. This is why having good insurance is important.

Before contracting to buy a property it is wise to consult with a suitably qualified person on the most appropriate structure for your investment.

Bank valuations

Like the Evil Emperor out of Star Wars, property valuers are rarely seen by property investors and hold way too much power. (They are mostly evil as well!) They have the ability to wipe hundreds of thousands of dollars off your portfolio with the stroke of a pen or the touch of a button, without any reason why.

When you are refinancing your property or going to buy a new one, the valuer is the guy who goes out to inspect your home or the new property and lets the bank know what he (or she) thinks it is worth, so that the bank does not lend you too much money. Valuers work for a third-party valuation firm who conduct the valuations on behalf of the banks for which he/she will receive a commission. The main concern the valuer has is that he doesn't overestimate the value of your property. There's no problem if he underestimates, but God forbid if he overestimates. Because if you default on the loan, and the bank sells the property short with money still owed, the valuer can get sued. The only person the valuer is looking out for is himself. Valuers will therefore always be conservative in their valuations and undervalue rather than overvalue. It is of no benefit to them if they value the property too high. They have already been paid so why put themselves at risk? They don't really care if your deal goes through or not. It's no skin off their nose.

You need to be aware of how valuers operate and their limits. When refinancing, always be prepared that the valuer will give you a low valuation and don't take this to heart or take it personally. The valuer is not targeting you, he is just looking after himself. The variance can be anywhere from 5% to 20% to what you would value your home at.

It can be the same when buying property as well. I have seen valuations vary on the same property by $50,000 by the same valuation firm. It's crazy. What's more, the valuers won't give any explanations as to why their valuations vary. Personally, I always anticipate around a 5% variance between the sale price and the valuation. I think anything up to a 5% variance is acceptable, anything over that I generally try swapping lenders who may use a different valuer and may give me a better result. But be aware, valuing is not a science and the valuers have their own interests at heart, not yours.

Fixed or variable rate loans

An important part of the finance puzzle is the type of loan you choose – fixed rate or variable? I must get asked this question twice a week at least. It is a very hard one to blanket-advise people on because it is important to know what people's financial circumstances are and what is important to them in order to give them the right advice. The bottom line is this – it is virtually impossible to beat the banks.

A study was done a while back on those who fixed the interest rate on their loans versus those who stayed on a variable rate. It was determined that everyone ended up paying the same amount of interest. So don't go into a fixed rate or variable rate on the anticipation that you are going to beat the bank. There are, however, pluses and minuses for each.

What a fixed rate offers you is the ability to be able to plan and budget by knowing exactly what your outgoings are going to be over the next few years. Many people like this security. Myself, personally, if I can get a good, low, fixed rate, I like to take that so I am able to plan ahead. At the time of writing this book, there are some amazing fixed rates around and I am fixing in the majority of my portfolio and encouraging my clients to do the same.

Below is a summary comparison of both types of loan.

Advantages of a fixed-rate loan	**Advantages of a variable rate loan**
Allows you the ability to plan ahead for a number of years	Gives you the flexibility to be able to pay off more of your loan if needed
	You won't be caught on a high rate while everyone else is low. You will be paying the market rate
	It provides you with the flexibility to move the loan to another bank if you choose, without paying penalties
Disdvantages of a fixed-rate loan	**Disadvantages of a variable rate loan**
Extra payments are limited, so you are usually not able to pay out the loan early	You are at the mercy of the market rate and your rate will move with that
You lose your flexibility and ability to change banks	You have no ability to be able to plan and budget ahead

Principal and interest loans vs interest-only loans

Many novice investors can't understand why people use interest-only loans. Let me explain why initially, when in the accumulation phase of investing, they are so important. The first thing to remember is that cash flow is vital to an investor. It is the fuel that keeps the whole vehicle moving. It is very important to try and maximise that as much as you can. One of the ways that you can do this is to pay only interest on the money you have borrowed and not pay back the actual principal. That extra cash flow that you have saved can either go into expanding your portfolio or to paying off your non tax-deductible debts.

This brings me to the second point. When you are wealth-building you need to focus on paying off your non tax-deductible debt first. There's no point in reducing the tax-deductible debts before this. Therefore, why pay principal back on your investment loans while you have non tax-deductible debts to reduce?

This will change in the later phases of your investment cycle.

During the holding phase you should have paid down all of your non tax-deductible debt and now be concentrating on reducing the tax-deductible debt. During this phase it would be advisable to swap your interest only loans to principal and interest.

PART III

PROPERTY

Chapter 6

WHY RESIDENTIAL PROPERTY?

It does not necessarily have to be residential property that you use as the vehicle for building wealth; however, to substitute property you have to find an alternate asset class that displays the following characteristics:

- Low risk
- Able to be financed to at least 95% of its value
- Consistent long term capital growth
- Provides sufficient cash flow to enable holding at low cost
- Provides tax relief and if it's sold after 12 months ownership, it receives the capital gains tax (CGT) discount
- Is an asset that everyone must have
- Is easy to understand.

I challenge you to find another asset class with those characteristics.

Property vs shares?

Generally speaking, people invest in one of two asset classes: property or shares. People tend to like one or the other. I constantly get asked about the two and what my thoughts are on shares versus property. Let's take a look at the characteristics above and see how residential property stacks up against shares.

Low risk

Residential property is definitely much lower risk than shares. During the global financial crisis (GFC), the sharemarket was brought to its knees. During this time, trillions of dollars was wiped off the balance sheets of major companies' and investors' balance sheets alike. Many companies just plainly went out of business and some of the world's largest and most respected banks went bust. Even blue chip shares (which are considered the safest) still devalued by over 40%. Those unlucky people who were just about to head into retirement, and had held all of their assets in shares, took such a hit when the GFC came that many had to postpone retirement. Their assets had been devalued by half so they just could not make that transition.

Conversely, residential property did not really suffer at all. You may hear stories of how property was devalued by 50% and how it "crashed". This is just not true. Some property was devalued by that much but this was at the very high end of the market. To say that the whole market "crashed" and was devalued by 40% is not fact. The reason why the high-end property market was affected was due to the decreased demand for $1 million+ property. Very few people could afford to buy it. So when you have less buyers around, that part of the market is going to be heavily affected. We will cover this in more detail later. The truth is that the median house price in Australia dropped by around 5% during the GFC, not 40% or 50%. I challenge anyone to prove they purchased a house in an Australian capital city that was once worth $450,000 and they then purchased it for $250,000 during the GFC. It just did not happen.

Able to be financed to at least 95% of its value

One of the biggest benefits of property is that it can be financed to over 95% of its value. In some cases, right up to 98%. This is a huge benefit. It just goes back to the example I gave in the section on leverage and the ability to do more using less. The more leverage you can muster up, the more money you can make. Residential property can be so heavily leveraged because it is so safe. Banks know this and that is the reason why banks will lend you 95% of the value of the asset because they are so sure that it will hold its value.

The same cannot be said for shares. The maximum LVR you can get to purchase shares is around 60% to 70%. So, that power of leverage cannot be harnessed as well with shares as with residential property. Another thing to be careful of when borrowing to buy shares (sometimes called 'buying on margin') is that the bank will revalue these assets from time to time. If they think that the shares have devalued, they may check your LVR. In order to keep the LVRs as they originally were, the bank may ask you to reduce your LVR by way of payment in cash to the bank. If you don't have that cash or extra equity to give them, you will be required to sell shares to repay some of your loan. This happened to many people during the GFC and financially crippled a lot of share investors who thought they had a safe investment.

Consistent long-term capital growth

Residential property in Australia has shown terrific long-term capital growth of around 8% compounding on average. This means that it doubles approximately every 10 years and has done so since the numbers have been recorded.

Shares have pretty much shown the same growth rates. However, they carry so much more volatility and risk than residential property. At any one time you could have a substantial drop in the value of your share portfolio. If that time happens to be when you need to cash in some of your investments, then you could find yourself in hot water.

Provides sufficient cash flow to enable holding at low cost

Investing in residential property in Australia provides cash flow in the form of rent. It is of the utmost importance that you receive some income from your asset of choice to enable you to hold that asset for the longer term. While shares generally pay dividends, this is not always the case; sometimes these are not paid depending on the profits of the company. If they are not paid because the company decides to expand, or doesn't make enough profits for that year, this can seriously hurt your personal cash flow. Residential property definitely offers more consistent cash flows than shares.

Provides tax relief

Apart from the cash inflows from rent, residential property also provides outstanding tax relief. This gives the property investor a clever way of increasing cash inflows. Shares also provide tax relief if the dividend is franked. However, if the dividend is not franked, extra tax will have to be paid on that income with no tax benefits. The non–cash deductions that residential property provides (see discussion on depreciation later in the book) are very favourable and this is something that share investments do not offer.

Both property and shares benefit from the capital gain tax (CGT) discount if the asset is held for more than one year.

An asset that everyone must have

This is probably one of the greatest benefits of residential property: housing is a necessity in life. Everyone has to live somewhere. So residential property will always be in demand. Shares on the other hand are a discretionary investment.

Easy to understand

You don't have to be a rocket scientist to make money out of property. Just follow the fundamentals and buy for the long term and it will happen. Shares on the other hand can be very tricky. Unless you are an accountant, it is very hard to read an annual report with balance sheets and profit and loss statements. Even then, how accurate are they? Share markets work in very strange ways and can be very difficult to make head or tail of. Most people invest in the sharemarket via tips they receive from friends – not exactly the best way to invest!

So you can see from the above that property is an all-round better asset class to invest in for most people.

Two methods to make money out of property

In the earlier chapters you learnt about the mindset of successful investors: how they set goals, act on those goals and persistently follow those goals through until they have been achieved. They differ from the majority of people who don't set goals, don't act in a positive manner and just lay blame at the first sign of any trouble and then give up. One other thing that most people are pretty bad at is being motivated. They can be a bit lazy. They are not prepared to put in the hard yards over the longer term to achieve what they want. Many people want to become rich through one big deal and it almost never works out that way.

I meet with literally thousands of people and talk to them about their plans and what they want to achieve. Quite often I get a phone call from someone I may have met and they proceed to tell me about how they have found this great development site that they are going to buy, build six units on, sell them off and make millions of dollars. No need to tell you how this ends up 99% of the time – in tears. These people have no development experience, not a lot of capital and in most cases no idea. How do they expect to develop six units and make money? Development is very risky and the margins are very fine, but the lure of so-called "easy money" sucks people in for the big hit and most times they lose everything. Unfortunately, it is the gambler in us. Australians are reknowned for it. Aussies love gambling. How much do we love it? Well, we have an annual public holiday in Victoria for a horse race! Did you know that we spend more money on gambling than we do on any other sporting activity, social activity, or cultural activity in Australia? We lose about $1,000 per head to gambling each year in Australia and that folks, makes us Australians the biggest group of losers in the world! You just have to walk through any of the RSLs or clubs in your local area to see the amount of poker machines. It's scary.

The two methods to "make money" out of property are through:

- Risky investing
- Safe investing.

Let's look at each in turn.

Risky investing

Risky investing comes from the gambler mentality: lay it all on the line and if it works, great! If not…well I haven't really thought that far ahead. I just assumed that it would work.

I have seen lots of people try their hand at development with no experience and fail miserably. In fact, I have seen experienced people fail as well. The problem with development is that it carries so much risk. I believe the statistics are that nine out of ten developers actually go broke. In development, you have two enemies that are out to get you and take your money. Those enemies are interest rates and time. I can tell you they are very strong adversaries. You see, with development, everything has to be done within a strict window of time. Once you have found the site and done the feasibility, you can then settle on the site. Once settled, the clock starts ticking. You have to get Development Approval, Building Approval, have the site cleared, get the properties built, put them on the market and have them sold all within a window of time. If you go outside of that window of time, your enemies – interest rates and time – get together and start to eat away at your profits like some hungry invisible Pac Man. You cannot take your eye off the ball for a milli-second. If you do, it could be the end of you. The thing is, it is not always your fault that things don't go according to the timeframe you have anticipated. Councils can be notoriously slow, you may get an objection to the development or the market could just plain stall and you are unable to sell the properties. This is the stuff that can send you bankrupt.

We need to get away from this gambler way of thinking. It does have its place and that place is with lots of experience and capital backing. But the majority of people need to take on less risk and build a portfolio over time, safely and steadily.

Safe investing

Safe investing is what I advise my clients to do. That is, build a sizeable portfolio of quality properties over time. What you want to do is remove those two enemies – interest and time – and make time come over to your side. So rather than time working against you, time now becomes your ally and works for you. This means that the longer you hold a property, the more money you are going to make. This is why one of the big mistakes you can make when building wealth through property is to sell. Buy and hold, buy and hold. This is what you want to be doing.

Why having a system is so important

To be able to retire comfortably from your property investments, you will need at least a few properties in your portfolio. You will not be able to retire off one property alone, even two for that matter won't be enough. Therefore, you are going to need a "system" or a "structure" that you can continually implement that enables you to buy and hold several quality growth assets.

Think of it a bit like a franchise, such as Starbucks or even McDonald's. These companies have developed a system over time that they know works. Everything is pretty much the same in each store and the company knows if it can use that system and continually roll it out, it will make money. Donald Trump is a great example of this from a property perspective. He has a system that he uses to develop, and he applies that system and rolls it out across all of his developments. He looks for certain indicators in the market and once he has found the right market and time, then just like a franchise, he develops and sells his product. This not only means he has a very good idea of the outcome, it also means that he can streamline the operation so that it is much easier for him to implement.

You ***also need a system.***

You need a system that is going to enable you to buy multiple properties and hang onto them over time. Did you know that 87% of people who actually go ahead and buy an investment property only ever own one property. The reason is that they don't have a system in place to be able to purchase their next property. They get the first, generally by some sort of fluke. Quite often it is their old residence (which incidentally is the worst investment decision you can make), they hang onto that and then wonder why they cannot get their next property.

There is a system, though, that can ensure you get it right. It has been tried and tested and unless someone had shown it to you, you can be forgiven for not knowing about it because it is a little tricky to work out. I want to share with you this system of acquiring residential property. Once you know it, you will wonder why more people are not doing it. This is the system that I have used many times over to acquire property. It is the same system that many of my clients have used to build sizeable property portfolios.

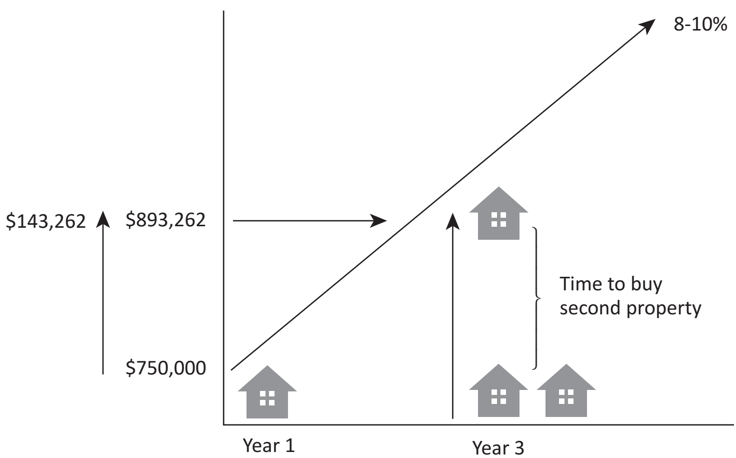
The system is quite simply this: buy brand new residential property in areas that are high in capital growth. Give the property time to grow in value. While the property is growing in value, you need to make sure that you are getting maximum cash flow so that the property is not costing you too much to hold. Once the property has increased in value and the rent has increased as well (so that the property is costing you less to hold), then you use the capital growth in that property to springboard yourself into your next property.

Sounds easy, right? Well, to be honest it is!

Let me explain in more detail with the use of the diagram below.

You buy your first property at year 1 on the time line below. Let's say that property costs you $750,000. Property on average grows at 8% per year in the longer term. This is an average, therefore not all property grows at this rate. That is why you need to do some homework to make sure you have the right location. Let's assume for a moment you don't get 8% and only get 6%. Well, that means that the property you purchased for $750,000 is now worth $893,262 after four years and you have made nearly $150,000 in capital growth.

Three-year investment strategy



Now what you can do is get the property revalued. A new valuation will prove that you have made a gain of $150,000. You are now able to go back to the bank and draw out that $150,000 capital profit, not by selling the property, but by refinancing. You can then take that $150,000 and use it as a deposit on a second property.

Now you have two properties in your portfolio.

This is the key to the whole thing. Let's just say that your next property costs the same as the first, which is now worth $893,262. You now have two properties worth $893,262 that are growing at 6%. That means your total portfolio is worth $1,786,524. Once again, you let it grow for four years at 6% compounding per year. Your portfolio will then be worth $2,127,779. You have made $341,255 in capital growth. Can you see the pattern emerging? The more property you have, the bigger and faster your portfolio grows.

To see the pattern emerging, take a look at the table below. This example is based on buying three properties over a twelve-year period.

YEAR	NEW PURCHASE	TOTAL VALUE	GROWTH/PROFIT
0	750,000	750,000	-
4		893,262	143,262
	893,262	1,786,524	
8		2,127,779	341,255
	1,063,890	3,191,669	
12		3,801,327	609,659
TOTAL		**3,801,327**	**1,094,176**

Just using this simple system you can see that you have made nearly $1.1m in twelve years. To put that into perspective, that is about $251 per day that you have been making in capital profit over those nine years. It's very hard to save that amount. What's better is how much tax you have paid on it. None! And remember that this has been calculated over a lower growth rate of 6%. Imagine what you could do if you achieved a standard 8% growth rate?!!

Look at the "Growth" column in the table above. This pattern that you can see emerging is called "Compound Growth". It is one of the most amazing and important components in building wealth. The increase in your properties' values become exponentially bigger because the growth that the properties are creating, is going back into creating even more growth.

Compound growth

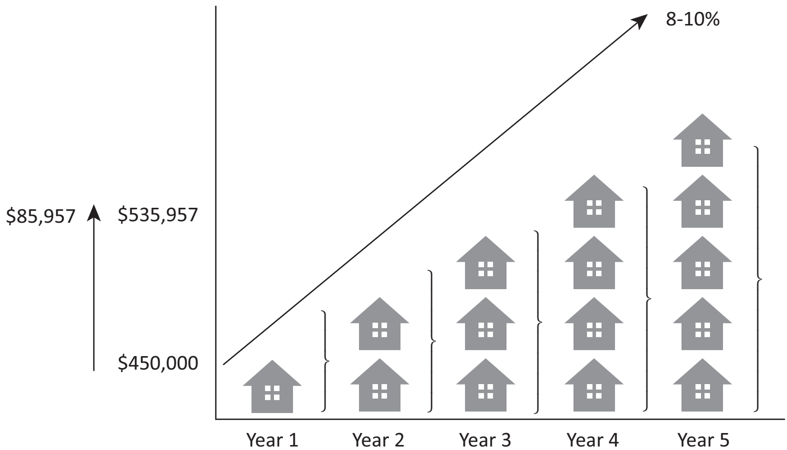
Compound growth was described by Albert Einstein as the 8th Wonder of the World. It is extremely powerful and if you know what it is and how to access it, then you are almost certain to make serious wealth. Most people would know what compound interest is: interest on top of interest. Compound growth is the same thing – just growth on top of growth.

There are a lot of stories about compound growth to show how powerful it is. The best one that I have heard is this:

"What would you rather? A million dollars today, to go and spend? Or 1¢ doubled every day for 65 days?" Advice: take the 1¢ doubled every day for 65 days. It works out to be several million dollars! That is the power of compound growth.

The diagram below shows a simple system of buying and holding property and building a property portfolio over time. It is just a case of buying property, holding onto it so that both the value and the rent increase over time. Once it has increased to a point where you have enough equity for a deposit on the next property, then refinance and purchase your next one.

Five-year investment strategy



When you are developing a system or "franchise" to build wealth, it needs to be done in a way that creates compound growth. If you can't create compound growth you are never really going to build much wealth in the long run. This is why I think that the idea of buying a home, renovating it and selling it, then buying a better one then renovating that, etc., is not a good way to build wealth in the long term. It may be a good way to get a nicer home, but not to build wealth. Where is the compounding? There is none. This is why selling property is one of the biggest mistakes that people make as far as wealth-building is concerned.

Remember the strategy: buy new property and hold that new property over time while the value and rent increases. When the value has risen enough to give you a deposit on another property, refinance and use that equity growth as the deposit on another property. That is how you build a property portfolio safely over time.

Don't get emotional on me

Investment decisions should be made solely based on the numbers, yet so many people invest emotionally. They let their emotions drive their investment decisions which is very much the wrong thing to do.

A great example, and one which really shows how emotions drive investment decisions, is the stock market. The stock market is more or less driven by people acting out of one of two emotions: fear or greed. When the market is going down, people sell their shares *en masse* because they are frightened of losing their money. Whether or not the company they have invested in still stacks up is irrelevant to most, they are just too scared of losing money and thus they jump out causing the share price to drop even more. When the stock market is rising, greed kicks in. People do not want to miss out and they invest as hard as they can. This is the reason why banks track the "sentiment" line – how people are feeling emotionally about investing. It is a major driver in the stock market. This type of investing, driven by emotions, is going to bring you unstuck. It is not based on any research and is just the herd mentality at work. Those sheep are usually walking towards the shearing shed about to get fleeced of their hard-earned money.

Warren Buffett, probably the world's greatest share market investor, has a couple of very simple rules that he follows:

- Be cautious when others are greedy. Be greedy when others are cautious.

- Don't be concerned with the daily fluctuations in price. Look at the intrinsic value of the asset and hold for the long term.

People also invest in property using their emotions before they have even researched or looked at the evidence. They tell me that they don't want to invest in a certain location. When asked why, they just say because they don't like that area and they would not live there.

I also regularly hear comments like, "I can't invest in that property because it doesn't have stone bench-tops in the kitchen and bathrooms" and according to their expert knowledge "everyone wants stone bench-tops these days". Yet they have failed to recognise that the property is in the lower bracket so the cost of stone bench-tops is not going to be returned in either capital growth or rental yield.

You must judge a property only by numbers and facts and not by emotions. Emotions will just bring you unstuck.

Chapter 7

WHAT IS THE RIGHT TYPE OF PROPERTY?

Remember that the safest, most efficient and most lucrative way to build wealth through investing in property is to buy new property with a focus on capital growth. Hold that property until it has risen in value. Once it has increased in value, use that increase for a deposit on another property while keeping the first. Now that the strategy has sunk in, we need to find property that is going to fit our strategy.

When starting out, it can be very difficult to determine what the right property is for you. After all, there are so many different types of property available, in different locations, doing different things around Australia. Also, every property in Australia is up for grabs. Gone are the days when you were limited to you own neighbourhood or suburb. Why can't you buy in another state? There is no reason why you can't. In fact, I would encourage it if market conditions are right. Thanks to the internet, you can buy property anywhere from Perth to Brisbane and everywhere in between. You can buy anything from houses in Hersten, apartments in Applecross to townhouses in Tassie. There are loads of different properties out there. But how do you determine which is right for you?

The three-step deduction method

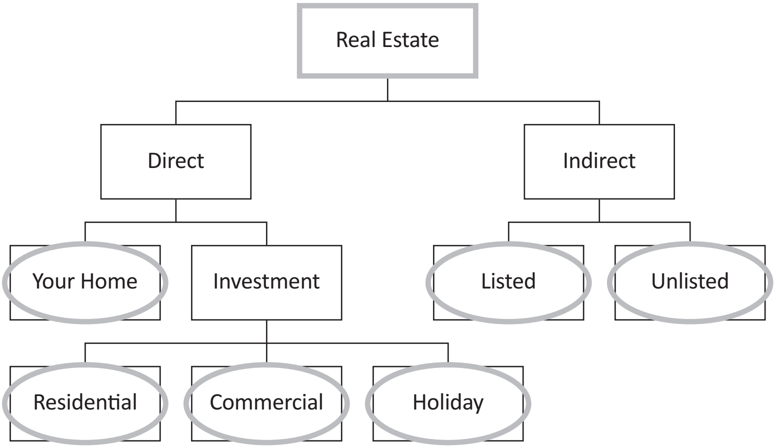
Perhaps because I am a Chartered Accountant, I am very analytical by nature. When I am looking for a property to add to my portfolio, I use a three-step method of "deduction" to find the right one. That means I consider every property available in Australia as a potential for my portfolio. Then what I do is remove certain properties when they do not fit the criteria therefore "deducting" them from what is available to slowly reduce the list down until I have the right property.

Here are each of the three basic steps of deduction:

1. Work out what TYPE of property is going to fit your strategy
2. Determine in WHAT STATE that property will be located (macro level)
3. Determine WHERE (LOCATION) you need that property to be located (micro level).

What a lot of people don't realise is that there are many different types of property, not just houses (see the diagram below).

Types of property



Indirect property

The first decision you need to make is whether you will invest directly or indirectly. With indirect investment you don't own the whole property. You own a very small portion of it, together with many other investors. It might be that you own a share in a property company that owns a number of different assets, such as shopping centres, office buildings or maybe some industrial property.

Indirect property can be broken down further into the following two categories: listed and unlisted.

- **'Listed' property:** means that the company through which you purchased property indirectly is listed on some stock exchange somewhere. This makes life much easier if you need to sell your property-holding because it can be traded on the stock exchange for the listed price.
- **'Unlisted' property:** means that the company through which

you purchased property indirectly is not listed on a stock exchange. Be very wary of these types of investments and know that if you need to sell, there is no certain secondary market. Some people think that they can just go and resell their property holdings in unlisted property trusts but this is not the case.

If you are looking to build sizeable wealth, then you want to steer clear of indirect property investments. They tend to carry more risk and people have lost a lot of money in these investments in recent years. A good example, where people lost billions of dollars, is MFS. It was a property fund that went broke due to poor management. Another problem with indirect property is that you will not be able to borrow very much to invest in it. Just like any type of share, your LVR will be limited to 70% which is no good for building wealth.

Bottom line: *Cross indirect property off the list for wealth-building.*

Direct property

Direct property can also be further broken down into the two categories: your own home (also called your principal place of residence or PPR) and investment property.

- **Own home:** While your own home can also be considered an investment it does not fit within our system to create compound growth. You can trade up and get a better home but you can only ever own one home so there can never be any compound growth. Plus your own home never gives you any cash flow or income. There are plenty of older people out there who are living in very expensive houses but have no income. If you want to build substantial wealth through property, then stop thinking about your own home as your number one investment.

- **Investment property:** There are three types of direct investment property: commercial, holiday and residential.

Commercial property

Commercial property is made up of many different styles, including: office space, industrial sheds/warehouses and commercial show-rooms, etc. When the economy is doing well these types of assets also do well because they rely totally on business thriving. Their values have a strong correlation with the economy. However, when the economy starts to contract, these assets can be the death of an investor, due to an oversupply being created very quickly. This makes commercial property very risky.

Another drawback of commercial property which also adds to its high risk is the fact that the banks can come back and revalue the property whenever they want to. If the economy starts to slow up and your tenant goes broke and moves out, or just doesn't renew their lease because they have moved on, you could be left with vacant premises. If the bank then revalues your property at that stage, it could be worth substantially less then what you paid for it. What will happen next is that the bank will want to keep the LVR of the property the same, so will request that you put in extra cash to keep that LVR constant. If you can't come up with the cash in 30 days they will start to sell off your assets. No questions asked. This particular scenario has happened many times and has sent thousands of wealthy property investors broke. I have personally seen it happen time and time again. Furthermore, commercial property is not a necessity in life, unlike residential property. This means the demand for commercial property will never be as strong as for residential property.

> ***Bottom line:*** *Steer clear of commercial property as it carries too much risk and can very easily send you broke.*

Holiday investment properties

The lure of investing where you enjoy going on holiday can be very strong. Who wouldn't want to own a unit or house near a beautiful sandy beach somewhere along the Queensland coast? After all, you can claim heaps of tax deductions and get free holidays. Right? Wrong?!! This approach is fraught with danger and the Australian Tax Office does not like it.

You must be very careful if you buy a holiday rental and use it yourself for your own holidays and still claim tax deductions. If you live in a western suburb on the east coast of Australia and have a holiday rental on the beach in the eastern suburbs then the Tax Department may look at the two different postcodes and decide to audit you. That is not a problem if you are not claiming tax deductions for the time that you are using the holiday property for personal use. However, for many people the temptation is too high. They claim deductions for this personal use and the Tax Department comes down hard on them.

The other thing to consider which is probably more important is that holiday destinations tend not to perform as well as the capital cities. These places tend to lag a bit in growth because there is nothing substantial driving them and little employment. Many of the properties in these locations are second homes for families and when the economy is not doing so well, people tend to reduce these holdings and sell them off. That tends to flood the market and prices drop dramatically. This creates a fickle market that is not as steady as the capital city market.

> ***Bottom line:*** *Holiday rentals are not good properties to invest in to build wealth. They can be a tax hazard and they just don't provide the capital growth that less seasonal places provide.*

Direct residential property

This brings us back to residential property – the best vehicle for building a property portfolio. It has all the ingredients to make it right. Firstly, it is very safe. Provided you buy somewhere around the median house price in that capital city, and you do some research, then you won't wake up the next day and find your property is worth 50% of what you paid for it. This can happen with all other asset types including shares, indirect property, commercial property and holiday rentals.

Residential property is a necessity in life. In modern days you cannot live on the street. Therefore while the population is growing, there will always be growing demand for it.

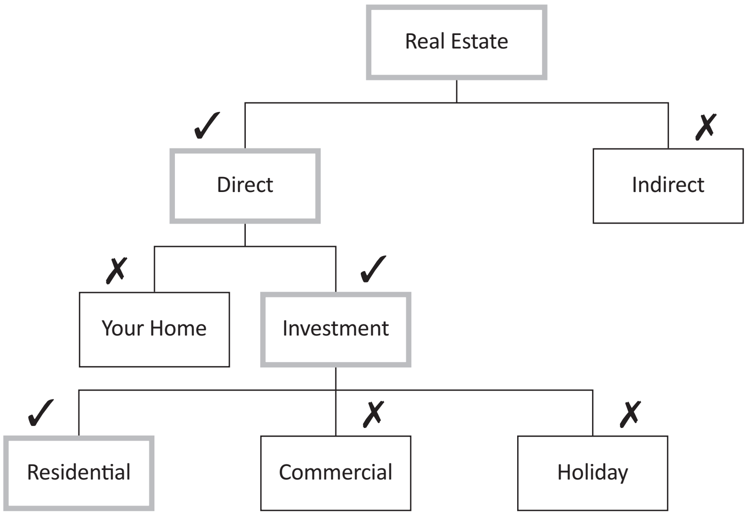
Residential property, unlike commercial property, won't be revalued down and you won't be required to give the bank cash to make up that lost valuation. This helps property remain a safe haven for investors.

Probably best of all, residential property can be mortgaged up to

95% (LVR) and even higher in some cases. This allows the aggressive investor the ability to build up a portfolio fast when the market is running hot.

> ***Bottom line:*** *Direct residential property is by far the best vehicle for building wealth.*

Process to get to residential property investment



OK, now you are starting to work your way through my theory of deduction and excluding things that don't fit into the wealth-building criteria.

You have worked your way through all the various types of property: indirect and direct, right through to commercial and holiday rentals. You have determined that the best vehicle for building wealth is direct residential property. You are starting to narrow it down. However, there are various types of residential property including:

- Apartments
- Townhouses
- Houses.

How do you know which of these is going to be your asset of choice? Once again, let's go through the theory of deduction and remove what we don't want to narrow the field down further.

In order for this system of growing a portfolio to work, there needs to be capital growth. Capital growth is quite simply the value of the property increasing. How can you ensure that your property is going to grow in value? Let's take a closer look at how we get capital growth.

Finding capital growth

A property is made up of two separate parts: the land and the structure that sits on that land, whether it be an apartment, townhouse or a house. Out of those two parts (land and structure) the part that is going to grow the fastest in value is the land. This is a basic principle of property. The reason that the land increases the fastest in value is because you can't create any more land. It is a finite commodity. It is especially finite in places where people want to live, and in Australia, that is by the capital cities. Therefore, to determine how well your asset is going to perform, you need to work out what its land content is. It is interesting to look at much more mature cities around the world such as London, Paris or New York. Those cities prove to us that it is the land that you pay a premium for. That is the thing that grows in value because it is in such short supply.

Land content

Land content has nothing to do with the size of the land. 500m^2 at Bondi Beach will far outperform 1,000m^2 in Campbelltown, west of Sydney. Size does not really matter, unless you are a developer. What you need to focus on is the ratio of the value of the land to the value of the total property. It is expressed as a percentage:

Land content = land value / total value x 100

EXAMPLE

Land value	$200,000
House cost	$200,000
Total value	$400,000
Land content	= $200,000 / $400,000 x 100
	= 50%

This means that 50% of the value of your asset is made up of the land. This is a good percentage. The range that you want is anything from 40% to 70%. If you go below 40% you will not get the growth you need for the system of portfolio-building to work. If you go above 70%, then there is a very good chance the house is a pull-down and it will not provide you with the tax deductions and rent that are essential to cash flow and keeping everything afloat.

So what type of asset fits within that 40% to 70% land-content bracket?

High-rise apartments?

No. While they are generally on very expensive pieces of land, you are sharing that with potentially hundreds of other owners. The structure of a high-rise apartment makes up the majority of value of this type of asset, with very little value coming from land. Generally, high-rise apartments have around 5% to 10% land content. Therefore, you have approximately 90% to 95% of the value of your asset depreciating. This is why high-rise apartments do not perform as well as houses.

Townhouses?

Yes. A townhouse can fit within that 40% to 70% land-content bracket; however, for this to happen, the emphasis must be very much on location because the land value needs to be high. For example, it costs the same amount to build a townhouse in Campbelltown as it does to build one in Bondi Beach. But the difference in land values will be immense. The land content will be much greater on the same property in Bondi because the land value is so much more. Therefore, if you are investing in a townhouse, make sure it is very well located and the land value is right because it will be so much smaller in size.

Houses?

Yes. A house definitely fits within the bracket and will generally have around 50% land content, if you are buying around capital cities. If you stray into regional markets you will get caught with a lower land value so be careful there.

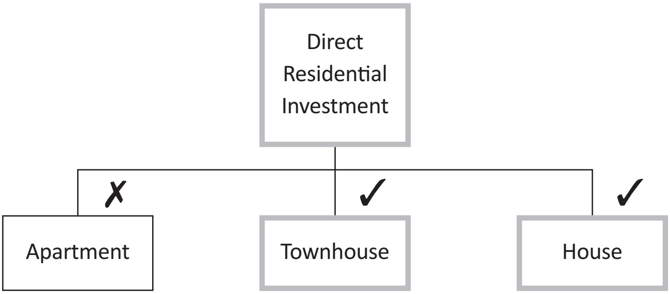
Can you see now that using my theory of deduction, you are slowly reducing your pool of properties and narrowing down to exactly what you will need?

Let’s recap on what you have removed from the pool of potential investments from direct residential investment properties:

- Own home: No good for the wealth-building strategy because it does not have the benefit of compounding

- Residential property:
  - Apartments – do not provide the capital growth due to lack of land content
  - Townhouse – YES, but must be well-located
  - House – YES, safe and provides strong growth and can be easily financed.

Direct residential investment short-list



So, you have determined that the TYPE of property to be investing in is either a townhouse or a house.

Chapter 8

MACROS AND MICROS

Congratulations! You are one-third of the way through the three-step theory of deduction to working out what is the right property for you. Now, to keep working through steps two and three, remember the categories:

1 Type
2. What state (macro)
3. Location (micros)

Macros

The second step is determining in which state the property will be located. This is looking at the big picture or 'macro' level.

You have now determined that the best way to build a portfolio of properties is with residential property – either houses or town-houses. However, there are lots of places in Australia where you can either build or buy a house or townhouse. How do you then decide where the best location might be?

When I first started investing in property, I treated the Australian property market a little like the share market. I broke it up into its different sectors. For example, with shares, sectors include: tech stocks, pharmaceuticals, mining, etc. If I could find one of the sectors that was buoyant at any one particular time, I knew it would be a lot easier for me to find a hot stock within that sector, rather than trying to find a hot stock in a sector that was flat. For example, between 2002 and 2007 it would be easier to find a hot share in the mining sector than it would in the tech sector where the bubble had just burst.

I applied that same way of thinking to Australian property, but substituted sectors with states. With property, it tends to be a case of different states doing well at different times. They all seem to have their own sub-markets based on their economic conditions and population movements. If I could find a state that was doing well, and showed signs that it would continue to do so, then that would be a good place to start. I could get within that state and find the location on a lower level that was going to be right.

Demand

From a macros perspective, there is a very simple economic equation that you can apply to just about any asset that you are thinking about investing in – whether it be shares, property, precious metal or even foreign exchange. It is basic economics:

Increase in demand of that product + decrease in supply of that product = increase in price.

It's very simple, but so few people actually recognise it when they are going to invest. That is because, as I pointed out, most people invest emotionally and not with their heads. Investing emotionally can get you in all sorts of trouble because emotional investing is exactly that, using your emotions to drive you and make decisions for you which, when you take a step back, you realise is absolutely crazy.

It is important to look at both parts of the equation.

Increase in demand

What creates demand in property? Demand in property is driven by population growth. You could argue that there are other factors, such as an increase in the labour market. But this will drive population and it is population growth that is the driver behind demand in residential property. Demand is absolutely essential to capital growth. Without demand there is a very low likelihood of capital growth.

If you are a serious property investor you must keep a very close eye on population growth. The best place to find the numbers on population growth is the Australian Bureau of Statistics (ABS) website: www.abs.gov.au. It breaks the numbers down by state, showing growth for the quarter and year and also gives predictions of future growth.

Below is an excerpt of what you can expect to find on the ABS website. The data shows both percentage increase and actual increase. Be very careful not to use percentage increase on its own as that can be misleading. This is even more important when looking deeper and looking at growth on a city-by-city or town-by-town basis. For example, you may get a town that has a population of 500. If that town has 100 new residents move into it, it has a growth rate of 20%

which you could argue makes it the fastest-growing place in Australia. I have seen many unscrupulous salesmen use this data to their advantage and try and sell investors into an area on this pretence.

Example of ABS population data, 31 Dec 2021

Preliminary data	Population at end Jun qtr 2014 ’000	Change over previous year ’000	Change over previous year %
New South Wales	8,095	11.2	0.1
Victoria	6,559	-3.5	-0.1
Queensland	5,265	73.7	1.4
South Australia	1,806	9.6	0.5
Western Australia	2,762	30.5	1.1
Tasmania	569	4.3	0.8
Northern Territory	249	0.2	0.1
Australian Capital Territory	453	1.9	0.4
Australia(a)	**25,766**	**128**	**0.5**

Source: ABS

What you must also be aware, of in places of small population, is if 30 new houses are built, the place would be oversupplied and you would see no capital growth whatsoever. Don’t just rely on percentage increase alone. You must couple that with volume. Steady and large volume population growth is important to strong demand.

I have taken this data from the ABS website and put it into a more graphic form below so it is easier to assess.

As you can see from the graph at the time of writing, Australia’s QLD & WA states show the majority share of the population growth for 2021.

What does this information tell you? Well, if you want demand for your product (property) then you should be sticking to the growth states.

Population growth ('000)

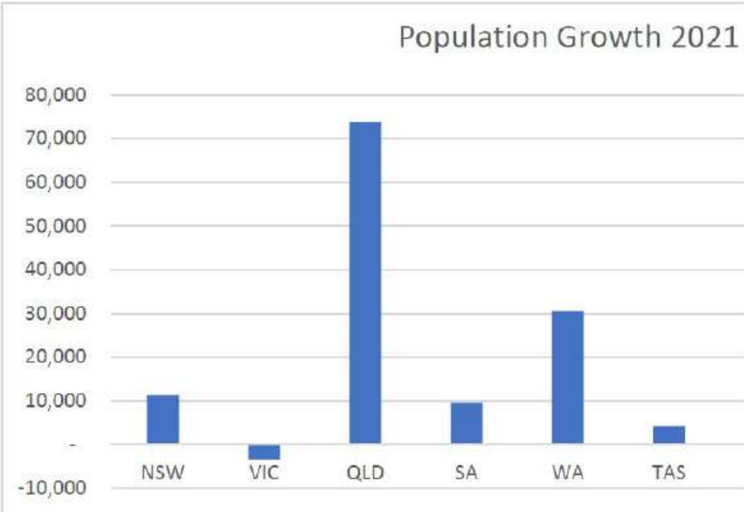
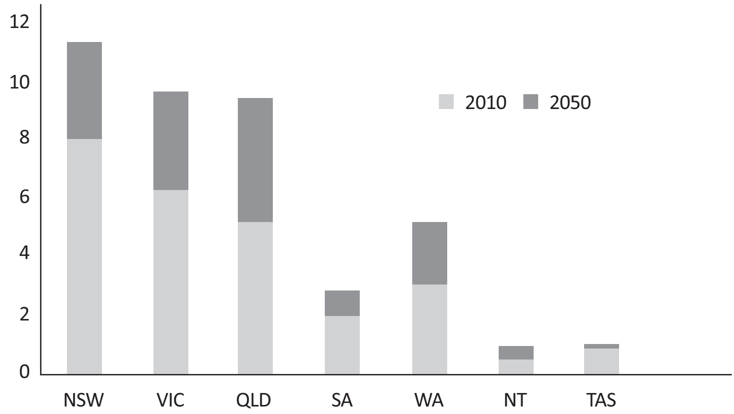


Photo: Brisbane City, QLD

Anticipated population growth to 2050



Source: ABS

Supply

OK, so now you understand demand and how it is created. You have also determined that the four major states are going to provide that demand both now and right out to 2050. So, let's go back to our economic equation.

Increase in demand of a product + decrease in supply of that product = increase in price of the product.

According to the equation, if we can couple demand (population growth) with a decrease or undersupply of property, we can be reasonably sure we are going to get some price growth. Undersupply is quite simply not enough new houses getting built to keep up with demand. The difference is what is referred to as a 'dwelling supply gap'. The greater the gap, generally speaking, the bigger the gain and the more poised growth is to happen.

Determining where there is a restriction in supply of new houses is

Supply

It is not as easy to find the figures for supply of housing as it is for population growth. A couple of good sources that I like to use are the Housing Industry Association (HIA) and also BIS Schrapnel. They each release reports on this on a quarterly basis that highlight the current supplies and new starts of property around Australia. The now defunct Housing Supply Council of Australia was also an excellent source of data.

Remember, you need to be coupling increasing demand and reducing supply. Another, simpler indicator I like to use to determine supply is to look at

1. Vacancy Rates
2. Rental Yields

Vacancy rates

High vacancy rates indicate that there is an excess supply of property. Anything above 5% would be considered high. Low vacancy rates on the other hand indicate a tightly held market where there are not enough houses to go around.

The table next page shows the current vacancy rates across the Australian capital cities for May 2022.

From the table we can determine that all capitals with the exception of Sydney and Melbourne have vacancy rates below 1%. These are the cities I would be earmarking as having a low supply. These would warrant further investigation for investment.

Rental Yields

Rental yield is inversely correlated with vacancy rates. The lower the vacancy rate, the higher the rental yield.

VACANCY RATES MAY 2022

Sydney	1.40%
Melbourne	1.60%
Brisbane	0.60%
Perth	0.60%
Adelaide	0.30%
Hobart	0.40%
Canberra	0.70%
Darwin	0.50%

RENTAL YIELD MAY 2022

Sydney	2.60%
Melbourne	2.90%
Brisbane	4%
Perth	4.40%
Adelaide	3.70%
Hobart	3.70%
Canberra	3.80%
Darwin	6%

Ideally, when selecting location, you want LOW Vacancy Rates and HIGH Yield.

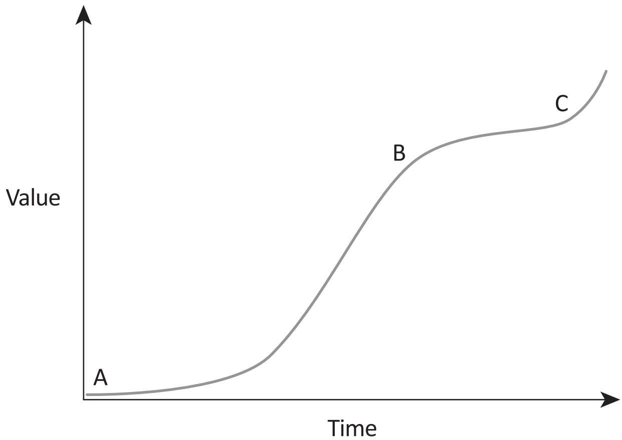
Property cycles

These rules of supply vs demand and dwelling supply gap are how property cycles are created. It is important to know that property does cycle. While residential property in Australia has a longer term growth rate of 8% to 10% per year, it does not grow at exactly that rate every year. That 8% to 10% is a long-term average. What happens with property is that some years you may get a 15% to 20% growth rate and other years you will get no growth. The diagram opposite represents these cycles.

The full cycle, from A to C on the graph, generally takes around eight to ten years. As you know, property doubles in value around every eight to ten years. These times can vary a little but history shows this to be the case.

It is important to know and understand that property does cycle.

Property growth cycle

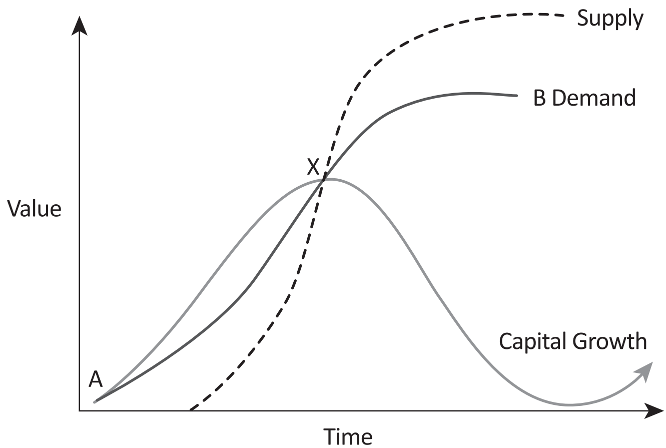


If you know that property cycles then you know that if you buy a property at say point B on the graph, you are not upset when in four years' time your property really has not risen in value at all. So it makes sense to try and pick point A or C to invest – right before, or in the very early stages, of the next upward cycle. After all, that is what you want, isn't it? You want capital growth to be able to springboard you into your next property?

Wouldn't it be great to be able to predict the next upward cycle? Well, in a very loose sort of way you can. It is very hard to accurately predict the top or the bottom of the market and also hard to predict when the market will make its next surge. However, there are certain indicators that allow us to do that. Once again, it's going back to basic economics: supply vs demand.

The diagram overleaf is a blow-up of the one above but focusing on points from A to B.

The relationship between demand, supply and capital growth



The heavy continuous line represents demand. The dotted line represents supply and the thin continuous line represents the capital growth rate as a percentage. In order for the growth to start, supply needs to be less than demand. This means that the market is in a state of 'undersupply' or in other words there is a dwelling supply gap. When the market gets into this undersupply state, values start to increase. When values start to increase, that in turn also increases demand because people can see the capital values going up so more investors try to get into the market. The smart investors get in very early in the cycle and buy and hold.

Remember this, while investors are getting into the market and driving values up, so are builders and developers and they drive values down by creating more supply. Developers want to get their share and bring as much stock onto the market as they can and cash in on the rising market. So that is exactly what they do. Flood the market with new stock. This is where you can see the dotted line starting to rise.

What then happens is developers bring so much new stock onto the market they eventually flood it and the supply line will cross the demand line on the way back down. At this crossover point, when there is a supply and demand equilibrium, the market will steady and start to slow and the capital growth rate will also pull back. Smart investors will see this coming and put a halt on buying. They won't necessarily sell because if they are smart they will hang on for the long term and get more cycles out of the property.

With investors not buying anymore, demand will drop. Supply will then exceed demand. When supply exceeds demand, (there is no more dwelling supply gap), the values will no longer increase and there could even be a small correction depending on the variance of these two lines. If there is a correction the capital growth rate will drop below zero.

The funny thing is, the sheep investors who don't know what they are doing see everyone else making money and want a piece of it. This is when greed kicks. This generally happens right about Point X when supply is just starting to exceed demand. Greedy investors are always too late. They have procrastinated and been too fearful to get into the market but finally they decide they don't want to miss out. The greedy/sheep investors will push the market values up a little higher, then once the supply has exceeded demand and the capital growth stops, they wonder what happened. Then they tell everyone that property "just doesn't work".

The trick with all this is to know what is happening with the cycles. To do this you need to keep up to date with supply and demand and buy in a market which is beginning its next cycle and is buoyant.

Property prices will rise over time

A lot of people like to say that the capital growth in property has finished. That it was all due to this or that, that happened in the past and it will never happen again. That is absolute rubbish. Property prices will continue to increase over time – especially when you look at the increase in population that Australia is experiencing and the lack of new house starts.

The table below proves the historical increase in values of median house prices in the various capital cities. As you can see, the median house price has consistently doubled in value about every 10 years. Who would have thought right back in 1980, when Sydney's median house price was $64,800, that it would eventually be $1,600,000? I think if you had told people that they would have thought you were mad. When I wrote in my last edition that the median house price across Australia will hit $1 million at some stage – people said I was crazy. Now look, Australia's median house price is over $1m.

Historical increases in median property prices ($)

City	1980	1990	2000	2010	2015	2022
Adelaide	6,600	99000	132,000	405,000	418,000	731,547
Brisbane	34,500	108,000	185,000	455,000	470,000	792,065
Canberra	39,700	119,000	175,000	549,647	535,000	1,178,000
Darwin	n/a	95,500	190,400	576,125	621,000	583,750
Hobart	n/a	89,000	129,500	318,119	380,000	752,110
Melbourne	40,800	140,000	241,000	549,980	658,000	1,100,000
Perth	40,000	101,000	171,800	519,526	535,000	622,000
Sydney	64,800	185,000	308,000	609,500	811,000	1,600,000

Australia's Median House Price: 1,033,000

The next table is also great proof of the increase in average growth rates of residential property over different decades. Once again, the claim that property has around an 8% to 10% growth rate in the longer term certainly holds true. While no one has a crystal-ball, I will let you make your own assumptions as to whether residential property is going to continue showing strong capital growth. My vote is YES!

Historical % growth rates in residential property

City	1970s	1980s	1990s	2000s
Adelaide	n/a	8.3 %	6.9 %	15%
Brisbane	11%	9.7 %	8.1 %	14%
Canberra	n/a	9.1 %	7.5 %	15%
Darwin	n/a	6.3 %	7.4 %	8 %
Hobart	n/a	n/a	8 %	15%
Melbourne	10%	9.1 %	6.6 %	8.5 %
Perth	9.3 %	9.6 %	7.5 %	12%
Sydney	9.8 %	8.5 %	6.8 %	9.9 %

Ok. Let's recap on our steps so far:

- **Step 1. Type of property.** We have looked at various types of property and have determined that to build a property portfolio we need to buy residential property. To be more specific we need to buy houses or townhouses for their land content.
- **Step 2. What state of Australia** (location and the macros or big picture). There are a lot of places where we can buy that house or townhouse, so we need to divide Australia up into its different states and determine which of these is buoyant. We do this by looking at both the supply and demand of residential property in each of the states and determining which has an undersupply, compared with where demand is creating a dwelling supply gap.

Micros

Now let's move onto Step 3. Don't forget, we are still using our method of deduction and we have identified the states that we want to invest in. are Qld, NSW and WA. But where within those states do we need to be looking and what is going to create a good location from a micros perspective? Remember, micros means the little picture point of view.

When working out what is going to make a good location, it is really just common sense and once again you can't get emotional about it. Here are some points that I have always used when expanding my portfolio. These will help you find the right location that is not only going to give you sustained capital growth but also give you a safe and stress-free asset.

You need to choose property close to:

- Places of employment
- Transport
- Schools
- Shops
- Recreational facilities.

Let's take a closer look at each of these.

Employment

Employment is probably the most important thing. You cannot survive without money these days and to get money you need to work. Tenants will definitely need money to be able to pay you rent so you need to be near employment – not just employment, but multiple employment streams. (This rules out mining towns which

I have never been a big fan of.) The problem with rural, and in particular, mining towns, is they often rely totally on one employment stream, e.g. the mine that the town is built near. If that mine slows up in production or shuts down altogether, then there goes all the employment in the area. When there is no employment, people will move to find more work. That means excess housing supply which leads to vacancies.

I have seen this happen many times. One case in particular springs to mind. BHP spent $2.2 billion building a nickel mine in Ravensthorpe in the south of Western Australia. Anticipating huge gains and rents, many people built investment properties around the mine to house the workers. The issue with the mine was that the price of nickel dropped heavily just a year after the mine was open. In January 2009, BHP decided it was not worth keeping the mine open and closed it. This led to $3.6 billion in write-downs for BHP. Not only that, 1,800 employees lost their jobs. You can only imagine what that did to the local economy! The majority of the town was left vacant and all investors lost huge amounts of money. Although I was not involved and none of my clients had invested in that area, I watched it from a distance and it served as a great reminder about how multiple income streams are so important.

If you want multiple income streams, you are best to stick to the capital cities. That is where the work is and that is where the population is growing. This will give you the best long-term capital growth and also provide you with a safe investment. You don't necessarily need to be 5 km from the CBD (because you will pay too much) but try to find property within a reasonable distance. This will vary from capital city to capital city and also depend upon your budget. The median house price of the city will be a good indicator of how far out you should be.

Transport

Access to transport is very important. Tenants need to be able to get around town whether it be to work, to take the kids to school or just socialise. While proximity to trains is an obvious plus, any type of public transport helps. Bus-ways and also access to major arterial roads is also important. When buying, I personally like to be within 3km of either a train station or bus route and within 4km of a major arterial road.

Schools

Your property does not need to back onto a school but it does have to be within a reasonable distance, which I would consider 5km. You need to remember the type of property that you are investing in (houses or townhouses) will generally have three to four bedrooms. That means that it will attract families. Families have kids and kids need to go to school. So don't be too far away from schools.

Shops

Shops are just an amenity that people need. If you can be within a reasonable distance of shops, preferably a major shopping centre, you will have a more attractive property. These areas tend to have café precincts within them too.

Recreational facilities

A tenant with active children will be grateful for being close to things like parks, football grounds and other facilities for children and adults alike. It will make life easier for them.

* * * *

Before we leave this discussion on macros and micros there are two more things to consider:

- The level of rental properties in your suburb
- Capital bechmarks

The level of rental properties in your suburb

Looking at the level of rental properties in the area where you are looking to invest, brings us back to the discussion on that magical economic equation of supply vs demand.

You have to make sure that there are not too many rental properties in your suburb so that you are not competing against too many other investors for rent. Too many rental properties available will mean that tenants are spoilt for choice. Too much choice means that rents will not increase as fast as they should. I try to make sure that the number of owner-occupiers (i.e. people who own and live in that house) in my suburb is no less than 65%. This means that I am not competing against too many others for rent, and it also gives me security in my property's value.

Let me explain.

If you purchase in an area that is made up of 80% investors – as is the case in some of the mining towns around – and the property market gets smashed for some reason (it could be the GFC, interest rates, whatever), what will then happen is all the investors start to sell up because they don't want to lose their money. When people start to sell *en masse* and more properties come onto the market, you know what happens next. Supply overtakes demand and prices drop. If I invest in an area where the majority of people are owner-occupiers and the market gets hammered, I can rest easy, because owner-occupiers will stay where they are and won't sell. That is where they live. Therefore, the value of my property is safeguarded.

Capital benchmarks

No doubt you have heard the saying: "Buy the worst house in the best street". This conjures up an image of buying a dump in a nice street. Well, this may be a popular remark but it's not really great advice.

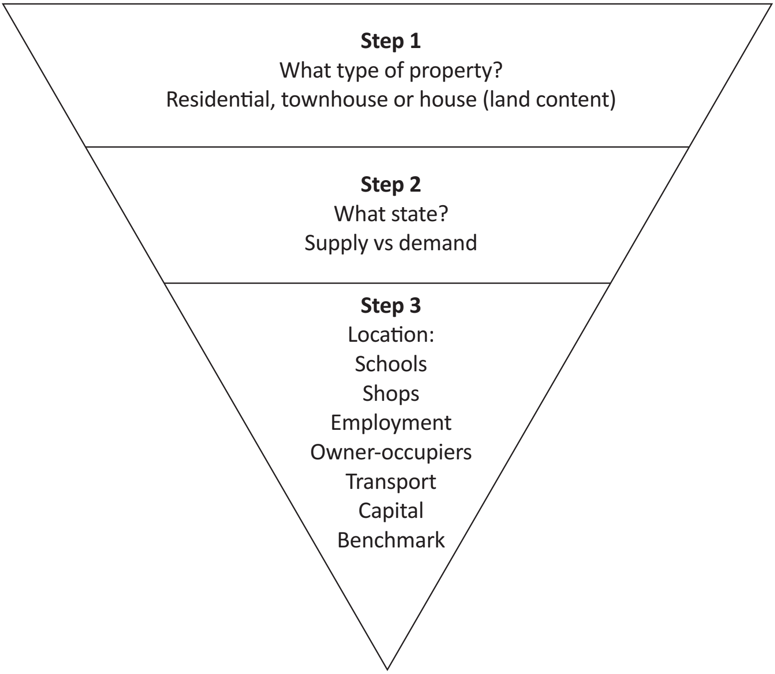
Better advice is not to buy the most expensive house in the street, but to buy something standard, particularly if you can see that other people in your suburb have spent double on their property than what you have spent on yours.

The house that is worth twice what you have paid for yours is called the 'capital benchmark'.

Your house and the capital benchmark house have a common denominator and that is the land. You have both paid the same dollar/m^2 for land, but capital benchmark house-owners have spent loads more on their house. What this does is sets the benchmark for the suburb and drags your property upwards in value.

Congratulations! You have now been able to identify the right property, in the right location, that is going to give you the best chance of capital growth using our three step method of deduction.

The 3-step method of deduction



Chapter 9

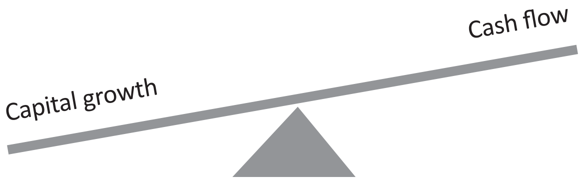
CASH FLOW

So far we have used the three step method of deduction to determine the right property in the right location that will give us maximum capital growth. Capital growth is our main aim when purchasing property, because that is what creates wealth. Going back to our original strategy, we wanted to take capital growth one step further and get compound growth. That means investing in multiple properties. In order to hold multiple properties, you will need sufficient cash flow to be able to fund them all and keep everything afloat.

If all that you wanted to do was to get maximum capital growth, you would just buy land, because land is where the capital growth comes from. However, that strategy is flawed because land does not produce any cash flow. So while you may own one piece of land, you can never achieve compound growth because you will have limited cash flow.

While you are focused on capital growth, there needs to be a balance with cash flow. Many a developer and land speculator has come unstuck due to lack of cash flow from land. It's like being in the clutches of a huge python, the lack of cash flow just slowly restricts breathing until it is cut off altogether and you go under.

Balance between capital growth and cash flow



Let's take a look at cash flow now and see how you can maximise it by careful property selection. There are three things that affect the cash flow from a property:

- Rent
- Tax deductions
- Maintenance costs.

The impact of these can depend on property selection.

You may argue that interest rates affect your cash flow too. However, you cannot change this no matter what type of property you select. Property selection does not influence how much interest you pay on your loan. Whether you are buying a new unit in the city or an old house in the suburbs that needs a renovation, you will pay the same interest rate – unless you start to get into commercial property or developing, in which case you will then pay more interest.

So let's stick with the three things that affect your cash flows that can be influenced by your property selection.

Rent

Don't ever buy a property that is not going to give you some sort of rental income. Seems pretty obvious and pretty simple, but it is amazing how many people stuff this up. They generally do it with land speculation. When the Western Australian property boom was on from 2003 to 2007, I saw so many people speculate on land. While the land went up in value, people who had just purchased land alone, and not built a house on it, were stuck with that one piece of land and could not buy any more. Their finance was tied up in that one block of land and because the land did not create rent, they were unable to finance another property. Whereas those investors who purchased houses or bought land and built houses on it, did much better. They were able to use the increases in rent and equity to finance themselves into their next property.

OK, so now you know not to buy a property that won't produce rent. But what type of property will maximise your rents? In order to explain that, you need to take a closer look at the rental market.

Remember this, 33% of Australians rent permanently. Out of that 33% of people who rent permanently, approximately 90% of those people are in the lower- to middle-income bracket. Think about that statistic for a moment. What does that tell you? It tells you that you should be providing property for the lower-income bracket tenant. That way, you will have more potential customers. Easy!

So if you go to your broker and they advise you that you have $2million in borrowing capacity, are you going to buy a $2 million house? No way. If you spend $2 million on a house you have greatly reduced the potential rental pool for your property.

The smarter option is to split the borrowing capacity in two and buy two $1million properties. This will ensure that your property has less vacancy periods because you have more people who can afford to rent it. The yield on your property will also be better. The more expensive your property is, the less yield you will receive.

For example, a $750,000 property may give you rent of between $650 and $700 per week but a $2 million property probably will not give you $1,800 per week. Another thing to consider is that if you decide to sell that property at a later stage, if you have purchased somewhere around or below the median house price of the city, rest assured the majority of people will be able to afford to buy it. This is the reason why the median house price of capital cities never crashes. It may come off the boil by a maximum of 5% but never more. Whereas your high-end property ($3 million-plus houses) can reduce in value 30% to 40% without much problem.

Another point to be mindful of is, don't be greedy when it comes to rents. People are renting generally because they can't afford to buy, therefore they are going to be very price-conscious. If there are five properties for rent in your area and they each are advertised at $450 per week, why wouldn't you advertise yours at $440? Whose property do you think potential tenants are going to go for? Yours, of course. Isn't it better to lose $10 a week over the space of six months (which is $260) rather than go two weeks without a tenant (losing $900). It's an easy choice to make.

Tax deductions

Tax deductions make up a huge part of cash flow from property investing. Many investors don't realise this and miss out. In order for you to maximise tax deductions, you first need to understand what negative gearing is.

Negative gearing

Negative gearing is quite simply when the expenses of the investment property are greater than the income from that property and so the net situation is a loss. The loss that is created can be used to reduce your personal taxable income and as a consequence the amount of tax that you will pay:

Income (rent) – expenses (cash and non-cash)
= negative gearing amount

The key thing with negative gearing is that the expenses that you are able to use to reduce your tax do not necessarily have to be expenses that you have to pay for. Sound strange? Let me explain.

It's clever accounting. These items are called "non-cash items" or "Book entries". They don't cost you anything but you are still able to claim them as a tax deduction. Great! The non-cash items are mainly made up of depreciation. If you are a property investor you need to know what depreciation is. Depreciation is the devaluing of an asset over time. For example, when you buy a car, you keep it for a few years and when you go to sell that car again it is worth less than you paid for it. This concept is depreciation. Just as the value of your car goes down (i.e. depreciates) in value, so does your property. It is important to note that it is only the house (the building) that decreases in value, not the land. The land is actually increasing in value (appreciating) while the house decreases in value (depreciates). Therefore we can only claim depreciation on the "house" part of the property, not the total value of the house and land.

This also serves as a good reminder of the importance of land content when buying your investment property. If you buy an apartment with 90% of its value in the building and not the land then you will have 90% of the value of your asset going backwards in value from depreciation – is it any wonder units don't perform as well as houses?

When calculating the amount of depreciation that you are able to claim from your property there are a few things you need to know.

1. The age of the property

If you have purchased a property that was built before 20th September 1985, then you are not entitled to claim any depreciation on the structure of that asset. The reason that this date is so important is that is when capital gains tax (CGT) was introduced in Australia (more on CGT later). Therefore, don't buy anything pre-20th September 1985.

2. The value of the fixtures and fittings

Fixtures and fittings provide a major part of the depreciation for a house. They include things like ovens, air-conditioners, cook tops, hot water systems, etc. All the items have different and individual taxable lives, according to the ATO, which generally range from around two to ten years as an "effective tax life". So to average it out, for estimation, we look at a tax life of around five years across all fittings. To find out accurately how much depreciation you are entitled to claim, you will need to use the services of a quantity surveyor. A quantity surveyor provides you with a depreciation report which your accountant will use to prepare your tax return. There are a few different methods that you are allowed to use to depreciate your fixtures and fittings. The two main methods are the "diminishing value" method and the "straight line" method. The most popular method is the diminishing value method. This is when the amount claimed is inflated in the first few years, and then tapers off in the later years. This allows greater deductions up-front when most people want them. The straight line method is where the asset is written off in equal amounts over the specified timeframe.

3. The value of the structure

The structure of your investment property has a taxable life of 40 years and must be written off via the straight line method. Remember that anything built before 20th of September 1985 will not be allowed to be depreciated. Let's look at an example.

EXAMPLE

Let's say that you have just built a brand new house as an investment. The property cost you $230,000 to build. It is made up of the following:

Asset	Value	Average life	Deduction
Fixtures and Fittings	$30,000	5 years	$6,000
Structure	$200,000	40 years	$5,000
Total	$230,000		$11,000

Two different parts of the property make up its value: $30,000 for fixtures and fittings, then another $200,000 for the structure. The allowable amount to be deducted is $6,000 and $5,000 each year from depreciation. That is a non-cash deduction of $11,000 in total.

Think about that for a moment.

You are getting a deduction of $11,000 for no cash outlay at all. You do not have to spend money on interest, or repairs or anything to get that deduction. It is just a straight out deduction from an asset that is going up in value. If you are lucky enough to be on a tax rate of 47% that is the equivalent of $5,170 back each year in cash! Or to look at it another way, the government is giving almost $100 per week in cash to keep down the costs of owning that property. If you are on a tax rate of 30% then you get $3,300 back per year.

You can see that depreciation has a huge effect on how much your property is going to cost you to hold. That is why it is so important. The above is a great example and highlights the importance of buying a new property. People buy old places and think they are getting a bargain. This is not the case. They have this idea that it doesn't matter if they buy an old place, "it's just for tenants", they think. That is the wrong way to think on a number of different levels. Firstly, have a terrible house and you will generally attract a lower standard of tenant. Secondly, you are missing out on too much depreciation.

Developing the example in the table above, let's assume the property is brand new and we compare it to a house that is 10 years old.

Firstly, all the fixtures and fittings would be written off after 10 years or have very little value. Therefore, there is $30,000 that you have missed out on. Secondly, the structure is also written back 10 years so you have lost 10 x $5,000 = $50,000.

So you have missed out on around $80,000 of depreciation, just because you purchased something that is 10 years old. If you are on a tax rate of 47%, that is $37,600 in actual cash lost. If you are on the 30% tax rate, you have lost $24,000. This is serious money we are talking about and this depreciation can be the difference between owning one house or owning three houses.

This is why I am a big believer in buying new. It will not only give you so much more depreciation, it will allow you to set higher rents so that you are able to hold more property. It amazes me that some investors don't know about it.

Further Note regarding Depreciation

Since my last edition of the book, the laws around taxation were changed to disallow most of the depreciation allowed to be claimed on an investment property. This came into effect into effect on 9th of May 2017. The idea behind the change was to stop investors buying from the pool of established properties because they have such an unfair advantage over owner occupiers. This change in tax law makes it very expensive for an investor to hold a second hand/ established property because they are not entitled to the depreciation deductions that they were formally. I would strongly advise against second hand property for a buy and hold strategy based on the cost of doing so.

Further tax deductions

Lenders Mortgage Insurance, Interest payments, Rates, Insurance, Maintenance, Agents' management commission, Letting fees, Pest control and Body corporate levies.

Negative gearing statement of accounts

Let's go back to the discussion on negative gearing, now that we understand non-cash items or on-paper deductions. Overleaf is an easy example of a profit and loss statement for a negatively-geared property.

Example profit and loss statement

INCOME		
Rent (52 weeks x $450pw)		$23,400
EXPENSES		
Council rates	$2,000	
Insurance	$1,050	
Interest on loan	$22,500	
Property management fees	$1,872	
Maintenance	$443	
Sundry expenses	$215	
Total cash expenses	($28,080)	
Net profit/(loss) before non–cash items (pre-tax cash flow)	($4,680)	
Depreciation	$11,500	
Lenders Mortgage Insurance (LMI)	$2,500	
Total non – cash expenses		($14,000)
Net profit/ (loss)		($18,680)

This means that this property is negatively geared to the tune of $18,680. But remember this: $14,000 of that negative gearing loss you have created is from the non-cash items – depreciation and LMI. You haven't actually had to spend the $14,000 to claim it.

Let's look at the tax implications of owning the above property based on the assumption that you are on a 30% tax rate. If this is the case, the property has only cost you $4,680 to hold for the year. That is the pre-tax, cash flow amount. That is the equivalent to $90 per week. However, you are saving $5,604 in tax or saving $108 per week in tax. Therefore, although the property is negatively geared it is cash flow positive. Great, isn't it?

Also, think back. Your main focus is the capital growth of the property. So let's assume for a moment that this property is valued at $500,000 and goes up by 8%. That means that you have made $40,000 plus the property has been cash flow positive for you ($5,604 – $4,680 = $924).

Simple, isn't it? It is simple when you understand it and you have a system set up that works. Most people go out and buy an old property because they think they are getting a bargain. They can't claim any depreciation on it and the rent is low so it has a poor cash flow. Not only that, they get hit with big maintenance bills which puts an end to their cash flow. They wonder why they can never afford to get a second property and think that the notion of owning several properties is false.

That brings us to our next cash flow item that you need to control.

Maintenance

Maintenance costs cover anything from hot water systems blowing up, to tiles cracking on the roof, to the plumbing going. These are just a few maintenance issues that can come up with properties. Yes, the cost you pay to get them fixed is tax deductible but they are out-of-pocket expenses. It doesn't make sense to spend a dollar to save 30 cents in tax. Crazy!!

Maintenance is a thing that you want to avoid at all costs. It is just cash out and does not add any value to the house. I have owned plenty of old properties in my time and speaking from experience, they are nothing but headaches. The best way to avoid maintenance issues is just to buy new property. This is especially true when you are buying interstate. I own property all over Australia, even as far as Perth, and provided they are new houses, I never have a problem.

In fact, I like to go a step further and have my properties built for me. That way they are designed for the modern way of living and everything is covered under a builders' warranty so I don't have any maintenance issues at all.

Insurance

Insurance is a necessary cost of investing. It is tax deductible and essential. You have to be insured or else you run a huge risk. Insurance is all about managing your cash flow because cash flow is the thing that you just can't be without when building up a property portfolio. If your rental property burns down and you don't have rental income this can spell disaster. If you get sick or injured and can't work, there's no cash flow. Once again, disaster.

There are a few different types of insurances that you will need to consider when owning and buying investment property.

Building and contents cover

This will cover you in the event that the house burns down or is damaged in some way. It is a vital insurance for obvious reasons. If your investment property burns down and you are not insured, unfortunately you will still have the debt that you need to pay to the bank but you are not getting any rent to pay that debt. The consequences are not good, as you can well imagine. What you will be surprised about, though, is how much cheaper your insurance for your rental property will be compared to your own home. This is because the rental property will have very little contents that can be damaged or stolen – the tenants have to insure their own furniture and belongings. The contents you will be insuring will be just the basic things like carpets and light fittings, etc.

Public liability

In today's litigious age, you need to be insured against people making a claim because they slipped over in your backyard or tripped down the stairs. Your public liability insurance is nothing to worry too much about as it is generally covered under the same policy as your building and contents – just check to make sure you are covered for at least $10 million.

Landlord protection insurance

A lot of people who I have met who own investment properties don't have landlord protection insurance. Many don't even know about it. However, it is a must. I insist that all my clients take it out. Landlord protection insurance will protect you against rogue tenants. If a tenant were to skip their lease then you could make a claim for the loss of rent. If the tenant were to trash the house and leave, then you would be covered for the damage and loss of rents as well. Rogue tenants are very, very rare. In fact, I have never had anyone trash one of my properties. I have just had one fellow who we had to evict due to a relationship break-up with his girlfriend and he couldn't keep the rent up. While rogue tenants are rare, you still need to be covered in the event it does happen. Landlord protection insurance is relatively inexpensive (only a maximum of a few hundred dollars). Make sure that you check the policy and you are covered for all eventualities.

Personal insurance

This is insurance that covers you personally. Once you start to build a property portfolio your level of assets will rise, and so will your level of debt. If you were to get sick and unable to work, then you would not be able to continue making interest repayments. If you die and are not covered the financial heartache gets passed onto those you leave behind.

There are a few different types of personal insurance, all just as important as one another. With all of these types of insurances, there are different levels of cover that you can get so it is important that you consult with a suitably qualified professional to determine what is right for you.

- **Income protection insurance.** Income protection insurance will cover you if you get sick or injured and are unable to work. This will generally cover you for around 75% of your wages but this can be increased. This insurance premium is tax-deductible to you.
- **Total and Permanent Disability (TPD).** If you were left with a lifelong disability and were unable to work again, TPD cover would pay you a lump sum to help you financially. This generally covers modifying your home so that you are able to live and may pay down some debts, depending on the level of cover.
- **Trauma cover.** Trauma cover will pay you a lump sum in an event defined on the policy. The policy is not intended to replace health insurance but to ease the burden financially if one of these events did occur.
- **Life insurance.** You may be thinking that if you die well then "what the hell, I'll be dead, it won't bother me!" That is true, but imagine leaving your wife or husband and children with huge debts that they can't handle and the huge burden of taking care of the portfolio of properties that you have worked so hard to build. You need to be covered in the event of your

death. Your debts will be paid out and your family will be able to live comfortably in financial security knowing that you took care of them.

Summary

In order to maximise your tax deductions from property you need to do the following:

- **Buy new.** This will maximise your rents, non-cash tax deductions (depreciation) and will keep your maintenance costs low.
- **Make sure you buy property around the median house price of the city**, not in the top bracket. This will ensure a greater pool of potential tenants and future buyers.
- **Take out interest-only loans** on your investment properties.

15 big mistakes property investors make

I'd like to share with you here the biggest mistakes I have seen property investors make over the years.

1. Buying old property thinking it's a bargain

Buying old is the wrong thing to do. The problem with old property is that it will impact on your cash flow too much because the rent you can charge is low, the depreciation is low and the maintenance is high. Everything is the wrong way around.

2. Buying in your own suburb

Just because you live there doesn't mean it is a great place to invest in. You need to do the research and go where the growth is. Look for a growing population and undersupply of property. The idea that because your property is close you can keep an eye on it is crazy. If it is close, it can often be a problem because you always want to drive past and have a look. There's no excuse to invest close to home so that you can do the maintenance yourself because if you are buying new then maintenance will not be an issue.

3. Buying a high-rise unit

As discussed, the growth in property is driven by the land. You need to determine what the land content of a property is. High-rise apartments might only have 5% to 10% land content. This means that the major part of the asset is going backwards in value. High rise apartments are not good growth assets. Even though they may be very emotionally appealing.

4. Selling property

If the aim is to achieve compound growth and build an asset base of multiple properties, how can selling be part of that? If you buy the right asset to start with, then there will be no need to sell. Just buy and hold. Buy and hold. I always hear people say, "I wish I had held onto that property. It's worth so and so now". There are limited circumstances when you should sell and I will cover those in the next chapter.

5. Keep your own home as an investment

This is one of the biggest drop balls, flops or mistakes, (call it what you like). I said there are limited circumstances when you must sell a property and this is one of those. The problem is that people hold onto their old home and think as they owe very little on it, it will be a great investment because it will bring in cash. Not true. What ends up happening is that the income the property is creating gets taxed and you end up with a very small tax deductible debt and a very large non tax-deductible debt on the new home. This is exactly opposite to what you want. Do not keep your old home as an investment.

6. Procrastinating

There is a saying in property, "The best time to buy a property is yesterday. The second best time is today." What this means is that property in Australia will continue to increase in value. The longer you leave it, the more you are going to pay. Don't procrastinate and try and pick the bottom of the market. Rarely will you get it right. If you are hanging onto it for the long term, you will always make money. Procrastination is really just fear stalking you.

7. Focusing on rent and not growth

If the goal is to build wealth then you must be focused on capital growth, i.e. the value of the property increasing. The rent (like deductions) is just a by-product of investing that allows you to hang onto that property as cheaply as possible while the value goes up.

8. Buying regional

You must be very careful when buying regional property. It can be very risky as most regional towns tend to rely on one type of employment stream. If that employment stream diminishes, then the population will decrease as people leave in search of another job. When population decreases there is less demand. Less demand means a drop in rents and property values.

9. Taking advice from unqualified people

You would not take medical advice from someone who watches

MASH or ER would you? Then why take advice from a similar unqualified person on investing? Taking property advice from someone who was a used car salesman the month before selling you a property is a recipe for disaster.

Likewise, taking advice from friends and family who don't own a large property portfolio is also the wrong thing to do. Be very careful of the armchair experts.

10. Buying emotionally

Buying with your heart and not with your head is a sure-fire way to lose money. People get too caught up with the thought that their investment property is actually for them to live in. It's not. It is simply a vessel that allows them to grow their wealth. The most important thing is that the numbers are right.

11. Not setting goals

It's very hard to achieve what it is that you want if you don't even know what it is you want! You must have a clearly-defined set of goals if you are going to achieve anything. Look at any leaders in their field. I guarantee you they will be goal-setters.

12. Not doing your homework

You must do your due diligence before buying an investment property. If you just buy something that you think is a good investment, it may come back to bite you later. What is the demand in the area like? What is the supply like? How many investors are in that area? Sounds like hard work? Yes, it is. If you don't have time to do the homework, then pay a suitably qualified person who you trust to do it for you.

13. Renovating

People have this false idea that there is a huge amount of profit to be made out of renovating. Nine times out of ten, investors lose money on renovations. A great example is a property down the road from my home. The guy purchased the property for $1.7m and spent $700,000 on renovations. Once complete the property was amazing. It owed him (not including purchasing costs) $2.4m. The property was sold after he had held it for a number of years for $1.8m. That is a loss of $600,000. This is just one of many examples I have seen of people losing money on renovations.

The problem with renovations is that both the costs and the amount of work needed are always underestimated. When costs blow out, it is very hard to recover those outlays. Even worse is when the timeframe blow outs. If the property is worth $500pw in rent, then every month that you have the property off the rental market you are losing $2,000. Investors often forget to take those costs into consideration when calculating their budgets. Renovating may be OK when it's your own home and you don't have time constraints. You can plod along and do the work yourself at your own pace but when it comes to an investment property, just stay away from it.

14. Being underinsured

In order to reduce your risk you need to be insured. You would not drive around in your car without being insured and your investment property is no different at all. If you are not insured and something happens, it will cost you much more than your premiums. Not only should your property be insured, you should be insured personally. If something were to happen to your health, you may not be able to work and you run the risk of massive cash flow issues. Cash flow issues lead to interest repayments not being made and that is what sends people broke.

15. Not using a property manager

The legislation is very exact when it comes to dealing with tenants and it protects their rights. Once the tenants have leased the property from you, you can't just march onto the property and give them a dressing down if the lawns are not mowed. If they miss a week's rent, you can't just kick them out. You need to know the legislation intimately. This is where a property manager is worth their weight in gold. They know the exact timeframes when they can issue notices to tenants and the legalities of the whole thing. Use a property manager because they can save you thousands further down the track.

Chapter 10
EXIT STRATEGIES – WHAT HAPPENS IN THE END?

To understand exit strategies, we need to go back to the different phases of investment that we covered in chapter three:

- Accumulation
- Holding
- Harvesting.

Your exit strategy is part of the harvesting process. There are two different methods to harvest.

Living off rents

The first method of harvesting is living off the rents. If you have owned your properties for a significant period of time then the rents will have increased enough to be paying you an income that you are able to live off comfortably without having to do any further debt reduction. If the properties have not been held for long enough, then during the holding phase you should have switched from interest-only loans to principal and interest to slowly reduce the debts on the properties. This frees up more cash flow for income. In the event that you have not been able to reduce the debts on the properties by enough, then you will have to implement further debt reduction. This can be done by either of the following strategies or a combination of each:

Selling investment properties off to pay down debts

Sell off the oldest properties first. These are the ones that you will have already claimed depreciation on and may now start to have some maintenance issues with. You will have to pay capital gains tax on these sales but will be entitled to a 50% CGT discount if you have owned the properties for more than one year.

Selling your own home and downsizing and using excess funds to pay down investment debt

This is not an ideal solution as no one wants to be forced to sell their own home and downsize. However, it can sometimes be a great option if your children have left home and the family house is now too big for you. This option does have its advantages in that when you sell your home, the profit you make will not be subject to capital gains tax.

Drawing down a lump sum of superannuation to pay down debts

This can only be done at a certain age (at or close to retirement age).This is a great option and a pleasant surprise for those who went through life thinking that superannuation was just a waste of money. Drawing money from your fund can be a clever way to reduce the debts on your investment properties. The beauty about superannuation is that it can be potentially drawn out tax free and used for whatever purpose you like. (Although I would not advise blowing it on a fancy car if you have property debts!) As to whether you can draw the money out tax free is heavily dependent on your age and work status (you must consult a professional adviser on this strategy).

Drawing down equity to live on

This is the second method. It is a clever option and one not many people in their early stages of investment consider. This is the drawing down of capital (equity) to use as income. If your portfolio has seen significant growth in value but you have not reduced your debts enough, then this may be the strategy for you.

Let's assume that your portfolio by retirement age is worth $4 million but is carrying $2 million in debt (don't laugh – a house worth $500,000 today will be worth $1 million in ten years, based on average growth rates and you only need four of these!). The portfolio is not costing you anything to hold as rents cover debts and it may even be a little bit cash flow positive but still not enough to live on. You have equity of $2 million in your portfolio. This is a significant amount. Provided your debts remain the same, that equity is growing by $320,000 per year on average:

Value of portfolio X growth rate = Increase in equity
$4,000,000 X 8% = $320,000

What is even better is that this compounds and increases the following year:

New value after 8% growth = $4,320,000
$4,320,000 X 8% = $345,600

Can you see what's happening? Your equity or capital profit is growing faster each year. This is called compounding.

You are able to set up a Line of Credit against your portfolio to be able to draw down on some of that equity. Provided that you are not drawing down more than the equity growth, you will be able to do it forever. This is because you are never eating into your original capital and the equity is growing each year.

This is one of my favourite strategies because of its many benefits:

No capital gains tax (CGT) is payable

As you are not actually selling anything off, a CGT event has not taken place so you do not have to pay CGT.

No income tax is payable

It gets better still. Not only is there no CGT payable, there is no income tax payable on the $320,000 that you are able to spend. The reason for this is that it is capital that you are using as income so it can't be taxed. The only way that capital can be taxed is if a CGT event occurs, i.e. if you sell the asset.

Able to keep entire portfolio so no growth is missed

This is probably the best benefit of living off equity rather than selling. I hate selling assets and advise my clients never to sell because they will regret it later when they miss out on all the growth. If you sell when you retire at age 60, you will probably live for another 20 years at least. If you sell half of your portfolio to reduce the debt, let's say $2 million worth, then you could potentially miss out on

$8 million worth of growth in that 20-year period, assuming that property doubles every 10 years. What a waste that would be. Your kids would hate you!

More to pass onto beneficiaries when you die

Let's face it, everyone wants to leave a legacy and be remembered fondly. This is why wealthy people set up charities and make donations before they die. It is part of human nature that we want to be liked. What better thing to do than to leave your kids a portfolio of properties? If you start selling properties off then you are reducing the size of the portfolio that is left behind. So what if it has a bit of debt attached to it? How wonderful it would be if your parents had left you a property portfolio of $8 million with $2 million worth of debt attached to it! Thanks Mum and Dad!

Teaching your kids how to build weath

Almost as good as leaving your children a valuable property portfolio is educating them to invest for themselves. So before I leave you, I want to share with you my passion about teaching the next generation to manage money and build wealth. I believe these are the most important skills you can have.

Unfortunately, schools do not teach kids money-related skills. They certainly don't teach them how to build wealth and invest, not even how to budget. It just does not fit into the curriculum. I don't blame schools. They have enough to fit into their ever-growing curriculum already. Also, we must bear in mind that kids really are not at an age where they can understand those more complex investment ideas until they are towards the very end of their schooling when there is a limited amount of time.

So money management and investing are skills that we as parents must pass on – like brushing their teeth and tying up their shoes laces. I am not saying school is a waste of time. No way, not at all. It is very important. And it is important that kids work hard at it. It is a great place to learn, interact socially, learn different sports and also learn how to work hard and achieve. My kids work hard at school and I will be pushing them to get a higher education and attend university. However, when it comes to their learning about how to make money and investing, that is when I will take over as teacher.

Personally, I went to a very average school. There was not a lot of encouragement to do well and not many kids did. I did OK at school but I had to work very hard to get good grades because there were so many other distractions – sports, girls and having fun, just to name a few. I look back on it and never regret it and I am glad I worked hard as it has helped me my whole life. My education in investment and money management though was given to me outside of school. My teachers included my father and various mentors who I have had along the way.

Given that the majority of schools don't teach investing, it is up to you to teach your own kids. What better way than to teach by example. If the kids see Mum and Dad building a property portfolio of 10 properties then they are going to want to do that too. "Monkey see, Monkey do" they say.

Before they are at the age of being actually able to invest and fully understand what you are building, there are a few key concepts that you can teach them to get them started and begin to understand not only investing, but the value of money.

It is important to note that at different ages, different lessons are important and will be understood by your child. There's no point in trying to teach a five-year-old about compound growth and cash flow. They will get bored and just not understand.

What I will do is run through the different ages and highlight the sort of things that you can teach your kids at each of these ages.

Some points to note:

- You can never start too early. Researchers have said that your child has already formed their financial habits by seven years of age.
- Probably the most important lesson to learn is understanding the value of money and that you can't have everything you want, when you want it.

- Financial skills are just as important to kids as brushing their teeth.
- Kids feel a real sense of achievement when they have worked to earn money. This in turn creates a good work ethic and an appreciation of the value of money.
- Create real-life examples for them, such as when you are going to the shops together. These examples have the biggest impact on their development.

Age 3 – 6: The lesson – You can't have everything you want when you want it

Part of the problem with the overall economy now is the level of debt that your average Australian is carrying. A large portion of that debt is created by personal spending on unnecessary items that people just "want now" and don't necessarily need. Credit card debt is rampant throughout Australia and shows no signs of slowing down. This happens to be the hardest debt to get rid of because it carries the highest interest rates. Ask yourself:

- Is it necessary to have five flat screen TVs in the house?
- Do you really need the latest phone that has come out?
- Does your first car have to be a fancy one so that you can impress all your friends?

If you can teach your kids that they can't have everything that they want, when they want it, then you are half way there in their financial education. Making kids realise that you need to work and not to buy on credit is the cornerstone of their money-handling skills.

Some examples that you can use:

- When they see a new toy on TV or at the shops and ask if they can have it, explain to them that they will have to wait, as you do not have the money for that now and will need to save up to buy it. Waiting to have something is a great lesson.
- Pocket money. Have them do simple jobs around the house to earn pocket money. Keep a piggy bank or a record of how much they have earned so they can see that money accumulating.
- Set a simple financial goal for them, maybe to buy a new toy. Make it easy and obtainable so that they have the feeling of success. This will create that work/reward feeling.

Age 7 – 12: The lesson – You need to make choices on the best way to spend money so compare prices

Children often think that an ATM is just a hole in the wall where you get money. They don't understand that it has to be worked for initially and is not in endless supply. Kids need to learn that money is finite. What you spend on this item means less to spend on something else. At this age, you can now start to include your kids in some very simple financial decision-making and get them thinking about why you would spend money on one product over another. It is important to continue on with saving and goal-setting as well.

Some examples that you can use:

- When going to the supermarket, allow them to pick what type of juice you will buy. Explain to them that the generic, cheaper one may taste the same but is much cheaper and will save money.

- One I like to use is when taking the kids for an ice cream treat I will buy them a $1 cone from McDonald's even though they would rather a $6 ice-cream from Baskin Robbins. I explain to them that Mummy and Daddy are going to save money so we can go away on holidays.

Age 13 – 18: The lesson – Money comes from work

At this age it is important that kids have some type of job. Whether or not they are studying they should be working to get the things that they want. Obviously children at the lower end of that age bracket will need to get a job that suits their age and ability. The most important thing for them to learn is that things are not given, they are earned. Once a child realises how much work goes into earning $20 they will also learn to value money more.

While it is important to be working and studying, work hours should be limited to around 20 hours per week. Any more than this may affect study time and grades.

Some examples that you can use:

- For kids at the younger end of the age bracket, they may be limited to jobs around the house, such as washing the cars, mowing the lawns, laundry and house work. Something that suits their age and ability.
- As your child gets towards the later years of that age bracket, they may take on an external job. This will not only start to challenge that idea that all money comes from Mum and Dad but it will also start them realising what is expected in the wider workplace.

Ages 16 and upwards: Lesson 1 – The necessity to invest

Kids this age will be able to understand the concepts of investing and why you need to put something away, not only to buy things but for financial security.

You will notice there is an overlap between this age and the previous bracket. This is because it is really only at 16, when they are young adults, that they will be able to understand these more sophisticated concepts and to put them into practice.

Some examples that you can use:

- Explain the concept of compound growth. There are some very simple parables on the power of compound growth. Combine these with some mathematical examples.
- Explain to your kids how so few people retire wealthy and that most people retire poor because they don't start to invest early enough.
- Explain to and show them about what life is like retiring poor and how investing can provide financial freedom.

Lesson 2 – How to use credit effectively and safely

The very first lesson that you taught your kids should have been that they need to wait to get things that they want. This means being patient and saving up for things. What credit does is allow you to bypass that process and have things now. It is extremely important that at this stage you teach your kids about good and bad debt and why it is actually OK to incur good debt. They need to understand that money has a time-cost attached to it and this is called "interest". Show them how interest payable is calculated and how it can be reduced by certain habits like paying debt off early.

Explain to them that in order to get a loan they don't just go to the bank and ask. They will need both income and a deposit before the bank will lend them anything.

Some examples that you can use:

- Show them your home loan statement: what you owe, how much interest is paid each month and how much interest you have paid over the years.
- Explain to them and show them the LVR on your home.
- Give them this book and tell them to read it!

Afterword

Well that is about all I can teach you about building a property portfolio safely and effectively in under 200 pages. I hope that I have somewhat "enlightened" you about not only the "hows" of building wealth through property but more importantly the "need" to do it. It is now up to you to write the next chapter. You **can** do it. Set your goals. Motivate yourself and act to make those goals reality. And never ever give up until you have achieved what it is you have set out to do. Good luck.

The Rogers Property Group

Lucas Rogers is the keynote speaker for the Federal Government in their aim to educate the general public on property investment in order for them to become self funded retirees and become less of a burden on the welfare system. Alongside this he is also the guest speaker for many private organisations that aim to teach their clients and staff how to invest in property safely and correctly.

Lucas' business, The Rogers Property Group, educates its clients on how to build a property portfolio using clever but simple tax-effective strategies. Lucas' team shares the same passion that he does for property and outstanding client service.

If you would like to chat with Lucas or one of the team, either to organise an appointment for yourself to learn how you can achieve financial freedom through property or to book Lucas for a public speaking event then please call **1300 148 178**. Alternatively please send us an email at **info@rogerspropertygroup.com.au**.