



A Parent's Gift of Knowledge

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GOWDIE FAMILY WEALTH

Contents

Foreword	3
CHAPTER 1 The Keys to Build an Amazing Life	5
CHAPTER 2 The Power of Compound Interest	8
CHAPTER 3 Control Debt to Avoid ‘The Tail Wagging the Dog’	14
CHAPTER 4 The Best Investment You Can Make is in Yourself	33
CHAPTER 5 A Navigation Guide to the World of Investing	36
CHAPTER 6 Cash and Fixed Interest Investments	50
CHAPTER 7 Investing in Property	55
CHAPTER 8 Investing in Shares	61
CHAPTER 9 Commodities — The Earth’s Resources	72
CHAPTER 10 Emerging Markets — Enormous Opportunity for Your Generation	76
CHAPTER 11 Biotech and Energy Efficiency — The Other Big Trends	79
CHAPTER 12 Insurances — The Necessary Evil	82
CHAPTER 13 Estate Planning	91
CHAPTER 14 Inflation / Stagflation / Deflation — How the Various ‘ations’ Impact Your Investments	93
CHAPTER 15 Superannuation — The Pros and Cons	98
CHAPTER 16 Sources of Knowledge	101
CHAPTER 17 Be Aware of False Prophets	107
CHAPTER 18 Starting a Business	110
CHAPTER 19 Summary	117

Foreword

‘A book is a gift you can open again and again’

– Garrison Keillor

The inspiration for this book came from my wife Linda who suggested I should leave a legacy of knowledge to our three daughters – Alexandra, Emma and Grace.

None of us know how long our tenure on Earth is, so I wrote this book for the girls to use as a reference source in the event I was no longer here to have that one-on-one chat with them.

The following is the personal message I penned to the girls in their personal copies of the book.

‘You have been truly blessed to have a Mum whose primary goal in life is to be the best mother she can be.

‘From the day you were born, Mum and I have loved you unconditionally. It was important to us to provide you with a safe, secure and stable home environment.

‘Your development was a responsibility we took very seriously. An integral part of our parenting role was to provide you with the opportunities and wisdom for you to grow both physically and mentally.

‘We did not always get it right. We too were learning along with you. This is one of the lessons you will learn in life; you will not always make the right decision all the time — it just isn’t possible. The trick is to be right more times than you are wrong.

‘The purpose of this book is to share with you what we have learnt in our life journey.

‘Over thirty years ago, Mum and I were the ones entering the adult world. A lot has happened to us in those thirty plus years. Marriage, three beautiful children, mortgages, career developments, tragedy (loss of parents), investments (good and bad), travel and many more experiences. Along the way we have shared some of the knowledge we have gained with you.

‘Now you are entering the adult world and we are more conscious of our mortality and it is important we commit to paper a greater insight into what we have learnt. Hopefully this knowledge will steer you in the right direction and enable you to avoid the pitfalls that have led to financial hardship for so many people.

‘Watching you grow up has been a sheer delight. From a very young age you all had a special quality about you. But talent alone is not enough and to your credit you have applied a great deal of determination and energy to mature into the special young ladies you are today.

‘Over the years you have been creating the foundations and principles upon which your lives will be built. Ask any builder and they will tell you a building is only as solid as its foundations — based on this truism, you are destined to build truly magnificent lives for yourselves.

‘Hopefully this book of knowledge from Mum and I assists in putting some structural integrity into the life you create for yourselves.

‘Gradually our day-to-day influence in your lives reduces and this is the way it should be. However the principles we have espoused and the knowledge we have shared has hopefully formed part of the fabric of your life.

‘Love always and forever, Dad.’

1 The Keys to Build an Amazing Life

‘When we are motivated by goals that have deep meaning, by dreams that need completion, by pure love that needs expressing — then we truly live life.’

– Greg Anderson

In 1987, my wife and I attended a self-development course conducted by Lou Tice (The Pacific Institute). We credit this course with giving us the tools to harness the positive energy we possess and the ability to turn our then-dreams into reality. Every single one of the goals we committed to writing down has been achieved. Some took longer to reach than others, but life has a way of testing resolve to see just how much you really want your goal. Remember: never, never, never give up.

Take time to sit down and commit to writing what you would like to achieve over the next decade — how you would like your life to look. It is important to keep balance. It is no good having a fantastic career and finding you have no time for friendships, or attaining impressive financial goals at the cost of your integrity.

Your goals are personal — be very careful whom you share them with. People may say, ‘Why do you want that?’ or ‘Who are you kidding?’ People may consciously or sub-consciously try to sabotage your yet-to-be-realised reality. If you conceive it and genuinely believe it, you will achieve it. If you are going to dream, you might as well dream big. The size of your success will be determined by the size of your belief.

The areas we set goals in are:

Personal: How we want to:

1. Strengthen our personal relationship
2. Build an amazing family life
3. Build strong and loyal friendships
4. Broaden our horizons with travel and exciting places to explore.

Health: Maintain a balanced diet and exercise program — all the money in the world is useless if you are bed-ridden with ill-health.

Career: Where you see yourself in ten years' time and what steps you will take to build the skill sets necessary to achieve the goal.

Financial: How much you want to earn; what your net worth will be; what sort of house/apartment you want to own; what type and colour of car do you want to drive.

Spiritual: (this is not religious) — take time out to appreciate the world and gain an inner calm and strength — this could be doing Pilates, yoga, walking on a beach or being in a beautiful garden.

The more specific you make your goals, the more your sub-conscious will have to focus on and the greater the success rate in achieving your goals.

While this book is primarily based on my views on how to handle money, it is equally important that you are enriched in all facets of your life.

Money should be respected but not worshipped. Money is only one dimension of life. There are so many other poignant parts in your life, which is why it is important you set other broader goals to give your life deeper meaning and satisfaction.

I can honestly say that if my life ended tomorrow, I would feel that it's been a job well done — a great marriage; three wonderful girls, strong family ties, a close group of good friends, a successful and rewarding business career, a reasonable amount of worldly goods. I've seen a fair bit of the world and enjoyed good health — not to mention Queensland has beaten NSW eight years in a row!

These were all goals (with the exception of the State of Origin wins) that were put in place over twenty five years ago.

Conceive, Believe, Achieve.

Take time to focus on what you really want out of all facets of your life. Commit these goals to writing and read them every morning and night. You'll be amazed at what power you will unleash from within. Each tiny success will build into a list of achievements that will reinforce your belief system.

The world is your oyster and you know what's inside an oyster — pearls.

I found this quote and thought it was an appropriate note to end this chapter on:

'Don't live in the past, thinking about mistakes or changes you made. Think of your life as a book, move forward, close one chapter and open another. Learn from your mistakes, but focus on your future, not on your past.'

I can't wait to witness your stories.

So far they have been a great read but I suspect the best chapters are yet to come.

2 The Power of Compound Interest

'The most powerful force in the universe is compound interest'

– Albert Einstein

Compound interest is interest that keeps on snowballing. It is interest that is calculated not only on the initial amount invested but also the accumulated interest of prior periods.

For example, if you invest \$10,000 for one year at a rate of 6 percent you will earn \$600 interest. At the end of the twelve month period you add this interest to your initial investment and you re-invest \$10,600. Assuming the interest rate is again 6 percent for twelve months, at the end of the second twelve month period you will have earned \$636 interest (the additional \$36 in interest is the 6 percent return on the \$600 of interest from the previous twelve month period).

This interest-on-interest-on-interest exercise creates enormous momentum for your money over the long term. Using the above example of \$10,000 invested at 6 percent per annum, after approximately twelve years the investment principal will have doubled to \$20,000. Therefore in the thirteenth year you will have earned \$1,200 interest (\$600 on your original \$10,000 investment and \$600 interest on the \$10,000 of interest you have accumulated).

The following table highlighting the experience of two investors over a 45 year period perfectly illustrates why Einstein made the comment about compound interest being such a powerful force.

Investor B saved \$2,000 every year for seven years (from age 19–25) and allowed this \$14,000 to compound for the next 40 years.

Investor A started saving \$2,000 every year at the age 26 for the next 40 years.

The example assumes that they saved into the same fund and received the same annual rate of return.

As you can see, they ended up with nearly the same amount of money at age 65 but Investor B increased his investment by 66-fold compared to Investor A whose money grew 11-fold.

Age	INVESTOR A		INVESTOR B	
	Contri- bution	Year-End Value	Contri- bution	Year-End Value
8	-0-	-0-	-0-	-0-
9	-0-	-0-	-0-	-0-
12	-0-	-0-	-0-	-0-
13	-0-	-0-	-0-	-0-
14	-0-	-0-	-0-	-0-
15	-0-	-0-	-0-	-0-
16	-0-	-0-	-0-	-0-
17	-0-	-0-	-0-	-0-
18	-0-	-0-	-0-	-0-
19	-0-	-0-	2,000	2,200
20	-0-	-0-	2,000	4,620
21	-0-	-0-	2,000	7,282
22	-0-	-0-	2,000	10,210
23	-0-	-0-	2,000	13,431
24	-0-	-0-	2,000	16,974
25	-0-	-0-	2,000	20,872
26	2,000	2,200	-0-	22,959
27	2,000	4,620	-0-	25,255
28	2,000	7,282	-0-	27,780
29	2,000	10,210	-0-	30,558
30	2,000	13,431	-0-	33,614
31	2,000	16,974	-0-	36,976
32	2,000	20,872	-0-	40,673
33	2,000	25,159	-0-	44,741
34	2,000	29,875	-0-	49,215
35	2,000	35,062	-0-	54,136
36	2,000	40,769	-0-	59,550
37	2,000	47,045	-0-	65,505
38	2,000	53,950	-0-	72,055
39	2,000	61,545	-0-	79,261
40	2,000	69,899	-0-	87,187
41	2,000	79,089	-0-	95,905
42	2,000	89,198	-0-	105,496
43	2,000	100,318	-0-	116,045
44	2,000	112,550	-0-	127,650
45	2,000	126,005	-0-	140,415
46	2,000	140,805	-0-	154,456
47	2,000	157,086	-0-	169,902
48	2,000	174,995	-0-	186,892
49	2,000	194,694	-0-	205,581
50	2,000	216,364	-0-	226,140
51	2,000	240,200	-0-	248,754
52	2,000	266,420	-0-	273,629
53	2,000	295,262	-0-	300,992
54	2,000	326,988	-0-	331,091
55	2,000	361,887	-0-	364,200
56	2,000	400,276	-0-	400,620
57	2,000	442,503	-0-	440,682
58	2,000	488,953	-0-	484,750
59	2,000	540,049	-0-	533,225
60	2,000	596,254	-0-	586,548
61	2,000	658,079	-0-	645,203
62	2,000	726,087	-0-	709,723
63	2,000	800,896	-0-	780,695
64	2,000	883,185	-0-	858,765
65	2,000	973,704	-0-	944,641
Less Total Invested:	(80,000)		(14,000)	
Equals Net Earnings:	893,704		930,641	
Money Grew:	11-fold		66-fold	

The lesson to be learnt is start saving *early*.

There are no secrets to creating this long-term wealth effect; it is as simple as SPENDING LESS THAN YOU EARN.

I appreciate this is easier said than done. Society has a much greater focus on consumerism. Those who are dedicated to a savings regime are in the minority. Think of all the subliminal messaging we receive everyday and it is all targeted at spending:

- Interest free loan for 48 months
- Buy now, pay later
- No deposit, no payments for (so many) months
- Bad credit history – no problems
- Our operators are standing by now to take your order
- Here's your pre-approved credit card
- Sale – 50-70% off

It takes discipline to resist the continual temptation to spend. The feel good chemical (serotonin) your brain releases when you make a purchase is as addictive as alcohol, tobacco and illicit drugs — the term 'shopaholic' isn't as amusing as it first sounded.

On the other hand, saving is boring and there is no immediate chemical rush from it. The real buzz comes many years later when you begin to see your savings efforts accumulating into a serious amount of money. This is called 'delayed gratification'. Unlike the spending quick-fix, the feel-good effect of wealth creation is both sweet and long lasting.

The best idea I have heard of in relation to committing to the discipline of saving is by treating *yourself* as a monthly account.

In a similar way of paying your electricity bill, car rego, phone bill regularly each month, make an allowance in your monthly budget to pay your *personal* Wealth Creation account. In the same way as non-payment of your electricity or telephone account would see these services terminated, failure to pay your Wealth Creation account will mean your future wealth plans will also be cut off.

How much you need to save will depend on the amount you require in forty years' time. As a guide, to accumulate \$1 million (in today's value) in 40 years you would need to save approximately \$160 per week (this calculation is based on an after inflation rate of return of 4.8 percent per annum).

Initially, finding a spare \$160 per week may prove difficult. The important discipline is to start saving (like an exercise regime or healthy eating lifestyle) so it becomes habit-

forming. Starting with \$10 per week and gradually increasing it is better than not starting at all.

As your salary increases or you identify other areas in your budget that can be trimmed you can increase your weekly savings figure.

It is common knowledge that two people who earn identical amounts of money can end up with two entirely different financial outcomes.

One can overspend and be forever waiting for their next pay day, while the other lives within their means and gradually builds financial independence by simply spending less than what they earn.

How do you find those savings? Here is an exercise from *I can make you Rich* by Paul McKenna:

Write down a list of absolutely everything you spend your money on.

Go through the list and assign an A, B or C to each expense.

A = essential items

B = important, but not essential

C = everything else

Allocate your budget to the As and Bs first. Before you spend money on a C item, ask yourself: 'Is this moving me closer or further away from my saving goal?'

Another way of identifying savings is to make paying yourself an 'A' item i.e. essential expenditure. Identifying savings first is a form of reverse budgeting. Most people work out what they spend first and whatever is left over (if any) is allocated to savings. By saving first, you then don't feel guilty about spending the balance of your income.

Your **minimum** savings target should be to have a three-month cash buffer i.e. you should have at least three months worth of your living expenses as cash in your bank account.

Having financial reserves is empowering as you are not sweating on how to make a 'quick buck' and can afford to wait for the right employment opportunity rather than be forced to accept a position due to your dire financial position. Also, when markets go through their corrective phase (fall in value) you are in a position to acquire assets (property and/or shares) at discounted levels.

The important lessons are:

1. Start saving early
2. Pay yourself as an important monthly account
3. Use the power of compound interest (interest-upon-interest-upon-interest) to create financial independence.

There are a few simple ways of accessing compound interest:

1. **Term Deposit** – When you take out a term deposit, the financial institution could re-invest the interest back into the original investment e.g. invest \$10,000 for one year at 6 percent = \$600 interest. At the end of the one-year term, you will have \$10,600 to invest and this will then start the process of earning interest on interest. Don't forget that you will have to pay tax on the \$600 interest you earned.
2. **Superannuation** – Nearly every young person (by this I mean those under age forty) feel that superannuation is a waste of time. The prevailing view is that they won't be able to access this money until they're at least sixty years old and who knows; by then the government will have changed the rules on accessibility... In fact superannuation is a great way of starting the savings snowball. Each week/fortnight/month your employer will invest 9.25 percent (rising to 12% by July 2019) of your income into superannuation. When you are younger with mortgages to pay, children to educate etc. the thought of committing more of your income into an inaccessible superannuation fund is far from appealing. The day-to-day bills are far more pressing than worrying about accessing an investment in twenty to thirty years' time. Where possible, in your young and carefree days you should make the decision to invest more income into superannuation.
3. As you can see from the previously-mentioned chart, investing \$14,000 in your twenties is the equivalent of investing \$80,000 in your thirties, forties, fifties and sixties. Start the snowball early: it will pay dividends.
4. **Reinvesting dividends** – When you buy shares they will usually provide you with the option to reinvest the dividends (the income you receive from the company's annual profit). This is another way to compound your money. Here's an example: you own 1,000 shares in XYZ Ltd at a cost of \$2 per share. The company pays you a \$100 dividend and if you reinvest the dividend you will receive a further fifty shares, bringing your total shareholding to 1,050 shares. In theory this sounds like a perfect way to accumulate capital.

But, unlike a term deposit which does not lose value, the share price of a company can rise and fall. To highlight the strength and weakness of the dividend reinvestment strategy let's look at two companies — Telstra and Commonwealth Bank (CBA).

In early 2000 the Telstra share price was \$8 and CBA was \$27.

If each company paid \$216 in dividends, the Telstra shareholder received 27 shares and the CBA investor received eight shares.

The current Telstra share price is \$4.90 and CBA \$73 The Telstra shareholder's 27 shares (that cost \$216 in 2000) are now worth \$132 and the CBA shareholder's 8 shares (that cost \$216) are now worth \$584.

The lesson is that not all dividend reinvestments result in an appreciating value. Be careful before opting for an automatic dividend reinvestment. In the more extreme cases some companies have gone into receivership and investors not only lost their original investment but also the dividends they reinvested. Ouch!

What I have outlined above is called a 'stock specific risk', that is, you are dependent on the performance of an individual company to determine whether your net worth increases, stagnates, decreases or is obliterated. Chapter Eight discusses how to minimise this risk when investing in shares.

3 Control Debt to Avoid ‘The Tail Wagging the Dog’

‘Debt is like any other trap, easy enough to get into, but hard enough to get out of’

– Henry Wheeler Shaw

A loan today is an advance on tomorrow’s income. In other words, a portion of your future income is committed to repaying a loan you take out today. The more debt you accumulate now the more of your future income you are committing to loan repayments. The greater the income required to service debt repayments means that there is less to spend (or save) in other areas of your life.

When it comes to debt you *must* — and I stress *must* — remember that banks make their enormous profits by keeping people on the debt treadmill.

Banks, credit unions, mortgage brokers and other lenders only stay in business because people continue to borrow money. At most stages of your life these providers of debt will try to entice you into taking on more and more loans. You’ll receive flattering letters in the mail firstly proclaiming what a fine upstanding person you are and how they would like to offer you an upgraded limit on your credit card, a new personal loan or an increase on your home equity loan.

It is through these marketing methods that lending institutions are able to easily get you hooked on the habit of debt. Many people are unable to resist the flattery or temptation conjured up by marketing departments, with the end result that they usually end up dependent on the ‘goodwill’ (that term is used loosely) of the lending institution who help them feed their habit.

That ‘goodwill’ evaporates during tough times. When you have loaded up with too much debt and you lose your job or the economy gets tough, the lending institution inevitably contacts you and says, ‘We want our money back.’ If you cannot meet their demand for repayment (in part or in full) the next step for the lender is to take action to recover their debt by whatever means is legally available to them. In some cases this results in the borrower being declared bankrupt.

Admittedly, most lending institutions provide a worthwhile service and play an important role in society, but you must, must, MUST borrow wisely and err on the side of being conservative to avoid becoming a ‘money slave’ to the banks.

The first step towards avoiding this trap is to educate yourself on what products they offer.

Credit Cards

Travis Smiley said this about credit cards: *‘When people use credit cards, they are often spending money they don’t have on things they don’t need to impress people they don’t even like.’*

When first starting out credit cards are likely to be your introduction to the world of debt, so we will discuss these first.

We live in a world where credit cards have become a necessary evil. It is therefore imperative that *you* control the card and not the other way around. The adrenaline rush of an impulse buy is quite addictive and many a person has fallen under the spell of the ‘credit card drug’.

The credit card ‘drug’ is very costly. The annual interest rates can range from 16 percent to 25 percent. This is in addition to the annual fee (\$150–\$300) they charge you for the privilege of using the card.

The best way to impose discipline with credit cards is to have only one card and request a low limit (say \$1,000–\$2,000). This way the worst financial damage you can inflict on yourself is the amount of your limit.

Too many people have fallen into the trap of having multiple cards with very high limits. They become snared in the debt trap and never recover because the annual interest costs spiral out of control.

Remember, the secret to credit cards is to pay the card off in *full* every month, otherwise the card’s high interest rate will be charged on the balance owing and your spiral down into deeper debt begins.

To illustrate this with a real-life example, imagine someone with five credit cards (and some people have more) that each have a \$20,000 limit. If all cards are maxed out and the annual interest rate is 20 percent the person will be paying \$20,000 a year in interest alone and is unlikely to ever be in a position to pay off the \$100,000 debt. Paying \$20,000 of your after tax salary in dead interest is an exhaustive waste. That \$20,000 could have been committed to a savings program instead of merely enriching

the credit card companies. This is an example of compound interest in reverse — it makes the bank rich and the cardholder poor.

Also, if you withdraw cash (known as a cash advance) from your credit card you will be charged interest from the time the cash is withdrawn. There is no interest-free period on cash advances. This is another reason why you should have a three-month cash buffer in your bank account so you are not forced into scraping the bottom of the barrel for money.

There are other factors to consider too. Financially stressed people can suffer from ill health. Sleepless nights spent worrying about your financial situation are not conducive to your overall well-being.

Applying discipline to the use of your credit card is as essential as maintaining a healthy diet, an exercise regime, avoiding excessive alcohol consumption and a zero tolerance for drug taking.

Personal Loans (Unsecured Loans)

Personal loans were a popular form of lending in the days before credit cards. A personal loan is an unsecured loan from a lending institution (bank, building society, credit union, finance company etc.) for the purpose of buying a car, going on an overseas holiday or acquiring — a large item (boat, caravan etc.). The interest rate is generally higher due to the unsecured nature of the loan.

Car yards will eagerly offer finance to purchase one of their cars. They usually receive a commission for arranging such a loan, so be very wary of the interest rate and conditions attached to these loans.

A number of retailers offer ‘Interest Free’ loans for a period of time — twelve months, 24 months or longer. Again, be aware that once the interest free period expires, the finance company will begin charging excessively high rates of interest.

If you are a cash buyer who does not require finance, usually you can negotiate a discount to the quoted price. Once again this is a case of a saver wins and a borrower loses.

The simple rule with a personal loan is that if you have to borrow money to buy that ‘personal treat’, then you’re probably not in a position to manage to pay for it as easily as you’d like to. Instead, these personal ‘treats’ should be funded from your savings. If you haven’t got the money to buy the treat outright then you should seriously consider **not** borrowing the money.

Even a car purchase should, where possible, be funded from cash.

Perhaps you may need to borrow a modest amount to buy a reliable vehicle. In this case focus on paying out the loan in the shortest possible time.

The saying goes, 'you should buy the cheapest car your ego will allow.' However, when it comes to reliable cars, cheap is not always better. To ensure you are not buying a lemon arrange for an independent mechanic or automobile club to conduct a thorough inspection of the vehicle to minimise the risk of buying a costly maintenance problem.

The only positive aspect from considering whether or not to access a personal loan is that if you have reached this stage it is a wakeup call for you to take control and sort out your finances.

As a rule of thumb avoid taking out a personal loan.

Pay Day Advance

Personal loans are dangerous but nowhere near as bad as payday advances. A payday advance is for those times when you have run out of money before your next pay is due; when you literally have no other form of cash. These lenders will give you an advance (loan) until you receive your next pay.

Details on payday lenders' websites reveal that borrowers are charged a fee of \$20 for every \$100 they are advanced (borrowed). This equates to a whopping 20% interest rate for a period of only one or two weeks.

When you pay them back the \$120 you borrowed, you now find yourself with \$120 less in your next pay. So unless you can manage the next fortnight without the \$120, you will be back in a week's time to borrow the \$120 back from them. Now you have to pay back \$140 (\$120 + \$20 fee).

A vicious circle has been created. You can see how easily people can get caught in the debt trap.

When you have to resort to this sort of borrowing you have hit rock bottom financially.

Heed the wakeup call and get your financial house in order.

Mobile Phones/Internet usage

Being connected 24/7 is another necessary evil in this modern world. Mobile phones and internet connection/usage are contracts you enter into with your preferred telecommunications provider.

Before entering into any contract make sure you fully understand the terms, conditions and costs associated with these plans. It is easy for these costs to get out of control and then another debt spiral is created.

People often incur large bills on their mobile phone and they pay the account with a credit card and, again, another vicious cycle of useless and unproductive debt begins.

Remember that telcos such as Telstra, Optus, Vodafone et al generate huge profits from people using their services (no different to the banks). Naturally they will offer you what look like very attractive deals: be very careful what you are entering into.

When you are going to a new plan, ensure there are no hidden traps and that the change is a genuine upgrade.

Another way of imposing discipline to this area of expenditure is to purchase pre-paid plans for your mobile phone and internet usage.

Home Loans *(note this section should be read in conjunction with Chapter Seven – Property Investing)*

Due to the cost of purchasing a home most people have to borrow to buy their home. Unless you have a lotto win or a generous benefactor a home loan is likely to await you in the future and is the biggest purchase of most peoples' lives. Oh, the joy....!

Remember what I said at the start of this chapter; the lending institutions are in the business of loading you up with as much debt as your budget can handle.

Their concept of responsible lending is a little different to mine.

When you apply for a home loan they (bank representative or mortgage broker) will 'advise' you on how much you can borrow based on your profession, income and age.

Looking for a home is a mixed bag of wants, needs and emotions.

Initially you think with your head and look for a good location, street appeal, solid construction etc. but somewhere along the line your heart comes into the home-buying equation and this is when things become trickier.

98.5 times out of 100 you will find a place that is above your budget. The bank will gladly convince you that for only an extra few dollars a month you can have that dream home.

Yet again this is where financial discipline is required. In addition to the home loan repayments, you must also factor in the following ongoing costs with home ownership:

1. The interest rate on the loan could rise. How much higher the rates could go will depend on where the interest rate cycle is, i.e. are home loan rates historically low (below 4–5%) or are they historically high (above 10%).

If they are on the low side, factor in a further 3–4% rise in interest rates. If they are high, it would still be prudent to factor in a further 1–2% increase as a buffer. Any reduction in interest rates should be treated as a bonus.

2. Council Rates
3. Electricity charges
4. Water Rates
5. Body Corporate fees (applicable to apartments/units/flats)
6. Maintenance — pool servicing, painting, electrical, plumbing, general repairs and the list goes on.
7. Insurances — when you rent you should insure your personal effects (computer, lounge suite, TV, camera etc.), but when you own a home you also have to insure the building in case it is damaged from fire, flood or any other cause (e.g. car landing in your lounge room unexpectedly). If you purchase an apartment, the body corporate fees incorporate building insurance but *not* contents insurance)

You must make allowance that, at a bare minimum, all of these costs will increase annually by the rate of inflation (officially referred to as the Consumer Price Index — CPI). In reality, the increases are usually in excess of CPI. They are running businesses for profit, after all.

All these costs need to be factored into your budget to enable you to determine your home loan repayment ability.

When looking for a home loan there are a number of online searches you can do.

The information you need to source is:

1. What are the initial loan establishment fees?
2. What are the ongoing annual fees (these are in addition to the interest rate)?
3. The current interest rate.
4. What are the costs if you wish to switch lenders?
5. Are there any other costs buried in the fine print?

There are two basic types of loans:

1. **Variable Interest Rate**

In theory, this rate moves up and down (varies) with the official interest rates (those set by the Reserve Bank of Australia — RBA). In recent times the banks have been dancing to their own tune and altered lending rates independently of the RBA's official rate policy. If the RBA decides to lower its official rate it is unlikely that the banks will pass on the full decrease. This is yet another reason why you should err on the side of caution when determining your repayment ability.

The variable rate allows you to repay more than the minimum monthly repayment. If you receive a pay rise or an unexpected cash windfall (a bonus from your employer or lotto win) you could use this to additional money to pay more off your home loan without penalty.

As a guide, if rates are historically high it would be best to use a variable home loan. In the short term this could be slightly more expensive, but you are taking a calculated guess that rates are more likely fall at some point in the not-too-distant future and the variable loan rates trend down as well.

Unfortunately a lot of people panic when rates are high. They fear rates may go even higher. This fear drives them to lock in a fixed rate loan (see below) at historically high rates and then sit and watch rates come down. Sadly they are stuck paying the higher rate for whatever period they fixed the loan for. This hurts.

2. **Fixed rate loan**

The fixed rate loan does exactly what its name says; it fixes a rate on your home loan for a specified period of time. The standard periods of time are usually one, two, three, four and five years.

Once the rate is fixed it cannot go up or down for the period of time you have locked the loan for. Let's say you want to fix a rate of 6% per annum for five years. For the next five years, no matter whether interest rates go up or down, your loan repayment is locked in on the 6% per annum rate.

The best times to use a fixed rate loan are:

- 1) when rates are low and/or
- 2) you want absolute certainty in your monthly repayments for a period of time to allow you to adjust to the new financial demands of owning a home.

3. **A combination of 1 & 2**

The third option is to have a 'combo' loan.

If you are not sure which direction interest rates are headed, you can hedge your bets and divide the loan between variable and fixed interest.

The percentage of the loan you allocate to each option will depend upon your reading of where we are at in the interest rate cycle.

Be very careful of *Introductory Rates*. These 'honeymoon' or 'sweetheart' rates are used as an enticement to seduce you into thinking the loan is more affordable than it really is.

Once the 'introductory' period is over (usually six to twelve months) the rate jumps up to the normal home loan rate (and usually goes a little higher so the bank can recover the loss of providing you with a cheaper loan for six to twelve months).

There are absolutely no free lunches with banks. You should be cautious of anyone offering a low initial rate as an Introduction special; it is highly likely there will be a sting in the tail.

Do your figures conservatively (over-estimate) on the loan repayments and remember to include *all* the added costs of the home ownership exercise. If the end result of this exercise means you need to borrow a lesser amount, then so be it.

Better to own and keep a slightly lesser home than borrow and lose a more expensive one.

How to own your home sooner

The following calculation is based on borrowing \$300,000 over a 25 year term at 7%. The monthly repayment is \$2,120. The smart option is to divide the monthly payment by two and pay \$1,060 each fortnight.

The loan term will be reduced by four and a half years and you will save over \$70,000 in interest. The reason is there are 26 fortnights in a year and this is the equivalent of making thirteen monthly payments. The one extra payment a year pays you huge dividends.

If you pay any additional windfalls (bonuses) into the home loan this will also accelerate the repayment of the loan.

The chart is from www.financial-calculators-online.com.au

www.financial-calculators-online.com.au

Fortnightly Mortgage Repayment Comparator

This calculator demonstrates the difference between paying half of a monthly mortgage payment each fortnight compared with making the scheduled monthly repayments. Simply enter the amount of the loan, the term (in years) and the interest rate to view the comparison.

Details of your Loan Requirements:

Amount of Loan: \$

Loan Term: (in years)

Interest Rate: (per annum)

Payment Frequency:	Monthly	Fortnightly	Saving
Repayment Amt:	\$2,120	\$1,060	N/A
Years to Repay Loan:	25	20.5	4.5
Total Interest Paid:	\$336,101	\$265,777	\$70,324

The marketing story behind Good v Bad Debt

Debt is borrowing money to buy a product or service. The theory behind ‘good’ or ‘bad’ debt is that some things are worth borrowing for (good) and others aren’t (bad).

In a simplistic world the difference between the two is:

Good Debt is usually associated with borrowing to invest in appreciating assets (predominantly shares and property). Included in this is a home loan to buy your own home — even though this loan is not tax deductible. The interest on debt incurred to acquire income producing shares or an investment property is generally tax deduction, therefore the cost (interest rate) of the debt is reduced by the offset of the tax deduction — in essence the Government is helping pay some of your loan interest. Getting anything from the Government is a powerful motivator — BUT it should not be the reason for taking on a debt.

Bad Debt is for borrowings to buy depreciating items or just plain old consumables — motor vehicles, holidays, clothes, shoes, computers, white goods etc. The interest on this debt is not tax deductible.

For example, if you borrow \$2,000 to buy a lounge suite on terms of 10% per annum over a three year period. Interest paid over this period is \$300. The total cost for the lounge suite is \$2,300 and in three years’ time it is virtually worthless — as confirmed by a quick search on Gumtree.

In theory, the concept of good debt being better than bad debt is correct. However in the world of money, nothing is ever as simplistic as the marketing departments of investment institutions make them out to be.

Consider the following example: A client goes to a financial planner with \$500,000 to invest. The client is ‘advised’ that the way to accelerate the wealth accumulation process is to add some ‘good’ debt to their investment capital.

It is recommended the client borrows \$500,000 and now has \$1 million to invest. The interest on the borrowed \$500,000 is tax deductible. If the market rises 10% they will make \$100,000 (\$1 million x 10%) and in theory the wealth creation process begins.

But what happens if the market falls by 50% (and this sort of fall can and has happened)? The \$1 million is suddenly worth \$500,000. Who do you think the remaining \$500,000 belongs to — the bank or the client? Of course the bank owns the remaining \$500,000 because this is the amount of the loan. The client’s \$500,000 has disappeared in the market crash. The big question is: ‘was this good debt really just a bad debt after all?’

Using the example of a 50% fall in the share market, if the client had never borrowed and only invested their \$500,000 in the market, their capital would have reduced to \$250,000. There is no doubt this would be painful, but at least they have some capital left and a base from which to try and re-build.

In hindsight if the client knew they were going to end up penniless, do you think they would have chosen to lose their money via an ill-fated investment strategy with supposedly 'good debt' that caused them nothing but heartache and despair *or* spend the entire \$500,000 on a year long, first class around the world holiday? At least with the holiday they hopefully would have had a great time and made some wonderful memories. So-called 'good debt' can sometimes lead to very bad outcomes.

Good debt is only good debt if the investment you have borrowed to invest in actually appreciates in value at a greater rate than the interest cost of the debt.

Don't get me wrong; borrowing to invest in shares and property can be a good strategy provided you are buying at a time when those assets are either undervalued or at least fairly valued.

It is a *bad strategy* when the assets are *over-valued*.

How do you know when an asset is over-valued? A simple, though not foolproof, way is when *it* (whatever the 'it' asset is at the time) is being talked up and excessively promoted. This should send a signal to you to take a closer inspection at the recent price history of the asset. If it has been appreciating for a period of time at above normal rates of return then it is a fair bet the market is in the mature stage of its positive phase and is due for a downturn. The golden rule is, 'The higher the market goes up the harder it will fall.'

Buying an over-valued investment with borrowed money is the financial equivalent of trying to swim against a tide. For example, you purchase a property at the top of the market for \$550,000. You have a \$50,000 deposit and borrow \$500,000 at an interest rate of 7%. The annual interest cost is \$35,000. After two years the property owes you \$620,000 (\$550,000 + two years of interest).

The following inclusions and exclusions apply to this figure:

1. In addition to interest payments there will also have been rates, insurances and maintenance — say \$4,000 per annum, which equates to \$8,000 over two years.
2. If you did not buy the property you will have paid rent of say \$25,000 per annum, totalling \$50,000 over two years.

The net cost of the property over the two year period was:

Purchase price	- \$550,000
Interest cost	- \$ 70,000
Rates, insurance etc.	- \$ 8,000
<hr/>	
Sub-total	\$628,000
Less allowance for rent payment	\$ 50,000
<hr/>	
Net cost	\$578,000

Over the two-year period the market has fallen 30% and the property is now valued at \$385,000. The two years of ownership have cost you \$193,000. This was not a 'good debt' strategy.

The critics will say that two years is too short a timeframe to properly assess the merits of the strategy. However, people who generally borrow too much at the height of a market usually can't hold on for a market turnaround in five or ten years' time, so the theory of market cycles is irrelevant to them.

The reverse of this example is the experience of the new purchaser of the home now valued at \$385,000. Let's say they had a \$50,000 deposit and borrowed \$335,000 at 7%. Their annual interest cost is \$23,450 plus rates, insurances etc. These numbers are comparable to the estimated rental payment of \$25,000. There's no guarantee that the property may not fall further in value or that the price may stagnate for a number of years, but at least the numbers look reasonable enough to make this a 'good debt' strategy.

Remember, borrowed money is the *bank's* money and they will want to be repaid. In the event of a forced sale the bank and the lawyers will recover their money first and you will be entitled to anything that is left over (irrespective of how much you originally invested).

Whenever an investment salesperson (either shares or property) starts talking about 'good debt,' be very wary. They are using a glib one-liner to push the particular investment they are promoting. This should send another signal to you to be prudent and do a bit more research to see whether the investment is over-priced or not.

Margin Lending

If anyone mentions margin lending to you, do a Google search on Storm Financial and read Wikipedia's account of the events surrounding its collapse and the losses suffered by its clients due to margin lending.

The glossy margin lending brochures are full of examples and illustrations of how beneficial a margin loan can be for an investor seeking wealth accumulation. The Wikipedia account of the Storm Financial saga is what the glossy brochures don't tell you.

Margin lending is a fancy term for 'borrowing to invest' in shares.. To be eligible for a margin loan the investor must have cash, managed funds or shares to offer as a margin of safety (security) to the margin lender.

The margin lender then provides a loan facility (the amount depends on how much security has been offered and where the borrowed funds are to be invested). The following is an example of a simple Margin Loan based on a Loan to Valuation Ratio (LVR) of 60%.

Investor's assets (cash/managed funds or shares)	- \$100,000
Margin Loan	- \$150,000
<hr/>	
Total Investment	- \$250,000

Loan (\$150,000) to Valuation (\$250,000) ratio = 60%

The way the margin lender looks at it, the valuation could sustain a fall of 40% (\$100,000) and they would be able to sell the portfolio and retrieve their \$150,000. The investor's \$100,000 is the lender's margin of safety.

Naturally the margin lender would start getting nervous before the investment had fallen 40% in value. The following example shows what happens if the value fell 30%.

Portfolio value (\$250,000 x 70%)	= \$175,000
Less	
Margin Loan	= \$150,000
<hr/>	
Investor's capital	= \$ 25,000

The loan (\$150,000) to valuation (\$175,000) ratio is now 86%.

This margin of safety is a little too close for comfort so the Margin Lender makes a 'Margin Call.'

A margin call is when the lender requires the borrower to lodge additional cash or shares to restore an acceptable margin of safety. For example the margin lender may require the LVR to be 75%. Loan (\$150,000) to value (\$200,000) ratio = 75%. Therefore, the investor must lodge an additional \$25,000 to increase the valuation to \$200,000.

In the event the investor fails to lodge the security, the loan contract permits the margin lender to sell down the portfolio and reduce the loan amount to the required LVR. In this example it means that \$75,000 would be sold and paid off the loan. The remaining situation would then be:

Investor capital	\$ 25,000
Margin Loan	\$ 75,000
<hr/>	
Total Investment	\$100,000

Being forced to sell investments at a reduced price is not a smart way to make money. Unfortunately this is the experience the majority of investors have. Buy high and sell low.

To add insult to injury, in the 2003–2007 market boom some financial planners encouraged investors to increase their investment capital by borrowing against the equity in their home and cashing out their superannuation funds.

This next example shows you how devastating this strategy was:

Investor owns a home (no debt) valued at \$500,000 and \$400,000 in superannuation.

The planner arranges for the bank to provide a home equity loan facility of \$350,000 (70% of the value of home). The home is taken as security for the loan.

The planner cashes out the superannuation fund.

The investor now has \$750,000 (\$350,000 home equity loan + \$400,000 superannuation fund) to invest.

The planner arranges for a margin loan with a LVR of 50%.

Investor funds	\$ 750,000
Margin Loan	\$ 750,000
Total Investment	\$1.5 million

As we now know, in 2008/09 the market fell in excess of 50%. In this example, the portfolio shrinks to the margin loan trigger point. The margin call is made but the investor has no more funds to meet the call.

The margin lender then sells the portfolio and clears their debt. The investor's funds have vaporised.

The investor's home has also suffered a 10% reduction due to the market uncertainty and is valued at \$450,000 with a debt of \$350,000.

The margin loan exercise has cost them their house and superannuation. A lifetime of savings are destroyed in a few short years.

Borrowing to invest in shares can be very profitable if you borrow when the market has collapsed and your investments participate in the upside of the inevitable market recovery.

The trick with this is having the rare ability of knowing *when* the market has hit bottom or close to bottom. Some people say the share market will never fall back to the lows it reached in March 2009, just after the full force of the GFC hit. They may be right, but I take another view and believe in the next few years the market may go even lower than its immediate post-GFC low. Time will tell which outlook proves to be the correct one.

Unfortunately most people adopt the herd mentality and take a margin loan (borrow to invest in shares) when the market is booming. Sadly when the inevitable bust comes they lose their money and spend the next decade trying to re-build their lives — financially and emotionally.

To prove this herd mentality actually exists, the following data is from the Reserve Bank of Australia (RBA) website (www.rba.gov.au). This is a copy of the spreadsheet the RBA publishes each quarter on the level of margin lending in Australia.

The two columns to focus on are:

1. At end of; and
2. Margin Lending Total \$m.

In June 1999, the total margin lending in Australia was \$4,713 million (or \$4.713 billion). The share market fell during the period of 2000–2003 due to the tech bubble bursting, Sept 11 terrorist attacks and the uncertainty about an impending invasion of Iraq. From March 2003 to Dec 2007 the share market staged a phenomenal rally on the back of the US Federal Reserve Bank's loose monetary policy. A closer examination of the official data on margin lending activity reveals that at the outset of the market rally in June 2003 there was a total of \$11.122 billion in margin loans.

Three years later in June 2006 this had grown to \$24.826 billion (an increase of \$13.7 billion). In December 2007 (when the share market reached its top) the total figures was \$37.767 billion — an increase of just less than \$13 billion. In eighteen months the amount of margin lending roughly equaled the same amount that was lent in the three years that preceded it. This was indeed a frenzy.

This official RBA data shows as the boom gathered pace it clearly seduced more investors into believing they too could participate in this 'wealth creation' exercise.

If you look at the RBA data in conjunction with the graph at the end of this chapter on the Australian share market, you can see how the rising market drew people into its web.

These gullible investors did not act alone. They were aided and abetted (the professional term is 'advised') by financial planners. Under the rules at the time, financial planners were paid much more for recommending margin lending than they were for not recommending it. Why is this so?

Most planners receive payment via a percentage of the funds invested. The percentage can be called a fee, brokerage or commission. Whatever it is called, it doesn't alter the fact that margin lending was much more lucrative for planners.

To illustrate the point here is an example of two clients — one with margin lending and one without:

	Investor A – No Margin Loan	Investor B – Margin Loan
Investor’s own money to be invested	\$250,000	\$250,000
Amount of Margin Loan	NIL	\$250,000
% fee to be charged on initial investment	2%	2%
Planner remuneration	\$5,000 (\$250k x 2%)	\$10,000 (\$500k x 2%)
Annual remuneration for ongoing advice — 1% of funds invested	\$2,500 (\$250k x 1%)	\$5,000 (\$500k x 1%)
Annual (or ongoing) commission from margin lending company — 0.4% per annum	NIL	\$1,000 (\$250k x 0.4%)
TOTAL revenue in 1 st year	\$7,500	\$16,000

Both investors had \$250,000 to invest, yet the remuneration to the planner is quite different. The planner could increase their remuneration by a staggering 113% through recommending margin lending. The temptation to more than double your earnings creates a genuine conflict of interest.

During a market boom, margin lending (the potential for accelerated wealth creation) is an easy dream for planners to sell to potential investors. The combination of an easy sell and the temptation to significantly increase their revenue would be hard for planners to resist. The RBA figures bear testament to this.

Great wealth can be created if you borrow, the market rises and you actually take a profit by selling the shares. Some people get the borrowing and market rising bit right, but greed (hoping the market goes unfeasibly higher) or fear of paying capital gains tax on the profit stops them from selling and actually turning that paper profit into real money (cash).

There is a world of difference between saying ‘my shares have gone up in value \$100,000’ and saying ‘my shares went up \$100,000 in value and I sold them and have the cash in the bank.’ If you don’t believe this, try paying your grocery bill with

D10 MARGIN LENDING		
Some of these series are affected by series breaks		
At end	Margin lending	
of	Total	of which:
	\$m	Protected
		financing
		\$m
Last updated:	17-Feb-11	17-Feb-11
Source	RBA	RBA
Mnemonic	DMLMLT	DMLMLPF
Jun-1999	4713	332
Jun-2003	11122	919
Sep-2003	11882	1048
Dec-2003	12502	1055
Mar-2004	12933	1042
Jun-2004	13699	1050
Sep-2004	14427	1051
Dec-2004	15162	1041
Mar-2005	16694	1068
Jun-2005	17859	1232
Sep-2005	18749	1199
Dec-2005	19869	1218
Mar-2006	21502	1226
Jun-2006	24826	1604
Sep-2006	26118	1657
Dec-2006	27989	1718
Mar-2007	30253	1700
Jun-2007	36205	2236
Sep-2007	35864	2395
Dec-2007	37767	2809
Mar-2008	32630	2826
Jun-2008	31889	2903
Sep-2008	27553	2772
Dec-2008	21093	2876
Mar-2009	18662	2724
Jun-2009	18268	2359
Sep-2009	18354	2060
Dec-2009	19238	2009
Mar-2010	19174	1952
Jun-2010	18777	1751
Sep-2010	17765	1643
Dec-2010	17520	1554
Mar-2011		

unrealised share profits. It's unlikely that Woolies or Coles would be interested in that deal.

While great wealth can be achieved, the winners are usually a very small number of astute investors. Most people borrow to invest when the market is booming, so they constitute a large chunk of the losers, and the other losers are those that never take their profits.

If you borrow to invest, it can interfere with your ability to wait out the tough times. Debt-free portfolios do not face margin calls, whereas portfolios with margin loans can be called on to make good on the margin of safety. Borrowing to invest impedes an investor's ability to be patient, and patience is one of the crucial elements of all successful investors. Lenders are very impatient when markets are negative and the long term is of little relevance to them. Shakespeare wrote, *'Neither a borrower nor lender be,'* and he shows a lot of wisdom for a 16th Century playwright.

Unless you have a real passion for understanding the share market and possess an uncanny aptitude to identify when the market appears to be undervalued or over-valued, it is better to avoid a margin loan like the plague. The herd may be short-term winners, but I guarantee you they will be long-term losers.

When the share market booms again (and believe me it will) it is a sure bet your friends, work colleagues, relatives or people you meet at dinner parties will be excitedly talking about how well their investments are doing and perhaps even telling you that margin lending (or borrowing to invest) is the greatest way to accelerate your wealth.

When everyone you know is seemingly making money out of the market, it will be hard to resist the temptation and not follow them into the market. This is when you must be your strongest.

The great irony is the longer the market rises, the greater the number of investors who fall into the trap of believing the market will continue in this upward trajectory forever. Experience always shows that the longer the boom, the greater the pain the bust will inflict.

When the boom is on and people are boasting about how much they have made, ask them this: ‘So have you actually sold and turned the profit into cash or is it all on paper?’ If it is all on paper then they have not made a genuine profit.

Look at the following graph of the share market and you will see it falls much faster than it rises. Their paper ‘profit’ can evaporate into thin air right before their very eyes, whereas cash in the bank stays rock solid.

The old saying is, ‘The markets goes up by the stairs but down by the elevator.’ How true it is.



4 The Best Investment You Can Make is in Yourself

'Before you speak, listen. Before you write, think. Before you spend, earn. Before you invest, investigate. Before you criticize, wait. Before you pray, forgive. Before you quit, try. Before you retire, save. Before you die, give.'

– William A. Ward

First and foremost you must recognize that life is NOT fair. If you accept this fact early in your life, it will equip you with the right mental approach to handle life's trials and tribulations. Wallowing in self-pity will not solve the problem. Determination, belief and integrity will overcome the obstacle and take you to new heights.

'History has demonstrated that the most notable winners usually encountered heartbreaking obstacles before they triumphed. They won because they refused to become discouraged by their defeats' – Bertie C. Forbes

It is not what happens to you in life, but it is how you respond to those challenges, that provides the true test of your character.

We all have been blessed with various gifts — some obvious ones and some not-so-obvious ones. These gifts provide you with a start in life, but life will not reward you on potential alone.

US President Calvin Coolidge famously said:

'Nothing in the world can take the place of persistence. Talent will not; nothing is more common than unsuccessful men with talent. Genius will not; unrewarded genius is almost a proverb. Education will not; the world is full of educated derelicts. Persistence and determination alone are omnipotent.'

The best investment you can make is in yourself (both mentally and physically). Your career will generate the revenue on which your future financial success is built.

In your working life, your growth will continue for as long as you maintain a commitment to acquire knowledge and experience. There are no shortcuts to lasting success.

Sometimes people experience fleeting success. The reason their success is temporary is they do not have the necessary skills, experience, desire or discipline required to maintain the success in an ever-changing and competitive world. Possibly success came too early or easily and they didn't appreciate it.

You must dedicate the time to be successful. This can involve hours of additional reading, talking with a mentor and exercising. These hours are in addition to your normal working day. It is your choice how you spend the 24 hours in a day — some will spend time on Facebook watching other people's lives and others will invest their time in themselves and live their lives to the fullest.

Ultimately you will become the product of your acquired knowledge and experience.

The more skills you acquire, the more valuable your services will become. Despite this, it bears remembering that not everyone will be delighted with your growth.

The underlying reason for this is they can feel threatened or inadequate. They'll compare themselves to you and think: 'I'm smarter than them' or 'I did better at school or university than they did.' What they don't realise is that academic results are only a small part of the bigger picture. Inner drive and a determination to succeed are not something you can quantify and compare on a person-by-person basis.

In the deeper recesses of their mind they most likely view your continued growth as a reflection of their lack of growth and this can be very confronting and difficult to admit for most people.

Unfortunately the more you grow the more likely you are to encounter negativity. This is the potential price you will pay for exceptional success. Accept this as part of human nature and wherever possible surround yourself with people who will rejoice in your growth.

The famous US football coach Vince Lombardi once said:

'Life's battles don't always go to the stronger or faster man. But sooner or later the man who wins, is the man who thinks he can.'

Your inner determination backed by an action plan to build an amazing life for yourself will put you firmly on the path to succeed at whatever your chosen endeavor is.

Invest in good relationships — genuine friends will be happy to see you go from strength to strength. Negative people will drain you of energy and depress you. Do not waste your time with those who are mired in negativity. They will only drag you down: misery loves company.

Surround yourself with genuinely inspirational people who, by the way they live their lives, inspire you to rise to another level. Spend time with people you want to be like; those who are living the lifestyle you aspire to and have the same core values as you.

Just as you would like them to rejoice in your successes, you must also rejoice in their successes. It is not a one-way street. What you give out you will receive back.

Choose a good life partner; one who will support and encourage you. Divorce is expensive (both emotionally and financially), so it is better to start on a solid foundation.

Remember that when you are dating you are pretty much seeing the best representation of the other person as they are actively trying to impress you. If you fantasise that they will change for the better when you get married then you are relying on a false hope. If it isn't good when you are dating it will most likely get worse when the pressures of married life really start to test the relationship foundations.

You must invest time, love, kindness and patience; as well as be unselfish in a relationship. If your partner does not repay you on this investment, then you have to seriously consider 'selling' the investment.

Investing in yourself on a professional and personal level does pay rewards. These rewards do not always present themselves immediately: this is where persistence comes in.

When the financial rewards do start to flow your way you should have an achievable plan on how to successfully manage the money — and the discipline to manage yourself. There are many sad stories about fortunes squandered due to ill-fated investment schemes, gambling and/or an addiction to alcohol and drugs. Learn from the lessons of others; it is far less painful than learning the same lessons yourself.

The investing knowledge that is revealed in the following chapters will assist you in retaining the wealth you create from your career.

5 A Navigation Guide to the World of Investing

‘Experience taught me a few things. One is to listen to your gut, no matter how good something sounds on paper. The second is that you’re generally better off sticking with what you know. And the third is that sometimes your best investments are the ones you don’t make.’

– Donald Trump

Investing is a bit like swimming in the ocean. It can be exhilarating, refreshing and fun. However, the ocean you swam in yesterday; the one that provided you with an uplifting experience may not be the same as the one you swim in today.

The conditions may have changed and there could be a strong undertow, dumping waves or even sharks in the water.

The world of investing must be treated with the same respect you give the ocean. Investment markets are powerful forces and they can create and destroy personal fortunes. Investment conditions are constantly changing: markets (property and shares) boom and bust and economic conditions are continually evolving. The business cycle goes through a regular process of expansion (boom) and contraction (recession) just like the tides of an ocean. This is a normal course of events. The thing to be aware of is where you are in the cycle. Is the economic wave about to rise or are you on the crest, about to be dumped?

When you decide to enter the investment world, it is wise to adopt the same caution as you would when deciding to swim in an unknown body of water. Gradually feel your way in.

Not to put too negative a point on it, but so many people have faced financial ruin by being naïve. Investment markets can be very rewarding, but it is important to remember some of the golden rules:

- Nobody can predict the future with absolute accuracy. There are those who have a better understanding of the trends but even they admit that timeframes can vary due

to influences from political events, government decisions and central bankers. The only certainty in the investing game is uncertainty. Stay alert, question assumptions and above all if it does not feel right do not proceed.

- There are two types of returns you achieve from investing:
 1. income and
 2. growth.

Income is derived in several ways:

Asset Class	Income Return
Cash (money in bank)	Interest payment
Term Deposit	Interest payment
Property	Rental payment
Shares	Dividend from company profit

Growth is achieved from the price of the investment (share or property) increasing in value.

Here is an example of how these two returns work:

Firstly, if you invest \$100,000 into a Term Deposit for twelve months at 6 percent per annum you receive an interest (income) payment of \$6,000. Plus, your original capital is returned to you (no growth).

Whereas if you purchase a property for \$300,000 there is the prospect for both income and growth. Here's how:

Income: Your tenant agrees to pay rent of \$300 per week. After allowing for your annual expenses (rates, insurances etc.) the net (before tax is paid) weekly rent is \$220 which equates to \$11,440 per annum.

The \$11,440 net rent equates to an income return of 3.8 percent on the property value of \$300,000.

Growth: Assume that your property is valued twelve months later at \$315,000. The \$15,000 growth in value equates to a 5 percent return on your investment (\$15,000 divided by \$300,000).

The total return for twelve months is *Income* of 3.8 percent + *Growth* of 5.0 percent = 8.8 percent in total.

Obviously if the value of the property or share falls, this will have a negative impact on your total return.

In the above example if the property had *fallen* \$15,000 in value, the total return for twelve months would have been -1.2% (income 3.8% less 5% reduction in value).

In boom times, investors tend to chase growth (appreciating asset prices) and income is a secondary consideration. Let's face it, an asset (property or share) going up rapidly in price is far more exciting than a boring monthly rental payment or half-yearly dividend.

When markets decline or are flat, investors' focus tends to return to income. The boring income return becomes highly sought after.

Value investors always look at income (the more certain rate of return) first and any growth will be seen as a bonus.

To determine whether you are buying value or not, the following example will assist you in doing the math to assess the merits of an investment:

Value of Investment	Income received	% of Income Return	Projected TOTAL return (Income + Growth)	% of Growth needed to achieve Projected Return
\$ 200,000	\$10,000	5.0%	8.0%	3.0%
\$ 400,000	\$10,000	2.5%	8.0%	5.5%
\$ 500,000	\$10,000	2.0%	8.0%	6.0%
\$1,000,000	\$10,000	1.0%	8.0%	7.0%

The lower the percentage of income (the more certain return) an asset produces, the greater the reliance on growth (the more uncertain return) to achieve the projected rate of return. In a rising market, higher rates of growth can be on offer but eventually the cycle moves on and markets stagnate or fall — there goes your ability to achieve the projected rate of return.

Use the 'Risk-Free' rate of return to assess the merits of an investment. This is a

simple and very useful guide in evaluating the quality of an investment.

The 'Risk-Free' rate of return is the twelve-month '*bank*' (not some dodgy institution) term deposit interest rate. With a term deposit from a reputable institution you are at no risk of losing even a single cent of your capital.

For example, if the Commonwealth Bank is offering 7 percent for twelve months, this becomes your 'risk-free' return by which you can measure other investments. If you have \$100,000 to invest you know for certain that at the end of the twelve months you will receive \$7,000 *and* your \$100,000 back.

A property investment may have a rental income of 3 percent (*after* expenses) so you have to achieve a growth return of at least 4 percent to equate to the risk-free return of 7 percent. In fact, to compensate you for the potential risk of the property falling in value, the expected growth return should be higher than 4 percent.

In the case of vacant land you receive nil income and incur annual rates (which may account for 1% per annum of your purchase price). Therefore you have to receive an 8% growth return to equal the 'risk-free' return.

A share investment may pay you a dividend income of 4 percent, so the growth would have to be 3 percent to equate to the risk-free return.

These are simple examples of assessing risk/return. In the world of investing, there are so many variables that turn the simple into complex.

For instance, the above examples do not take into account the tax treatment of the income and growth. Interest earned is fully taxable at your top tax rate. Property income (depreciation allowances) and share dividends (franking credits) have preferential tax treatment. While you may receive a three or four percent income from the property or shares, you may not be subject to tax on all of the income received.

The growth on an investment is referred to as a 'capital gain'. Provided you hold the investment for twelve months or longer, only half the gain is subject to tax. The other half is tax-free.

If you were doing this exercise back in 2000, the term deposit rate was 6 percent. BHP was paying a dividend of 2 percent at the time. Over the course of the decade, the BHP share price has appreciated at a rate of 17% per annum, giving investors a total return of 19% (2% income + 17% growth) per annum.

The Australian share market (via an index fund) pays an average dividend of 3.5 percent and has grown at a compound rate of 4.5 percent since 2000 — giving investors

a total return of 8 percent. The beneficial tax treatment of the income and growth from an index fund means the 8 percent would equate to an *after* tax return of approximately 6 percent.

For the same period, a 6 percent term deposit interest is fully taxable and the after tax return would be 3.6 percent (assuming a 40% tax rate).

As you can see from the above examples, risk (accepting capital volatility) has been rewarded with a return well in excess of the risk-free return. This is not always the case, so using the risk-free rate of return assessment process is always a good start to determining whether you should look more closely at the merits of an investment or not. Here are some key points to consider:

- Sales people are motivated by commission — until they have proven they are working in your best interest (and believe me, few will ever earn this absolute trust) be very, very wary of investment brokers/real estate agents/financial planners/property promoters/share brokers or any other fancy title they give themselves to sound professional. Remember, for them to receive money to run their own lives, they must first access your money. Obviously you will need to deal with agents or brokers during the course of your life and you should treat them with respect, but be cautious and do your own research to determine whether they really are being honest in their dealings with you.

As Donald Trump says, ‘Listen to your gut.’ If it doesn’t sit well or you feel you are not fully apprised of sufficient information, *walk away*.

- If it sounds too good to be true, it usually is — you cannot have it all — high returns and no risk make about as much sense as yours truly becoming a NSW supporter. The higher the return the greater the risk that you will lose some or all of your money. There is no shortcut with risk and reward. Promises of great riches also come with the unspoken and unwritten but ever-present promise of loss of money.
- Always, *always* do the calculations to determine ‘if this goes wrong (and believe me it can and often times will) how much will I lose and can I afford to take this level of loss?’

This is what Donald Trump refers to when he says, ‘Sometimes your best investments are the ones you don’t make.’ Leaving an investment ‘opportunity’ alone can often be the best investment you can make.

I am absolutely certain Bernie Madoff’s investors wish they had left him well alone.

- Booms *always, always, always* BUST. There is absolutely no exception to this rule. The longer a boom goes on the greater its gravitational pull to draw in as many suckers as it can before it busts. The US property boom (propelled by sub-prime lending) carried on for nearly five years before it finally collapsed. The 2003–2007 share market boom was the lure that Storm Financial used to attract many unsuspecting investors. The boom times felt like they were never going to end. For four years in a row the market returned a hugely impressive 20 percent per annum.

Because this incredible run went on year after year, people began to think that these results were normal. History clearly shows the long term average of the share market is around 9 percent per annum. This is less than half what the market had been delivering in the 2003–2007 boom and it is only common sense to assume that a prolonged period of above average performance should naturally be followed by a period of below average performance. It's called 'reversion to the mean'. Yet somehow this piece of information was lost in the rush to participate in this seemingly endless boom.

The Global Financial Crisis (GFC) caused the share market to fall 50% in value. People were given a serious wake-up call. The market was demanding and receiving respect. Some people suffered devastating losses and their lives will never ever be the same again. All booms, each and every one of them, *bust*. There are no exceptions to this rule.

The only difference with each boom is the duration. Some are short and others are long. The best telltale sign of a boom is when everyone is talking about it (whatever the 'it' is) and they know someone who has made a small or even large fortune or they personally are about to make a small fortune. Resist the temptation to follow the herd (in fact they are lemmings headed for a fall from a very high cliff).

As you know, it can be rather uncomfortable going against the popular trend, but when the trend has exhausted itself you will be the smart one. As Charles Mackay once said, *'Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one.'*

- Dollar Cost Averaging — An investment strategy designed to reduce volatility in which investments are purchased in fixed dollar amounts at regular intervals, regardless of what direction the market is moving. Thus, as the price of the investment rises, fewer units/shares are bought, and as prices fall, more units/shares are bought.

Here's how dollar cost averaging works:

Let's say that you wish to invest \$1,000 per month into superannuation/investment trust or shares. The following table shows how, over the course of twelve months, you can smooth out your investment entry point:

Month	Regular Investment	Price of Investment	Number of Units/ Shares purchased
January	\$1,000	\$1.00	1,000
February	\$1,000	\$1.10	909
March	\$1,000	\$1.00	1,000
April	\$1,000	\$0.90	1,111
May	\$1,000	\$0.85	1,176
June	\$1,000	\$0.80	1,250
July	\$1,000	\$0.75	1,333
August	\$1,000	\$0.70	1,428
September	\$1,000	\$0.60	1,667
October	\$1,000	\$0.75	1,333
November	\$1,000	\$0.85	1,176
December	\$1,000	\$0.90	1,111
Total	\$12,000		14,494

The average price paid over the twelve months was \$0.827 (\$12,000 divided by 14,494 units). Using the December price of \$0.90 the 14,494 investment units would be worth \$13,045.

If you had invested the \$12,000 in January you would have received 12,000 units and at the end of the year those units would be valued at \$10,800.

The above example is based on buying into a flat-to-falling market. If you buy into a rising market you will be buying less units in December compared to January.

Over the long term the 'ups' smooth out the 'downs', and dollar cost averaging is an excellent strategy to reduce the volatility of markets.

- Patience and common sense are pre-requisites for successful investing. Instant wealth can occur but rarely lasts. Lotto winners, sporting stars etc. can enjoy a flood of money, but due to a lack of patience and common sense this newfound wealth is usually transferred to the business people who know how to separate impatient and financially naïve people from their wealth.

Creating and preserving wealth requires a commitment to continual learning. Acquiring knowledge requires patience. This knowledge will assist you in avoiding the pitfalls the average person makes through being financially illiterate. Watching an investment portfolio grow requires patience. There will be times when the market (property or shares) is racing ahead and other times when it falls and stagnates. Provided you have quality investments, you have to remain patient through these periods.

Common sense is not as common as you would think. If something sounds too good to be true it is, and there is no such thing as a sure bet or guaranteed road to riches. This is not rocket science but experience and observation has shown me that fortunes have been lost because greed has blinded some people to a common sense appraisal of the so-called investment opportunity. There is an old saying that is well worth remembering: ‘The financial graveyard is littered with the corpses of the greedy.’

- Educate yourself on how the Australian tax system works. The following is a table of the tax rates in Australia. These tax rates apply to everyone, from politicians to CEOs and checkout chicks:

Tax Rates 2013-14 (Residents)

Taxable income	Tax on this income*
0 – \$18,200	Nil
\$18,201 – \$37,000	19c for each \$1 over \$18,200
\$37,001 – \$80,000	\$3,572 plus 32.5c for each \$1 over \$37,000
\$80,001 – \$180,000	\$17,547 plus 37c for each \$1 over \$80,000
\$180,001 and over	\$54,547 plus 45c for each \$1 over \$180,000

* The above table does not include Medicare Levy or the effect of any Low Income Tax Offset (“LITO”).

If you are earning \$45,000 per annum, the income tax you will pay is calculated as follows:

\$0–\$18,200 = NIL tax

\$18,201–\$37,000 = \$19,000 x 19% tax = \$3,610

\$37,000–\$45,000 = \$8,000 x 32.5% tax = \$2,600

Total tax on \$45,000 income is \$6,210 (\$3,610 + \$2,600).

You will also pay a 1.5% Medicare levy on the \$45,000 = \$675.

Income	\$45,000
Less	
Income Tax	\$ 6,210
Medicare Levy	\$ 675
<hr/>	
NET (after tax) Income	\$38,115

If you are paid fortnightly you will receive \$1,466 (\$38,115 divided by 26) into your bank account.

Your employer sends the tax to the Australian Taxation Office (ATO).

If you are earning \$100,000, then by using the above scale you will see \$20,000 of that income (from \$80,000 to \$100,000) is in the 37% tax category.

When your income starts to increase and push you into the higher tax brackets (37% and 45% tax rates) it is tempting to look for ways to minimize your tax. Be very careful. You may save tax but you could lose a whole lot more than the tax you save.

- Do not invest purely for the reason of reducing your tax. This is short-sighted and likely to fail. Instead, invest to make a healthy profit and in fact you will pay more tax.

The people who are behind these so-called 'tax saving schemes' are more than happy to earn lots of money from promoting their scheme. A by-product of earning this money is they also have to pay tax. This ironic state of affairs means that they want you to give them money to reduce your income so you pay less tax, but they are happy to earn big bucks for promoting the scheme. It begs the question: if tax is so bad then why don't they promote the scheme for a reduced commission rate

and earn less money? The only way you can legitimately pay less tax is to earn less money. These are the most common tax savings schemes that are promoted:

Negative gearing: this is a fancy term for taking out a loan to buy an investment property when the rent paid by tenant is not enough to pay the interest on the loan, requiring you to use some of your income to make the loan repayment. For example, you borrow \$500,000 at a seven percent interest rate to buy an investment property.

Your interest cost will be \$35,000 per annum
Council rates \$2,000
Building insurance \$1,000
An allowance for maintenance (or body corporate) \$1,500
Total cost of holding investment property \$39,500.

If we assume that your tenant pays you \$500 per week for 48 weeks per annum (this makes an allowance for a four week period when the property may be vacant), the total rent received will be \$24,000.

The difference of \$15,500 you will have to pay from your income and you are allowed to deduct this from your annual income when it comes to tax purposes.

So if you are earning \$100,000 per annum you will pay tax on \$84,500. Whilst you will save approximately \$5,700 in tax, you had to pay out \$15,500 to achieve this 'saving'.

The net (after tax) cost to you each year will be approx. \$9,800.

If you buy wisely and the property rises in value, this cost will have been well worth it.

The better option is to be as close to positively geared as you can be. This means that the rent you receive is nearly as much or more than your annual costs. This way you do not have to contribute as much of your income to meeting these expenses.

In the above example, if you did not contribute the additional \$15,500 you will pay an additional \$5,700 in tax. However, you would still be \$9,800 (after tax) better off and your tenant would have met the expenses of holding the property.

To improve the odds of negative gearing being successful for you, it is best to be in the higher income levels i.e. in excess of \$180,000 per annum and when the property market is not in a boom phase, otherwise you will pay too much for the property and any tax benefits will be lost due to the fall in property's value.

Another form of tax saving is investing in films, forestry schemes, vineyards and

other agricultural projects. These may sound creative and supportive of various industries, but past outcomes show that less than ten percent of these schemes are successful.

The vast majority of these schemes fail for a number of reasons (not helped by greedy or exaggerated promotion). Put simply: *ignore* these schemes. They may initially save you some tax but the odds are firmly against you ever seeing your investment ever again.

A legitimate low-risk tax saving strategy is an additional tax-deductible contribution to superannuation. Unlike a property purchase where you are committed to loan repayments and annual holding charges, you can make a one-off contribution to super to reduce your tax in any given year. You will be limited to a maximum tax-deductible contribution level of \$25,000 per financial year (which includes your employer's compulsory contribution plus any additional contribution you wish to make).

- Pay off your non-deductible debt *first* before anything else. Non-deductible debt is loan/s you have for personal use, i.e. to buy a home, car, holiday, clothes etc. The interest on these loans cannot be claimed as a tax deduction (as opposed to a loan to buy an investment property or shares). A conservative strategy is to own or very nearly own your home before you consider borrowing to invest in another property or shares.

Once you own your home you have secured your shelter. Be very, very wary of anyone who suggests you should borrow against your home — if the investment goes bad (Storm Financial example) you could lose your home, and this is in fact what has happened to many unfortunate Storm investors. Even if you have been genuinely duped (like some Storm investors) it will take you years of negotiating your way through the legal system before achieving a possible outcome (a huge waste of time and emotional energy).

You are better off avoiding the problem in the first place. As they say, 'An ounce of prevention is better than a ton of cure.'

- Avoid share-trading schemes. These are computer programs that theoretically teach you how to successfully trade the market. Trust your instincts: if you developed a program with the capacity to make an above average income from trading shares would *you* share it with anyone?

The only people who make money from these computer trading programs are the marketing smarties who sell them. Very few, if any, investors make a dollar — most lose, so save yourself the heartache and do not venture up this dry gully.

- Property seminars spruiking the benefits of property are usually high-priced and high-pressure sales pitches — some, not all, will try to sell you properties that they already own and have put a healthy profit margin on so they can find a sucker (sorry, ‘investor’) to sell it to.

This is where doing your own research and understanding what real value is will really help you avoid the common mistake of buying an over-priced property that has been dressed up by a developer or property spruiker.

Property developers are in the business to make a profit and they therefore build a hefty margin into their projects to ensure a healthy profit is realised. Often these properties can already be fully priced and offer little profit potential for the purchaser.

Do your research and look at what else of comparable standard is available and at what price. This will give you some idea of whether the developer’s product is value for money or not.

- Ponzi schemes. The best known Ponzi (pyramid) scheme was the one designed by the infamous Bernie Madoff. These schemes derive their name from the confidence trickster Charles Ponzi. The basic aim of these schemes is to pay early investors from the money gleaned from the later investors. The schemes always offer a high guaranteed rate of return which is the enticement to lure initial investors into the scheme.

In Madoff’s case, he offered a regular return of 1 percent per month (12% per annum). When compared to bank interest in the United States of three percent, this looked very attractive. In addition, Madoff once held the position of Chairman of the NASDAQ (small companies exchange), which afforded him a certain amount of credibility.

The money from the new investors into the scheme would be used to pay the interest to the existing investors.

The longer these schemes continue the more people believe that they are genuinely earning this rate of return and so the base of the pyramid grows larger. Initially it is one investor being supported by two investors. Then those three investors need to be supported by six investors so that you end up with nine investors (1+2+6) who need to be supported by a larger number of people and so it goes on.

All pyramid schemes are doomed to fail. The reason being is that even if everyone in the world joined you would eventually run out of people to be the new base of the scheme. So the rule of thumb is whenever you are offered an investment that has a track record of paying a guaranteed above average rate of return (much higher than bank interest), best to ignore it.

- Surround yourself with competent professionals including a solicitor and accountant. Finding a good accountant is imperative to legally minimising your tax. Investing in good legal and tax advice is money well spent.
- Press the delete button on spam and scams — any offer (email or phone call) of instant riches is an insult to your intelligence and should be dismissed immediately. There is no such thing. There is no exception to this rule. Remember, scams operate on the principle of, ‘A fool and his money are soon parted.’
- Avoid having to live through the ‘Act in haste and repent in leisure’ syndrome. Serious investors do their research on the relevant investment prior to committing their money to it. Buying on impulse or due to high-pressure sales tactics can lead to a situation where the cold light of day finds you regretting making a hasty and poorly thought out decision. Best to walk away and think it through and/or ask for the opinion of people you trust before committing to a particular course of action.
- There will always be another ‘one-off’ opportunity — do not be pressured by the ‘never to be repeated opportunity’ line. This is an old sales gimmick — do you really think there will never be another opportunity in the whole world ever again in your lifetime? It simply does not make sense. Whenever you hear the phrases ‘Never to be repeated’ or ‘Once in a lifetime opportunity’ be instantly wary.
- Do not do business with people you don’t trust even though they could make you a lot of money. At some point in the relationship the character flaws these people possess (usually greed or selfishness) will surface and work against you.

Successful partnerships can multiply your success, but these are in the minority. Be very careful before embarking on a financial venture with a business partner — this is where a good solicitor will be invaluable in drawing up a partnership agreement that will protect your interests in the event the partnership fails.

- CFD’s (contracts for difference) — I won’t bother explaining how the product works (due to the fact my knowledge is minimal in this area) because this is all you need to know: *avoid* them like the plague.

These investments have the potential to magnify gains (here again is the old marketing promise of ‘great riches to be had’) but what is hidden in the fine print is the potential to also magnify your losses. There have been instances where people have been wiped out (lost everything) in a single day. The other trap is that a few early successes (profitable trades) may make you overconfident in your ability to handle this sort of investment, and can set you up for a disastrous fall.

Due to the financially destructive powers of these investments they have been banned in the US. In Australia, ASIC (Australian Securities Investment Commission) carry a warning on their website that a CFD is akin to ‘borrowing to gamble’. CFD’s are time bombs that will blow up your money. Don’t go there.

- Follow the KISS (keep it simple stupid) principle with investments — if you do not understand it, leave it alone — if it sounds too good to be true, it usually is. The next chapters discuss the various asset classes — Cash/Fixed, Property and Shares — and hopefully will guide you on how to apply the KISS principle.

6 Cash and Fixed Interest Investments

'From birth to age 18, a girl needs good parents, from 18 to 35 she needs good looks, from 35 to 55 she needs a good personality, and from 55 on she needs cash.'

– Sophie Tucker

Sophie Tucker made this observation when she was sixty two years old. Obviously her life journey taught her the importance of cash in the later years of her life.

In investment terms, 'cash' means money in the bank. A popular theory among investment professionals is that cash in the bank is an idle use of money — hence the term, 'Cash is Trash.' As usual there is more than one dimension to this generalisation. I will elaborate on this a little later, but for now let's look at the basics for handling your cash.

To function in modern society it is essential to have money in the bank for ready access. There are living expenses to be paid. How much should you keep in the bank? My rule of thumb is at least three months' worth of your living expenses. If you have this money set aside it means you do not have the pressure of living from pay cheque to pay cheque.

Where should you keep this money? You need a day-to-day bank account to access cash — make sure the monthly fees are not excessive. You do not want to be paying the bank for holding onto your money.

A day-to-day account will not pay you any interest (or if it does it will be negligible). Therefore you should keep an operating minimum in your day-to-day account. The rest of your cash should be in a web-based bank's high interest earning account OR a higher earning account offered by the bank you have your day-to-day account with. This way you can earn a decent (based on prevailing rates) interest rate on your cash.

Earlier in this chapter I mentioned how investment professionals often refer to cash as an 'idle' investment. By this they mean your money is earning 3 percent but you stand to lose around 1.2 percent of this in tax (assuming you pay tax at the 37% tax rate plus

Medicare Levy). Your after-tax return is 1.8 percent, which is hardly enough to cover inflation (the rising cost of living). In contrast, shares and property are promoted as long term growth investments that, in theory, have higher rates of return and tax advantages.

However, there are times in the investment cycle when 'Cash is King'. The ability to immediately have access to cash to buy shares and property after a slump can provide you with an opportunity to acquire a sound investment at a discounted level.

According to Wikipedia, in 1987 Kerry Packer sold Channel Nine to Alan Bond for \$1.05 Billion. Packer sat on the cash and bought the business back three years later for \$250 Million. Not bad for 'idle' cash.

There is no question that when the investment markets (shares and property) do turn positive they will perform much better than money in the bank. However, while markets are falling, the buying power of cash is actually increasing.

Sustained periods of high inflation will also erode the buying power of money in the bank. In 1970 you were able to comfortably retire on \$50,000 (this was the value of two average homes).

During the decade of the 1970's inflation rose to 16 percent per annum and money in the bank was decimated. By 1980, \$50,000 would only buy you one home, therefore half your buying power was wiped out in the space of ten years. Nowadays \$50,000 would be a small deposit on a home or buy you a slightly better motor vehicle.

Over the course of forty years inflation has eroded the buying power of cash in the bank. If the 1970 retiree had bought two homes instead of leaving the \$50,000 in the bank, the value of the properties would have risen with inflation and be worth around \$800,000 (\$400,000 each — current average house price).

On the flipside, periods of deflation (which we haven't experienced in 80 years since the Great Depression) actually increase the buying power of cash. In a deflationary period prices of assets and goods actually decrease (deflate).

The nationwide slump in US house prices after the GFC is a case of price deflation. People were too scared to commit to a major asset purchase unless the price was right, so the value kept falling until those with cash found the price attractive enough (and were confident enough) to want to trade their valuable cash for the discounted asset.

The price of the motor vehicles is another example of deflation. Over the past decade the price of cars has hardly risen. In fact you actually get more features for the same or lower cost than the previous model. The car manufacturers are holding the prices down in order to attract sales.

Holding higher levels of cash can be a very sensible move in an environment when prices are falling, but at some point in the cycle prices will bottom out and begin to reverse. This is when you want to move from cash to hard assets (shares and property) so you can participate in the market recovery. Your timing will rarely be perfect; the trick is to buy somewhere near the bottom and be patient.

Generally cash is not a long term position — however over the past twenty years investors in Japan would have been far better off in cash than property and shares (both of which have fallen up to 80% in value).

The point is there is no hard and fast rule. You have to monitor the conditions and act on your judgement.

Fixed interest: Fixed interest is when you agree to invest your money for a fixed period of time (one month, six months, one year or longer) at a fixed rate of return for the investment period. The interest rate is usually higher for term deposits when compared to cash. Cash offers you immediate access to money and therefore the interest rate tends to be lower.

The banks called these fixed interest investments Term Deposits. There are other types of fixed interest investments — Government Bonds, mortgage funds, corporate bonds (where a company wants to borrow money for its business).

In my opinion it is best to apply the ‘keep it simple stupid’ (KISS) principle and invest in Term Deposits with a reputable bank.

There are higher interest options available with the other forms of fixed interest investing, but remember that the higher the return the higher the risk you will lose some or all of your money.

A number of mortgage funds that offered high rates of return have gone into receivership after the GFC — City Pacific, MFS and Australian Capital Reserve (ACR) to name a few. Investors in these funds received two to three percent above the rate banks were offering at the time, but they have now lost the majority of their money. The extra two to three percent came at a very high cost.

The risk with a term deposit from a reputable bank is that interest rates could move higher during your investment term and therefore you are foregoing the opportunity to earn a higher rate for a period of time.

The rule of thumb is you should only be prepared to invest for a term longer than twelve months if you believe that interest rates are near their peak in the cycle. If rates are about to fall, then locking in the higher rates for a longer period would be a sound strategy.

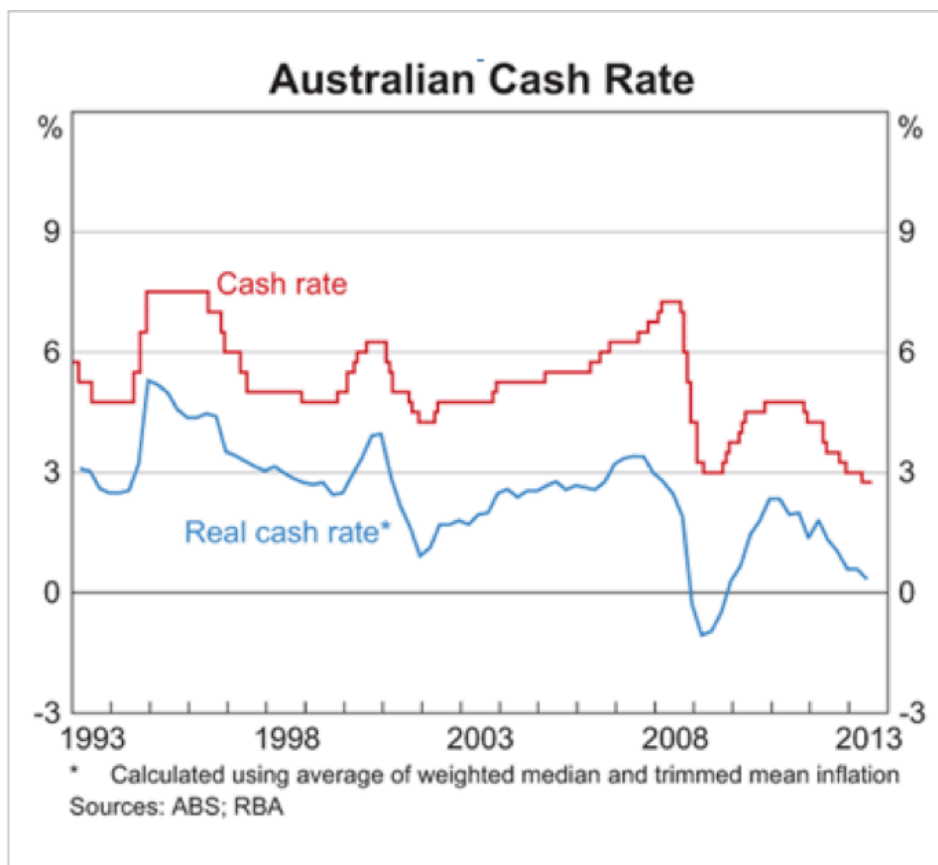
Currently in the United States interest rates are close to 0%, therefore an investor in the US would be reasonable to assume at some point interest rates will rise (logically they can't go any lower) and locking in current rates for three years may not be the smartest investment choice.

To ascertain where we might be in the interest rate cycle, do a Google search: 'chart of Australian interest rates'. The following chart is from the Reserve Bank of Australia website:

www.rba.gov.au/chart-pack/interest-rates.html

The Cash rate (red line) is the official interest rate movement. The 'real' cash rate is after inflation has been deducted from the cash rate e.g. if the cash rate is 5 percent and the CPI is 2 percent, then the real cash rate is 3 percent.

Since the mid-1990's the cash rate has hovered mainly between four and seven percent. After the GFC, the RBA dropped interest rates rapidly in order to stabilise the economic ship.



Post-GFC, when the global economy appeared to have settled down, rates moved up again. However, in the past two years rates have been falling due to underlying weakness in the global economy. Australia's official cash rate is now the lowest it has been in 50 years.

The interest rate movements shown on this chart suggest that it would not be wise to lock in a Term Deposit for longer than twelve months.

This should also give you an idea of where we are at in comparison to previous cycles. It is not foolproof, but uses historic charts as a guide to help you make an educated guess on the future direction of rates.

Your educated guess will be just as good as any economist, who in my experience are wrong as many times as they are right, so don't place too much weight or credibility in their public utterances. The utterances of these mainstream commentators are dealt with in more detail in a later chapter.

7

Investing in Property

‘Property has its duties as well as its rights’

– Thomas Drummond

Owning property will bestow upon you certain entitlements:

1. The ability to occupy; the ability to choose your tenant
2. The ability to generate a rental income stream
3. The ability to improve the property (provided the local council approves)
4. The ability to participate in the appreciation of the property.

However as a property owner you also have certain responsibilities:

1. Paying your loan repayments
2. Paying council rates
3. Paying Body Corporate levy (if applicable)
4. Paying Building and Contents insurance
5. Property maintenance
6. Paying land tax (the applicable level of land tax on investment property varies from state to state)

Property investment can be highly profitable. Just be sure to factor in the above costs before you decide on signing your name to a contract.

When most people think of property it is usually residential (homes and apartments), however there is a whole range of other property investments to consider.

1. Residential — owner occupied or tenanted
2. Commercial/Office buildings — business related property. The best examples of commercial property are CBD buildings occupied by solicitors, accountants, banks, insurance companies etc.
3. Retail — shopping centres
4. Industrial — warehouses, factories, sheds etc.

5. Vacant land — all vacant land is zoned for a particular purpose
6. Agricultural — farms, cattle stations, timber plantations, orchards etc.
7. Leisure — tourist resorts, golf courses

When you enter into property investments numbered two to seven on the above list (commercial to leisure) you will either require or need to access specific knowledge in these property sectors. There are a range of subtleties that can make investing in these areas a nightmare for a novice, so seek professional advice before you venture into an investment in these specialised sectors.

Your first foray into the property market is most likely going to be a residential property, so here are a few pointers on what to consider with this type of investment:

- The biggest trap with buying a residential property is to remember for the vast majority, emotion overrides logic. Developers and property sellers know how to press your emotional buttons (modern furnishings, state-of-the-art kitchens and well-presented bathrooms). Learn to think with your head and not act with your heart. Look at the cold hard numbers, because these costs will be with you long after the gloss of the kitchen and bathrooms have worn off.
- Location: Does it have schools nearby? University? Hospital? Shops? Day care? Car parking? Major shopping area? Cafes? Sporting facilities? These factors are important for two reasons a) if you live there it will make your lifestyle better and b) for re-sale or rental purposes. Also, find out if the property is located in an area that is flood-prone or subject to cyclones. This could have a major impact on your annual insurance costs as well as future re-sale value.
- Transport: How do people get to work in that area? How far is it to bus stations or train stations? With the rising cost of fuel and public car parking most people will commute on public transport. Easy access to bus or train will be a major selling point for potential buyers.
- Demographics: Look at the potential demand of the property by matching the household demographics to the property. Is the area suitable for families, young professionals, university students, retirees or empty nesters?
- Rent-ability: Review the logical layout of the home; does it have good-sized bedrooms? Are there usable living spaces inside and outside, other features such as storage? Does the property have sufficient features to attract a person to rent the property from you?

- **Potential:** Is there an ability to increase the value of the property through renovation or development? Sometimes the value of a property can be significantly improved with cosmetic touches — landscaping and painting. It is the major structural work that can blow your renovation budgets sky-high. Check the surrounding properties are not able to be developed into high-density blocks of units. Check the zoning of surrounding properties with the local council and see if there are any plans for government resumption of property or major roads to be developed.
- **Affordability:** Stay within the second and third quartile of prices in the suburb for price and rent. The bottom and top quartile of the price range in the area you are looking for will reduce your chances of finding a suitable tenant. Find out what the average weekly rent is in the area — few people could afford to pay \$1,200 per week, whereas a lot of people can pay \$300–500 per week. If you are relying on the rent to assist in paying a loan, this factor will be critical to you.
- **Value for money:** How do you know whether you are paying fair value or not? You must do your research. Go to open homes, attend auctions, read the Realtor section, look online at www.realestate.com.au or similar sites and talk to estate agents. Once you start programming your mind to seek out information you will be surprised at how attuned you will become to all sorts of data on the property market. Gaining an in-depth knowledge on the local market is critical but it is just as important to have a sound understanding of the broader property market — has the market been booming for a few years and, if so, will you be buying towards the top of the cycle or has there been a slump and there is an opportunity to pick up a bargain?

First Home-Owner's Grant

The First Home Owner grant will only be applicable if you purchase a home for you to live in. It does not apply to the purchase of an investment property.

The following is an extract from the Government website — www.firsthome.gov.au — about the First Home Owner Grant and the eligibility criteria.

'The First Home Owner Grant (FHOG) scheme was introduced on 1 July 2000 to offset the effect of the GST on home ownership. It is a national scheme funded by the states and territories and administered under their own legislation.'

'Under the scheme, a one-off grant is payable to first home owners that satisfy all the eligibility criteria.'

Each State or Territory has its own eligibility requirements and level of payment.

The www.firsthome.gov.au website provides a direct link to your State or Territory to review the eligibility criteria.

It is important to remember the Federal Government can increase or decrease the amount of the First Homeowner Grant depending upon economic and budget conditions — it is not set in stone.

It is always best to consider the FHOG as a bonus rather than an amount you are relying on to make the property purchase affordable for you.

- When buying a property there are the following costs:
 1. Loan establishment fees — banks charge you to prepare and execute the loan paperwork.
 2. Stamp duty — the rate of stamp duty varies from state to state and also on whether the property is your own home or for investment.
 3. Legal fees — these are commonly called conveyancing costs and are fees for the solicitor to ensure the Contract for Sale does not contain any nasty clauses. They undertake property searches to determine whether there is anything untoward with the property and they register your ownership on the title.
 4. Agents' fees — the real estate agent is paid by the seller and these costs are built into the sale price. For example the standard real estate commission in Queensland is: First \$18,000 at five percent and the balance at 2.5 percent.

In the case of property developers, they will sometimes pay higher rates of commissions to agents to encourage them to market/sell their property. Be aware that these additional incentives are already built into the sale price.

5. Building and pest inspection fees — it is essential you have the building independently assessed by competent building and pest inspectors to ensure there are no major structural problems and/or termite issues.
- When you are serious about investing in property make sure you have organized the following *before* signing a contract:
 - Solicitor to do the conveyancing
 - Finance in place (either through a bank or mortgage broker)
 - Building and pest inspectors ready to conduct inspections on property

Having these in place will avoid panic during the ‘cooling off’ period of the contract.

Depending on which State you buy in and whether it is an owner/occupier or investment property, the total of these costs will account for approximately five to ten percent of your purchase price. Therefore, if you buy a \$400,000 property, budget for your additional costs to be \$20,000–\$40,000. This is why it is imperative to buy well so you can recoup these costs in a shorter timeframe.

- Ongoing Costs — Council rates (issued quarterly or half yearly); insurance (building and contents); body corporate (if you buy an apartment); ongoing maintenance. All of these costs will increase each year at a rate greater than inflation, so make sure you have allowed plenty of room for this in your budget. The final and largest cost will be your loan repayment — you need to factor in the potential for interest rate rises (as mentioned in Chapter Three).
- Back yourself — By this I mean do not let real estate agents talk you out of putting in an offer that is on the low side. By law they must submit all written offers to the seller. You never know how desperate a vendor may be. The worse case is that they scoff and say no. You haven’t lost anything but you may just gain an asset at a bargain price.
- Liquidity — Property is an ‘illiquid’ investment, which means that the value cannot be readily turned into cash. With shares (except for small companies) you can sell anytime (at the prevailing price) and have your cash within three days. Property is a different matter. In a tough market you can wait months, even years, to sell the property for a fair value (it took us eighteen months to sell one property: fortunately we were not in a hurry).

The way to avoid having to sell a property at fire sale levels is to have a good cash reserve behind you. Even in a good market it usually takes around eight to ten weeks from the time the property goes on the market until you receive the money in your hot little hand.

You may not be a position to invest in commercial property for quite a few years, but here are a couple of tips I have learnt about investing in this sector of the property market:

- Look for a tenant with financial strength. The sad reality is that most new and small businesses fail, so securing a quality tenant is essential to ensure you do not have a building sitting vacant due to the bankruptcy of your tenant.

- Make sure your commercial property has multiple uses. For example a bank, doctor, employment agency, government department etc can occupy the property. Having a broader range of businesses from which to secure a tenant will hopefully minimise any vacancy periods. Whereas a property that is fitted out for a specific purpose e.g. a car wash can only be rented to someone who wants to run a car wash — this is a much more limited field of potential tenants.
- Main road exposure and off-street parking will also enhance the chances of securing a quality tenant.

An alternative to owning a commercial property directly is to invest in a Listed Property Trust or as they are now called Australian Real Estate Investment Trusts (A-REIT). An A-REIT is a property company that is listed on the share market — Westfield, Stocklands, Mirvac etc. The major A-REITs own shopping centres, CBD buildings and industrial property.

How you can invest in A-REITs is discussed in the next chapter on Share Investing.

8

Investing in Shares

‘The investor’s chief problem and even his worst enemy is likely to be himself’

– Peter Lynch.

Peter Lynch was a very successful investment professional in the 1980’s. I read his book *One up on Wall Street* in the 1990’s.

Investing in shares is a lot easier than investing in property. With a few hundred dollars you can buy shares through an online broker for a \$15 brokerage fee, whereas property is at least a \$300,000 investment and the transaction costs run into the thousands of dollars.

The ease of accessibility is why Peter Lynch warns that an investor’s worst enemy is themselves. The usual scenario is you receive a hot tip; the next sure thing, and think, ‘If I invest a spare thousand or two in it I could double, triple or even quadruple my money. What could be easier than that?’

There are many shares that have soared in value and if you had invested in them you would have significantly improved your financial position. On the flipside, there have been many more shares that have promised a lot and delivered little.

From personal experience we made a bit more than what we have lost from investing in the ‘hot tip’ or next ‘sure thing’. It can be fun when the share soars but it is demoralising when they vaporise.

The rule of thumb with investing in a hot tip is to only invest an amount you can afford to lose and which will not cause you financial discomfort.

Investing in shares is much more than having a punt on a hot stock. When you buy shares, you become a part owner of the business. If you buy twenty CBA shares (approximate cost \$1,500), you are now a shareholder (part owner) in one of Australia’s major banks. Depending on how the CBA business performs and whether the economy is in an optimistic or pessimistic mood, the value of your share in the CBA business

may rise or fall. Share investing enables you to participate in the fortunes or misfortunes of various businesses.

Determining the value of a share is not easy. There are so many variables. Before we scratch the surface on how to determine whether shares represent value or not, it is helpful to become more familiar with the jargon associated with share investing. Just like the law, medicine and building industry have their own 'language', so too does share investing.

The following will give you a layman's interpretation of some of the terminology associated with share investing:

1. Industrial shares — These are non-resource (mining) shares. These include banks, insurance companies, technology, retailers, transport, brewers etc.
2. Resource shares — mining or mining-related companies
3. Large-cap — meaning large capitalisation (value) and refers to the very biggest companies — Telstra, the four major banks, BHP, Rio Tinto etc.
4. Mid-cap — companies that are mid-range in their values e.g. Bank of Qld, Harvey Norman, Cochlear etc.
5. Small-cap — the companies that are at the small end of the value range.
6. Dividend imputation or franking credits. This means the company has paid company tax of 30% on their profits and as a shareholder you are permitted to use this tax credit to offset any tax the Australian Tax Office has assessed that you should pay on your dividend (your share of company profit).
7. Price/earning ratio — this is a mathematical formula used to determine the value of a business. For instance the average market P/E is 15. In theory a company earning \$1 million will be priced at \$15 million (15 x \$1 million).
8. Bull market — this means a market that is 'raging' ahead
9. Bear market — this means a market that is being 'clawed' down.

There are a number of accepted truisms relating to investing in shares. A couple of these are:

1. In the long term shares always go up; and
2. You can't go wrong buying blue chip shares.

Both of these statements are only partially correct and should not be treated as gospel. In my experience these statements have been marketed by self-serving groups such as share brokers, financial planners, investment institutions and media commentators with vested interests. If they say it often enough the average person will believe these are statements of fact without questioning the premise.

Over the very long term, share markets actually do rise. By 'long term' we're talking thirty years or more. For instance the US share market (as measured by the S&P 500 index) reached 1500 points in January 2000 and is currently (July 2013) 1680 points. This is only 180 points (12%) higher than where it was thirteen years ago. Now, over the next twenty years it may well rise significantly above its Jan 2000 level but the last thirteen years have not been too much fun for a US share investor. Without the assistance of the US Federal Reserve pumping \$85 Billion per month into propping up the market, it is doubtful the US share market would have even eked out this 12% gain.

The Japanese share market reached its high of nearly 40,000 points in 1990. Currently it is sitting at around 13,700 points. Over the past twenty four three Japanese share investors have lost a whopping 65% of their investment (at the Nikkei's lowest point, the loss in value was over 80%). The following chart shows how the Japanese market quadrupled in value from 10,000 points in 1985 to nearly 40,000 in 1990 and how it has been all downhill since then.

What a torturous path for investors in the Japanese share market to endure.

A study of the Japanese share market shows how the 1985–1990 exuberance (based on massive amounts of debt) got completely out of hand and investors **lost** touch with reality — a severe case of over-confidence. When a share market increases by 400% in value over a five year period, you can see how the general public can be seduced into thinking this economic miracle will go on forever. Unfortunately economic growth built on massive amounts of borrowing is just an illusion and for the past twenty-three years, investors in the Japanese share market have learned this very painful lesson.



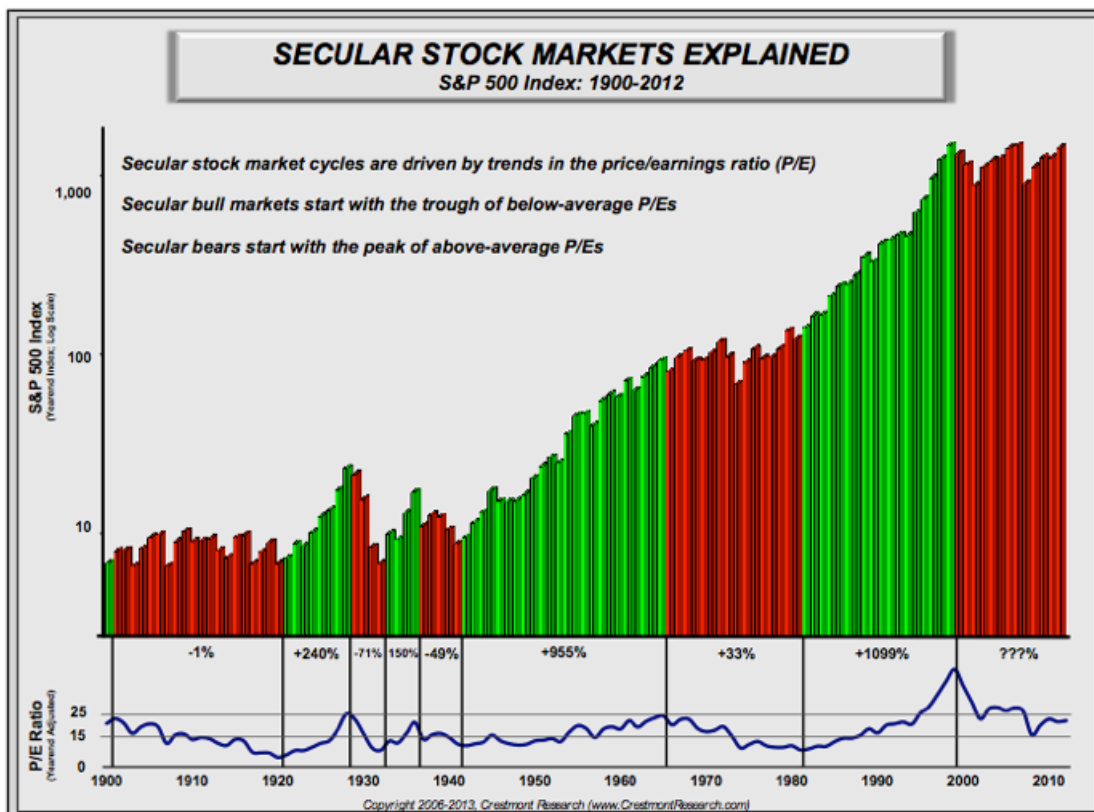
In Australia, the journey has been a little different. In 1968 the All Ordinaries index was 410 points and it rose and fell (stagnated) over the next fourteen years to reach 460 points. This 50-point gain represented a pitiful return of 12% over a fourteen year period (less than 1% per annum). However, from 1982 to 2007 the market rose from 460 points to 6800 points. This twenty five year period returned a phenomenal 1500%.

The point here is that shares are not the absolute certain wealth creation asset that the investment industry would have you believe. There are periods when the market delivers exceptional returns (**secular bull markets**) and periods when you wish you had just left your money in the bank (**secular bear markets**).

The following graph of the US share market (as measured by the S&P 500 index) demonstrates the truism that, 'In the long term markets go up.' However if you take a closer look at the journey you will see a definite staircase (rise and flat) pattern in the upward trajectory. History shows that prolonged periods of out-performance are followed by extended periods of under-performance.

The green sections are Secular Bull markets (prolonged period of upward movement) and the red sections are Secular Bear markets (prolonged period of sideways to down movement).

Most financial planners are unaware the market operates in this fashion. The investment industry tends to draw a line from the bottom to the top and does not study the pattern (staircase fashion).



The share market at its extremities operates on fear and greed (anxiety and over-confidence). Depending upon the prevailing mood, the value of a company can be rise or fall dramatically on the social mood at the time..

In the section on share market terminology I mentioned the P/E ratio. This is the multiple the market applies to earnings to arrive at a value for a company. The long term average P/E is around 15–16 times earnings. However anyone who has an appreciation of basic math knows an average is made up of high, middle and low points. For instance, what is the average of 20 and 10? Answer is fifteen. In this example you either received 20 (above average) or 10 (below average) and no one actually received the average of fifteen.

Often this can be the case with share market statistics. Be aware that statistics can distort the reality. There is much truth in the saying, ‘*A statistician uses statistics much like the drunk uses a lamp post. They are more for support than illumination.*’

In the graph above, the blue line (at the base of the chart) is the change in P/E ratios since 1900. Notice how after a prolonged green (bull) period the blue line rises and towards the end of a red (bear) period it falls.

To give you a real life example of how P/E's and share price valuations work, let's look at the giant US retailer Wal-Mart.

In 1999 Wal-Mart was earning \$1.25 per share (if Wal-Mart has issued 1 billion shares it would mean that they were earning \$1.25 billion) and the share price peaked at \$69. This means the Price/Earnings ratio was 55 (price of \$69 divided by earning of \$1.25).

This was way above the market average P/E of 15–16. Why? By the end of the 1990's the tech boom was in full flight. Millionaires were being created overnight and the US market was in greed overdrive. People forgot about genuine value and were prepared to pay ridiculous amounts of money for shares. Over-confidence reigned supreme.

The tech boom busted in 2000 and the era of cyber greed was over. Since then the Wal-Mart business has continued to expand, and over the past fourteen years Wal-Mart's earnings per share has grown to \$5.08 (this is a 400% increase in earnings since 1999). But what has the share price done? The current price is \$78. The current P/E ratio is now 15 (\$78 divided by \$5.08) — exactly the long term market average.

Wal-Mart fits the definition of a 'blue-chip' company i.e. solid business providing genuine products to a broad range of consumers — yet an investor who bought into Wal-Mart in 1999 (fourteen years ago) has made 13% (less than 1% per annum growth) even though earnings have increased 400%.

This is the secret to share investing — knowing when markets are over or under-valued. If you pay too much for a good company you run the risk of losing money for a very long time. Conversely if you buy a good company at a discount, you will increase your chances of making money in a shorter space of time.

This is borne out from the following chart. Looking back at the performance of the US share market since 1926, you can see the periods **starting** with **low** P/E's (under-valued) offered the best returns over the following decade. Conversely periods **starting** with **high** P/E's (over-valued) performed dismally over the next decade.

**Figure 9:
Results for S&P 500 from Different Starting Shiller P/E Ratios (1926-2012)**

Starting P/E		Avg. Real	Worst Real	Best Real	Standard
<u>Low</u>	<u>High</u>	<u>10 Yr Return</u>	<u>10 Yr Return</u>	<u>10 Yr Return</u>	<u>Deviation</u>
5.2	9.6	10.3%	4.8%	17.5%	2.5%
9.6	10.8	10.4%	3.8%	17.0%	3.5%
10.8	11.9	10.4%	2.8%	15.1%	3.3%
11.9	13.8	9.1%	1.2%	14.3%	3.8%
13.8	15.7	8.0%	-0.9%	15.1%	4.6%
15.7	17.3	5.6%	-2.3%	15.1%	5.0%
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
21.1	25.1	0.9%	-4.4%	8.3%	3.8%
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

Source: Amess, Cliff. "An Old Friend: The Stock Market's Shiller P/E." AQR Capital Management, November 2012.

One of the reasons mainstream financial commentators give for their optimistic views on shares is because 'the company has reported increased earnings'. This is only half of the equation. If the market decides to be more conservative i.e. by applying a lower P/E ratio to those earnings, then the share price can stagnate or fall – as evidenced by Wal-Mart's share price over the past fourteen years.

For instance, if a company earns \$1 million and the P/E is 20, this equates to a \$20 million dollar company. If the company doubles its earnings to \$2 million but the market is now only valuing companies at a P/E of 10, the company remains valued at \$20 million. Earnings rose significantly but it does not necessarily equate to a rising share price.

In periods of market optimism (greed) P/E ratios lose touch with reality (Wal-Mart at 55x compared to the average of 15x) and in periods of market pessimism (fear) P/E ratios can fall well below 10. It is in these periods of pessimism that you want to invest.

As Warren Buffett once said, 'Be fearful when others are greedy and greedy when others are fearful.'

The Australian share market has two major indices:

- The All Ordinaries Index
- The ASX 200 index

The All Ordinaries reflects the share price movements of a larger number of shares.

The ASX 200 reflects the movement of the top 200 companies in Australia.

The way an index works is relatively simple. The following is an example only and the values I have attributed to each company bear no resemblance to reality.

Company	Value	% of index
CBA	\$50 Billion	14%
NAB	\$30 Billion	8%
ANZ	\$35 Billion	10%
Westpac	\$40 Billion	11%
BHP	\$60 Billion	17%
Rio Tinto	\$40 Billion	11%
Telstra	\$25 Billion	7%
Woolworths	\$25 Billion	7%
Wesfarmers	\$30 Billion	8%
Harvey Norman	\$25 Billion	7%
TOTAL	\$360 Billion	100%

In the above example, if BHP (17%) and CBA (14%) share prices move up or down it will influence 31% of the index. Sometimes when they give the share market news on TV you will hear things like, ‘the mining stocks helped lift the index today,’ or ‘banking shares drove the market lower or higher.’ The sheer size of these stocks and their weighting in the index casts a huge shadow over the movement of the share index.

In my opinion the best and most economical way to invest (as opposed to speculate) in the Australian share market is to buy into the ASX 200 index fund (this fund can be purchased through an online broker, the ASX code is STW). This fund will give the investor exposure to the top 200 companies in Australia.

Why invest in the index (Beta investing) and not individual shares (Alpha investing)? With individual shares (buying shares in Telstra or NAB) there are stock-specific risks and rewards. Telstra is a classic example of this.

Telecommunication usage (mobile phones, wireless internet etc.) has grown exponentially over the past decade, but Telstra’s share price has fallen nearly 50% over the past fourteen years. The combination of the bursting in the tech bubble euphoria

and Government interference to reduce Telstra's monopoly in the telecommunication sector has created much uncertainty over the company's future profitability. Investors have re-priced the Telstra business accordingly.

The banking sector has performed strongly over the past decade, however NAB has been relatively weak due to poor management decisions. In Jan 2000 the NAB share price was \$21.80 and is currently around \$30. This is a compound growth return of 2.5 percent per annum.

Yet BHP, CBA and a handful of other quality companies have performed exceptionally well over the past decade. BHP was around \$8 in 2000 and is currently at \$35. This is an outstanding 440% return over thirteen years. Not bad compared to Telstra losing 50% in value.

Individual shares can be very rewarding but picking the right ones is difficult and requires painstaking research. For instance, will BHP continue its stellar run for the next ten years or will Telstra be the stand out performer?

The ASX 200 index over the past thirteen years has returned approximately 65%. This is not particularly brilliant when compared to BHP, but significantly better than Telstra. Investing in the index will reduce your reliance on an individual company to perform and will enable you to participate in the general movement of the market. In this case, if a managed fund had weighted more of their fund into BHP and less into Telstra, it would have significantly outperformed the index, but it is easy with hindsight to say this would have been the preferred strategy. Who are going to be the outstanding companies over the next decade? Foresight is a much harder task and this is why sticking with the index will enable you to participate in the general market movement — it is called Beta investing.

Investing in the ASX 200 index will still require you to do your homework to determine whether the market is over-priced or not. Anyone who invested in the index in late 2007 at 6700 points has lost 25% of their investment. The market had been rising for four straight years. Common sense dictates that this trajectory could not possibly be sustained yet the majority of people were lured in by the fact that it had run for that long and believed it would continue. Common sense is not so common when greed clouds judgment.

You are not limited to investing in the Australian share market. Financial planners heavily promote international shares. You will gain access to a larger group of companies e.g. Microsoft, Wal-Mart, Google etc. which can diversify your risk of just investing in Australia.

In my opinion the best form of international investing will be in Emerging Markets – India, China, Asia, Brazil and Russia. These are low debt, high growth regions. Over the next ten to twenty years the economic development in these countries will be reflected in their share markets. Investing in these regions will be volatile so you will need to do your homework on whether they are over-priced or not before committing your funds to this investment. Again you can buy index funds that are comprised of the companies that operate in those countries. These options are discussed in more detail in Chapter Ten.

The other area of the Australian share market is the Australian Real Estate Investment Trusts (A-REIT) will provide you with access to a broad range of property investments in companies such as Westfield, Stocklands, Mirvac, GPT etc. Between them these companies own most of Australia's prime commercial and retail property.

The A-REIT sector was absolutely smashed in the GFC, falling by more than 60% in value (compared to the broader share market that fell 50% in value). The reason it fell so hard was that the level of debt being used by A-REITs to buy property was too high. When investors decided to apply a more conservative value to the property assets, the impact was profound on the A-REITs.

Here is how 'gearing' or borrowing to invest works:

Property value	-	\$1 million
Investor Equity	-	\$300,000
Loan (Debt)	-	\$700,000.

In this instance the property is geared at 70% (\$700,000 debt to \$1 million property value).

If the property is re-valued to \$1.3 million, the investor has increased their equity from \$300,000 to \$600,000 – this is a 100% rate of return. So when the market is booming, 'gearing up' can significantly increase your rate of return. This is what the A-REITs did in the 2003–2007 period.

Unfortunately when the market re-values downwards, it results in carnage for the investor.

Using the above example, if the property is re-valued down to \$800,000, the investor's equity is now only \$100,000. This is a sobering 67% fall in value.

In maintaining the principle of investing in index funds, the preferred investment to gain exposure to the A-REIT sector is the A-REIT (Listed Property Trust) Exchange Traded Fund – ASX Code: SLF.

Finally, in my experience there are only a few brokers or planners who truly understand the dynamics of the share market. The majority thinks they know, but when questioned in depth, their knowledge is shallow. This doesn't mean they are trying to 'rip you off' but rather they do not have the experience or expertise to guide you successfully with your investment into shares – especially in a Secular *Bear* Market . Be cautious about acting on advice from parties who stand to prosper from you proceeding with their recommendations – are they doing it for your benefit or theirs?

It may well be excellent advice, but it is prudent to ask yourself the question prior to committing to the recommended course of action.

9 Commodities — The Earth's Resources

'The meek shall inherit the Earth, but not its mineral rights.'

– John Paul Getty

The rapid and unrelenting economic growth of the developing world had fuelled a boom in commodities – iron ore, copper, coal, oil, gold, grains etc. Getty knew those who owned the mineral rights would become rich and we have certainly seen that in recent years.

Among the wealthiest people in Australia are Gina Rinehardt and Andrew Forrest, and both made their fortunes in the resource (mining) sector. In 2000 they were not even in the top ten wealthiest people in Australia.

The big driver behind the voracious appetite for the world's resources is population growth. In 1970 the world was home to 3.7 billion people. The current population is 7 billion and is expected to rise to 9.5 billion by 2050. A greater number of people need water, food, housing and clothing.

The global population growth will underpin the need for resources. What you have to be careful of is the trend being turned into a bubble by an investment frenzy pricing assets above their real value (a bit like Wal-Mart in 1999/2000). The other major risk is that emerging markets can get ahead of themselves and will have to slow down for a few years and wait for demand to catch up with supply. China is experiencing a 'breather' at present and consequently this is having a negative impact on the Australian mining sector and our economic growth.

Investing in commodities can be very lucrative, however you need to know what you are doing. If at some stage you feel it is an appropriate time to invest in the resource sector my advice would be to invest in the Aii S&P/ASX 200 Resources Exchange Traded Fund – ASX Code RSR. This fund is an index fund (no surprise there) that will replicate the resource sector – it will allow you to participate in the demand for resources and eliminate the stock specific risk.

Gold is another commodity that has appeared on investors' radar in the past few years. Gold has risen significantly from its low point of US \$250 per ounce in 2000 to around US \$1,900 per ounce in September 2011. Looking at the history of the gold price will provide you with a valuable insight into the contrarian thinking that is required if you wish to invest successfully.

After World War Two the global economy was relatively stable. Countries went about the task of rebuilding and consumers started gradually acquiring all the new gadgets that were being produced – motor vehicles, washing machines, vacuums, hot water systems etc.

The factories were full of workers who were busily producing the various gadgets for eager consumers.

Little by little the developed world became overly-dependent upon oil to generate the energy sources to run the gadgets. Domestic oil production was not sufficient to meet the energy demands of a newly industrialised society. To meet the shortfall, oil was sourced from The Middle East.

By 1970 the economic stability that had existed for the previous twenty five years was starting to become unstable. The Vietnam War was draining financial resources in the United States and raising taxes to fund an unpopular war would have been political suicide. So what was the solution to their dilemma?

President Nixon revoked the Gold Standard. This action had a profound impact on the global economy. The Gold Standard was a method of tying a country's monetary base to the price of gold. It was a way of providing a real value (gold) to paper money (printed pieces of paper).

In revoking the gold standard Nixon was able to instruct the US Treasury to crank up the printing presses and print more dollar bills without having to worry whether these dollar bills would be backed by gold reserves.

The extra dollar bills created inflation (more money in the system chasing the same amount of goods that existed prior to the money printing). Then, in the early 1970's the Middle East realised how dependent the western world was on oil and they subsequently increased the price of their oil. The twin effects of higher energy prices and printed money sent inflation through the roof.

The economic uncertainty of the 1970's saw the gold price (the real store of wealth) soar from US \$35 per ounce in 1970 to US \$800 in 1980.

In 1980 the new chairman of the US Federal Reserve, Paul Volker, was committed to

breaking the inflationary cycle, and he succeeded in his quest by raising interest rates to over 20%. This action combined with the Middle East reducing the price of oil helped tame inflation in the developed world.

For the next twenty years the global economy stabilised. The ending of the Cold War, together with technology being commercialised and introduced into society in the 1990's ushered in a period of prosperity into the developed world.

The safe haven of gold was no longer required; the share market (tech boom) was where the action was at and the price of gold fell to around US \$250 in 2000/01. As an indication of how complacent governments had become, the Reserve Bank of Australia sold the majority of its gold holdings in 1998 for less than \$300 per ounce. They believed gold was no longer the ultimate store of wealth. This is why you have to be very wary of the so-called experts: they often sell when they should be buying and vice-versa.

What we now realise is this twenty year period of prosperity led far too many consumers, businesses and governments to borrow beyond their means. The extra debt in the system fuelled the economic growth of the 1980–2000 period but as always there was a price to pay. The inevitable collision of excessive debt with reality came in 2008 with the Global Financial Crisis.

The smart money (Bill Bonner was one of these and I will discuss him at more length in a later chapter) could see that gold was significantly under-priced in 2000 and began investing in it.

Now this approach was completely counter to the trend of the previous twenty years. From 1982–2000 the US share market had risen nearly 1,500% and gold had fallen by 70%. Conventional wisdom looks at the past and extrapolates this into the future and says, 'well, shares will keep rising and gold will keep falling.' Contrarian thinkers always look for value and what they saw was the US share markets valuing companies on a P/E of 55 (Wal-Mart for example) and an ounce of gold was trading at roughly the price it cost to extract it from the ground i.e. the gold miner was not making one cent of profit. The contrarian investor saw one asset class (shares) seriously over-valued and one (gold) seriously under-valued.

Interestingly, since 2000 the US share market has risen 12% and gold has risen five-fold.

The initial rise in gold was due to the mispricing between the extraction cost and the market price. However as the decade progressed and concerns began to grow about the direction of the economies in the developed world, investors gradually started

to increase their investment in gold. The Global Financial Crisis and the subsequent money printing antics of central banks in the US and Europe have seen a greater number of investor rush to gold.

Ironically the central banks of China and India have been actively buying more gold to increase their reserves. Yet twelve or thirteen years earlier the RBA was selling our gold reserves.

Will gold continue its stellar run of the past thirteen years? Since the price peak in September 2011, the gold price has retreated 30% in value. This is a normal and healthy correction — no market continues uninterrupted in a linear fashion. It would not surprise me to see further retracement in the gold price. The lower gold price offers an opportunity to acquire an asset that provides a hedge against the distinct possibility of higher inflation later this decade.

The poor financial state of the US, Japan and some European countries will see a day of reckoning in government debt and this will create havoc in financial markets. Gold should be a beneficiary of the flight to quality that will inevitably follow this period of mayhem.

There are a couple of ways to invest in gold:

1. Contact the Perth Mint and buy bullion bars directly from them
2. Buy the Gold Exchange Traded Fund (ASX code: GOLD) on the share market. The price of the ETF reflects the value of 1/10 of one ounce of gold.

It will be an interesting decade ahead. The resource sector is under pressure at present due to a slowdown in global growth. When this period of adjustment is over (and resource shares are trading at discounted levels) expect the resource sector to once again be a major participant in the growth of the global population.

10 Emerging Markets — Enormous Opportunity for Your Generation

‘Open markets offer the only realistic hope of pulling billions of people in developing countries out of abject poverty, while sustaining prosperity in the industrialized world.’

– Kofi Annan: Secretary General United Nations

The developed world has enjoyed an incredible level of progress since 1920. Life expectancies have been extended due to the eradication of major diseases and improved medical technology providing early diagnosis and treatments to previously incurable diseases. We have higher living standards due to all the ‘mod cons’ we consider an absolute necessity to function in our society. The ability to hop on a plane and travel to domestic and international destinations for business or pleasure is something we take for granted.

The 20th century was one of rapid change and development. The progress made in the last one hundred years was truly staggering when compared to the thousands of years beforehand. The genie is now out of the bottle and the accelerated pace of advancements in technology means the next century will usher in an even greater pace of change.

The 20th century was a tale of two worlds — the developed and the under-developed. Western society participated fully in the advancements that occurred in medicine, technology, transportation etc. however the under-developed world remained in a time warp — washing clothes by hand, preparing food over an open fire, no refrigeration, horse and cart transport and enduring primitive medical services .

Access to the internet has opened up a whole new world to the citizens of under-developed countries and they are now playing catch-up with the western world. The new term for the under-developed world is Emerging Markets.

The developed world has become fat and lazy after a century of progress. Its citizens, businesses and governments are heavily indebted. The earlier generations greeted the progress and prosperity with appreciation but subsequent generations have simply

assumed these twin benefits are their right and entitlement. Government subsidies for health, education, raising a family, flood relief etc. are a consequence of citizens expecting access to a better lifestyle as opposed to earning access.

Consequently, high levels of debt and an over-reliance on government are burdens on western society. By comparison the emerging markets have low levels of personal debt and the citizens receive little by way of government assistance.

Being free of these encumbrances has enabled the emerging markets (Brazil, Russia, India and China - BRIC's) to achieve significantly higher growth rates when compared to the western world.

Billions of people are now on a journey to improve their standard of living. It took the developed world the best part of eighty years to progress to its current level, so this journey will go on for years.

While the emerging markets will be a long-term trend that should reward investors, there will be periods when they suffer setbacks. No market goes up and up without correcting. China is the most likely to cause a reversal in the emerging market investment sector. China has gradually subsumed agricultural land for industrial and residential usage. Factories and apartments now occupy land that once produced food for the Chinese.

The government knows that hungry and unemployed people riot (look what happened in Egypt and Syria) so to avoid this situation occurring, the government has created jobs by instructing State-owned banks to lend to property developers and investors in an effort to keep people employed in the building and manufacturing sector. Reports now show that up to sixty five million apartments are vacant; shopping centres have no tenants and newly created cities have no citizens.

From the outside it looks like they are building for the sake of building. If this is indeed the case then it is a giant property bubble that is set to implode and will have nasty reverberations around the world - especially in Australia, as our resource sector has been a huge beneficiary of the China boom.

If the Chinese market does suffer a serious setback, it will provide an excellent opportunity to invest into the BRIC countries at a discounted level. The trend of economic progress in the emerging markets will continue for many decades and like all trends (e.g. technology) the expectations can get ahead of reality. The pricing of the BRIC investments did indeed get a little ahead of themselves and in recent times have suffered a sharp retracement. This is healthy.

A reversal in values does not necessarily mean an end to the trend, it simply means a more realistic value is being applied to pricing of the investment, and contrarian investors will take advantage of this opportunity to buy into the trend at lower levels.

When the markets in the developed world eventually succumb to reality (instead of being inflated by central bank intervention) the emerging markets will most likely suffer another downturn. The rush to liquidity in times of uncertainty makes these markets highly vulnerable to panicked selling.

This is the exact scenario contrarian investors ‘lick their lips’ over.

Keeping with the theme of reducing stock specific risk and capturing the broad trend, the best way to gain exposure to the emerging market story is via the iShares MSCI BRIC Exchange Traded Fund (ASX Code: IBK). This fund replicates the top companies in the indices of Brazil, Russia, India and China.

In decades to come they will be calling these the ‘emerged markets’ and they will have a profound influence on the global economy. Generations Y and Millennials will feel the impact of this change due to the employment opportunities that will open up in these countries, along with the cross-pollination of ideas and people from the developed and developing worlds. It will be exciting times for you.

11 Biotech and Energy Efficiency — The Other Big Trends

'We have the means right now to live long enough to live forever. Existing knowledge can be aggressively applied to dramatically slow down aging processes so we can still be in vital health when the more radical life-extending therapies from biotechnology and nanotechnology become available. But most baby boomers won't make it because they are unaware of the accelerating aging process in their bodies and the opportunity to intervene.'

— American author, inventor and futurist Raymond Kurzweil.

The world is on the cusp of significant advancements in medical science. The breakthrough technologies will revolutionise the way medicine is practiced and in turn we can expect an increase in life expectancies. As Kurzweil points out the baby boomers may just miss out on the longevity benefits of biotechnology, however the next generations will most certainly be the beneficiaries of this scientific revolution.

The introduction of biotechnology will also herald in 'the law of unintended consequences'. We learnt this with the introduction of computers. It was widely believed that computer technology would automate so many of life's mundane tasks and would provide us with a life of leisure. In fact computers have placed an immediacy on society. People want information *now*; they want a reply to their text or email *now* and they spend hours twittering and reading Facebook rather than relaxing.

This is a similar phenomenon to winning Lotto. People think winning lotto will solve their problems. Yes it does solve their immediate problems, but having money creates a whole new set of issues that people who don't have money are not aware of. The introduction of new dynamics will always have positive and negative repercussions.

Along with the obvious benefit of living longer there will be other repercussions for the cycle of life.

Living longer means working longer. If life expectancies rise to 120, it is inconceivable to think people will be retiring at age sixty five and living fifty five years in retirement.

As discussed in the previous chapter, the global population is set to increase by a few billion people over the next forty years and with rising life expectancies this poses enormous challenges to the supply of shelter, food, water and clothing to an aging and burgeoning population. The cost to access the new medical treatments (the developers of these new drugs, procedures etc. rightly expect a handsome return on their investment) will see a greater divide between the haves and have-nots.

With the increased life expectancy rates of the past century we have seen a number of new ailments afflicting society — Alzheimers is one of these. Years ago this disease did not have the same impact on society as it does today. The reason is the majority of people died of heart disease or cancer long before the body could release the Alzheimer gene. By-pass surgery, chemotherapy and other early detection mechanisms have reduced the early death rate but nature always has a way of surprising us. With the prospect of increasing life expectancies by a further forty years or more, we do not know what other genetic time bombs lie in wait in our bodies.

These are only some of the unintended consequences from scientific progress. As always, history makes us much wiser after the event.

So what can be learned from this look into the future?

1. Investment opportunities — those companies who genuinely discover the prevention, cure or manageable treatment of diseases/ailments (arthritis, alzheimers, cancer, paralysis etc.) will make a fortune. Already there are a number of companies who are well-advanced in the trial of treatments for various ailments. Initial trials are showing encouraging results; however they are still some years away from being able to commercialise their product. The US Health Authorities (US Food and Drug Administration - FDA) have very strict testing criteria and it can take years before a drug or treatment is allowed to be released for public consumption.
2. The biotech area will be full of companies — some who are the real deal and others looking to cash in on the next ‘hot thing’. This happened before, during the tech boom of the 1990s when companies started changing their business names to include the ‘.com’ at the end of the title. Determining which companies have genuine prospects of success will require expert knowledge. Also the majority of the opportunities are companies listed on US stock exchanges; so taking advantage of these stories will require access to an international broker. CommSec provide this service. When I decide to become serious about investing in this sector, I’ll let you know what resource I choose. Based on experience, not all recommendations will be winners, so if you choose to allocate some funds to this sector be prepared for a rollercoaster ride.

3. An aging and expanding global population will place huge demands on the earth's resources. Necessity is the mother of all inventions and the greater demands for food, water and energy will see new technologies emerge to meet these challenges. Smart people will find ways to increase food production, harvest water more efficiently, produce alternative sources of energy etc. This provides an opportunity for savvy investors to participate in another major global trend.
4. The demands on the earth's resources and access to medical advancements are likely to translate into higher living costs. Expect the cost of electricity, petrol, food, water rates and private health cover to constitute a larger portion of your budget. Therefore it is imperative you increase your skill levels to improve your remuneration and also to err on the side of caution when borrowing. You will need to leave plenty of buffer in your budget to absorb the rising costs associated with the essential items of expenditure.
5. Given that your generation will need to work well past the age of sixty five, the secret of compound interest can be used to improve your potential to retire earlier than most. Where possible you should try to invest a little more into superannuation and/or increase your cash savings so you have a greater deposit for a home purchase. The less debt you have to pay back, the quicker you can begin accumulating a retirement nest egg.

New drugs and treatments will not be a substitute for a healthy lifestyle. Eat well, drink moderately, exercise regularly and take time to rejuvenate (stress relief). Exercise is better than pills or stomach stapling to reduce weight; healthy eating and good skincare is preferable to (botox) chemicals or surgery to erase creases; going for a walk in the bush or on the beach is better than seeing a shrink to help you cope with life's stresses.

The more complex life becomes you realise that it is the simple things that really do matter.

12 Insurances — The Necessary Evil

‘There are worse things in life than death. Have you ever spent an evening with an insurance salesman?’

– Woody Allen

Woody Allen pretty much sums up how most people feel about insurances and insurance salespeople. The reason people are adverse to insurance is two-fold:

- 1) It costs money
- 2) It means having to look at the negative side of life — what if your house burns down, you have a car accident, you are disabled, you die, etc.

The combination of confronting this negativity and having to pay for it means that looking at insurance is about as much fun as having a root canal.

There is no doubt insurance is a boring topic, however assessing and providing adequate cover for life’s uncertainties is an essential part of ensuring your financial future is not placed in jeopardy.

In simple terms, insurance is the promise of reimbursement in the case of loss. The other important note to remember with insurance is that *cheap is not always the best*.

When it comes to lodging a claim you want to be able to lodge a genuine claim and be paid. You do not want to be caught up with a cheapskate policy that will look to weasel its way out of paying. The cheap premiums end up being expensive because you end up paying money for no real cover at all.

There are a plethora of insurance products. As your life expands and you become more successful and start acquiring assets you will become acquainted with just how many types of insurances are out there. What we’ll deal with are the most common types you will need to consider over the next few years.

Motor Vehicle Insurance

There are three types of car insurance:

1. Comprehensive coverage — this insurance pays to repair or replace the insured vehicle and personal property inside of the vehicle if it has been damaged or lost due to other factors such as fire, theft, flood, or vandalism. It will also cover damage to a third party vehicle or vehicles (in the event of a multi-car accident). Comprehensive cover is the most expensive car insurance. If you cannot afford to buy a car of similar value to the one you have then you should take comprehensive cover on your vehicle. The cover will not pay for the total value of the repairs or lost goods, as all policies require you to pay an excess and the level of the excess will vary with each insurance company. If your car is a write-off, some companies will pay you the market value (which is usually less than what it is really worth); an agreed value or if the car is a certain age it can be 'new for old'. Obviously the more the benefit that is likely to be paid out, the higher the annual premium.
2. Third Party insurance — liability cover purchased by an insured (the first party) from an insurer (the second party) for protection against the claims of another (the third) party. The first party is responsible for its own damages or losses whether caused by itself or the third party — as defined by BusinessDirectory.com. If you have an older car you believe is not worth covering with comprehensive cover then you should take out third party cover. This will protect you in case you have an accident with a Porsche and it is your fault. The repair bill for the Porsche will be covered by your third party insurance. If you do not have third party cover you will need to cover the repair costs and depending upon the extent of the damage this could bankrupt you.
3. Compulsory third party (CTP) insurance — this insurance is included in the annual cost of your motor vehicle registration renewal. CTP insures against damage caused to other people and is limited to personal injuries suffered by them. If you have an accident and it causes injury or death to a third party, CTP will cover this liability.

Home and Contents Insurance

1. Home insurance is to protect your home against damages to the building itself from various events — fire, water damage, earthquakes, floods etc. Check the wording as households in South East Queensland found out that flood cover does not actually mean *flood* cover. Home insurance also provides coverage

against accidents in the home or on the property that may result in a public liability claim e.g. someone slips and breaks a leg on your property and sues you for damages. The amount of cover you require will depend on what you estimate it will cost to replace the property in the event it is totally destroyed. If the replacement cost of the property is \$300,000 and you only insure for \$200,000, you run the risk of being under-insured and having to pay the additional \$100,000 from your own savings. Many people affected by the 2011 floods in South East Queensland have found themselves in very difficult financial circumstances due to being either un-insured or under-insured. This sets people back years in their quest for financial independence.

2. Contents insurance covers furniture, clothing, artworks, white goods and basically anything that is not nailed down inside the house. Here is the formal definition from homecontentsinsurance.com.au:

'Home contents insurance refers to a type of property insurance which cover the contents commonly found in homes and residential buildings. The purchase of home contents insurance makes an insurance company liable to pay for the costs incurred by a policyholder when the contents of an insured property are damaged or stolen. Home contents insurance typically covers the losses resulting from fire and theft. In case of damage as a result of flood, however, it is not home contents insurance that covers the loss but a separate flood insurance policy.'

Just like home insurance, you will find a majority of people under-insure the replacement of their contents. It is a balancing act between being fully insured and how much your budget can afford.

Mortgage Insurance

When you enter into a home loan, the lender may approve the loan subject to you purchasing Mortgage Insurance.

In nearly all cases, if you borrow more than eighty percent of the value of the property, the lender will ask you to take out their mortgage insurance.

This mortgage insurance protects the lender — not you — in the event that you default on your loan and the outstanding value of your loan is greater than what they receive from selling the property.

Lender's mortgage insurance is usually charged as a one-off premium and is calculated on a sliding scale. This means the greater the percentage the loan is of the

property value, the higher the mortgage insurance premium payable.

Mortgage insurance is not cheap.

How mortgage insurance works is as follows:

Let's say your property is valued at \$400,000. You have a \$40,000 (10%) deposit and require a loan of \$360,000.

The loan is 90% of the property value and the lender requires you to pay for mortgage insurance in order to protect their loan (*yes, you pay to protect them* — not a bad deal for the lender).

If you default on the loan and the bank has to liquidate the property for \$350,000 (\$10,000 less than the loan amount), the Mortgage Insurer will pay the bank the \$10,000 shortfall.

The Mortgage Insurer protects the *bank*, not you. The Mortgage insurer reserves the right to chase you for the \$10,000 it has paid to the bank.

The lesson to be learned from this is that the greater your home loan deposit, the better the chance you have in avoiding this expensive insurance and becoming entangled in legal proceedings with a mortgage insurer.

Life Insurance

When you are young and carefree, life (or more specifically, death) insurance appears to be completely superfluous to your needs. I understand that. The way I assess whether life insurance is necessary or not is to ask myself this question: 'If I die tomorrow will I leave anyone financially vulnerable?'

When you are young and single, you usually have no liabilities, no financial commitments with a partner or dependent children. Therefore life insurance would be surplus to your requirements at this stage. However when you begin to take on commitments — financial and family — you will need to re-assess the situation. As to the amount of cover you require, this varies with the extent of your commitments — debts and/or children. If you do not have children then covering your outstanding debts plus a small surplus should be adequate cover. When or if you have children, the level of cover you require needs to be increased substantially.

Children are expensive little suckers and you should provision for future education and activity expenses. Most employer superannuation funds offer a minimum amount

of life insurance cover and the amount can be increased if you make a special request (a medical questionnaire is usually required).

Total Permanent Disability (TPD) Insurance

This type of insurance provides a lump sum payment if you become totally and permanently disabled (the insurance industry rather callously calls this the ‘vegetable clause’).

The lump sum benefit is paid to you if medical opinion (after you have been off work six months) renders you unlikely to ever return to work. Total and Permanent Disability insurance is usually purchased with life insurance and can also be purchased on the same policy as income protection and trauma insurance (see below) or as a separate policy. There are two types of definitions with TPD insurance. The first is the better one, and is called ‘own’ occupation TPD and is paid if it is unlikely that you can ever perform the duties of your ‘own’ occupation ever again.

The second definition is ‘any’ occupation TPD and is paid if it is unlikely that you can ever work at ‘any’ occupation ever again.

The ‘own’ occupation definition is generally only available for specific occupations (professionals).

To determine whether you require TPD insurance or not, ask yourself the following question: ‘If I suffered a debilitating illness or injury that terminated my working life (your ability to earn an income), how would I cope financially? Who would look after me? How would I pay for ongoing care?’ Initially your parents might be there for you. However they are not going to live forever and depending upon your physical condition and their own expenses they may or may not be able to provide the level of care you require.

I used to joke with clients and call TPD my ‘selfish insurance’. My reasoning was that if I died, my financial burden to the family would have been the ‘cost of a rose on Sunday’. However, if I was unfortunate enough to be made TPD then I would obviously be alive and in need of ongoing care. A major illness or accident brings with it a whole lot of emotional issues, so being able to alleviate the financial pressures with a lump sum payment was important.

In my opinion when you enter the workforce it is well worth considering TPD insurance. The cost of the cover for non-smoker under age 25 and in a professional occupation is very low. As a guide \$1 million TPD cover will cost around \$5–6 per week.

Life and TPD insurance cover can be accessed through your superannuation fund. The benefit of this is that it means the premiums are paid out of your superannuation savings and not a regular bill that you have to pay out of your regular income. This way you have the cover but you don't really feel it in your hip-pocket nerve. This is how I have organised insurance cover for my wife and myself.

Income Protection Insurance

Income Protection insurance provides you with an income stream in the event you become unable to work due to an injury or illness. Benefits are paid to you monthly: you do not receive a lump sum payment. The maximum amount of cover you can insure for is usually 75% of your gross salary, so if your salary is \$60,000 then the maximum income protection you can insure for is \$45,000 (the idea is to make you a little hungry so you are motivated to return to the workforce).

The premiums are tax deductible but the benefits are taxable. This is a big trap the majority of income protection recipients fall into. Let's say the insurance company pays the claimant \$4,000 per month for a period of five months. The insurance company does not deduct any tax from the \$20,000 the claimant was paid. Most times the claimants spend the whole amount received and are not aware they must pay tax on the benefit. When they do their tax return there is a nasty surprise in the form of a tax bill in the thousands of dollars.

Income protection policies offer a variety of terms and conditions. You can elect to have the monthly income benefit paid to you for a period from two years to age sixty-five. You must also nominate a waiting period before a claim will be paid, usually this ranges from fourteen, thirty or ninety days. The waiting period is the timeframe you are prepared to forgo receiving any income. Monthly benefits can be indexed to increase with inflation - this is especially important if you have nominated a long payment period (say to age sixty five). Obviously the shorter the waiting period and the longer the payment period, the higher the cost e.g. if you elect to be paid after being off work fourteen days and to be paid to age of sixty five it will be a lot more expensive than having a ninety day wait period and only being paid a benefit for two years.

The cover I chose for myself was a 30-day wait period (if you follow the rule of thumb of holding up to three months living expenses in cash you will easily be able to fund yourself for the first 30 days) and payment to age sixty five. The reason I selected the longer payment period is that, statistically, if you have been off work over two years, the prospects of returning to the workforce is significantly reduced. Can you imagine how it would feel receiving the last payment after a two or five-year payment period and knowing you are still not well enough to return to the workforce? At least being

paid to sixty five gives plenty of time to re-arrange your financial situation so you will be able to cope with life after the income protection payments cease.

In my opinion income protection insurance is important. Most people insure their cars, houses, contents, boats and other items of value, so why not yourself? Ask yourself the question: 'How did I acquire these items?' For the vast majority of people (lotto winners and being an heir to a family fortune excluded) these items were made possible due to having the capacity to earn an income to purchase them. The ability to get out of bed each morning and trade your skills for money is what makes your material dreams come true. If that ability is denied to you either temporarily or permanently due to an illness or accident you must have a Plan B.

One exercise I undertook with clients was to estimate how many working years they have left and then multiply this by their annual income to determine how valuable the ability to go to work really is. For example a thirty year old has, say, thirty five years to retirement and if their annual income is \$100,000 it means their future earning capacity (in today's dollars) is \$3.5 million. If you had a \$3.5 million asset would you consider it worth protecting? Out of these future earnings there will be mortgage payments, school fees, retirement plans, travel etc. All those life plans will be thrown into chaos if life suddenly deals your health a cruel blow.

From my experience the policy definitions of Income Protection can vary widely from company to company, so do your homework and make sure you have a policy that will honour its commitment to you.

Trauma Insurance

Trauma Cover Insurance pays a lump sum in the event of a specific medical trauma you may experience e.g. cancer, stroke, heart attack, major head injuries. The trauma may not be fatal (therefore life insurance won't cover you) or it may not be debilitating enough to stop you from ever resuming your employment (TPD). Trauma insurance would pay if you suffered a stroke, for example, even if after a period of rehabilitation you are considered well enough to rejoin the workforce. The trauma event (stroke) is the trigger for the claim.

The trauma policies have a list of specified diseases or traumas and in the unfortunate event you contract one of these the insurance company will pay you the lump sum amount you are insured for.

Trauma insurance isn't a necessity for most people. I always felt it was another product (or profit source) that insurance companies introduced as another way of

scaring people into insuring themselves. To be fair, there have been some wonderful stories of people who have received a substantial amount of money for having a medical trauma and the difference this cash injection made to their lives.

Personally I never purchased a trauma insurance policy. The insurance industry has a body of evidence showing the percentage of people in various age groups who suffer some form of trauma. This data is used to paint a compelling picture as to why trauma cover is an absolute necessity. Perhaps I was lucky not to have been part of the statistics in the fifty-and-under age category. My suspicion for the insurance industry's motive is the commission paid to the insurance salesperson is usually equivalent to the first year's premium. There is obviously a lot of margin in the product to enable them to offer such generous remuneration.

The cost of trauma insurance is much higher than Life or TPD cover. The reason for this is there is a higher probability of claim. If you look at the escalating risks associated with health, you have trauma (serious), TPD (very serious) and death (this is the highest level of serious). When you are over fifty you need to virtually take out a mortgage to pay a trauma insurance premium it is so expensive.

The way I looked at it was to ask myself, 'how much insurance do I need?' If I die, life insurance will cover this (trauma will not pay on death). If I suffer an illness or injury, initially Income Protection insurance will pay a monthly income to cover our basic living expenses and if the trauma is so severe and I cannot resume my occupation, the TPD cover will provide a lump sum payment.

It is a calculated risk, but so is all of life. You weigh things up for yourself and by all means look at the cost versus the benefits and make an educated decision on whether this insurance is appropriate for you or not.

Life, TPD, Trauma and Income Protection Insurance premiums consist of two types of premium options:

1. Stepped Premium: Think of a set of steps' — each one higher than the last one. Stepped premiums are relatively inexpensive when you are young (the insurance companies know from statistics that the risk of a claim is minimal). As you grow older, the risk of a claim increases so the premium is stepped up accordingly. With a stepped premium payment option the cost of life insurance is the most economical between the ages of 25-30. After thirty the annual cost rises and for obvious reasons when you are over fifty it becomes prohibitively expensive.
2. Level Premium: This option means the insurance premium stays the same

(level) for the duration of the policy. In the early years you will pay a much higher rate compared to the stepped premium. However in the later years of the policy you will not be faced with an escalating premium schedule. I used to describe the difference in the two options by asking people to think of two seesaws side-by-side in the park. The first seesaw has one end resting on the ground and is pointing to the sky. The other seesaw is balancing level.

Which will be the better option for you? It will depend on whether you continue to live in Australia or not. The insurance companies will not cover you if you reside overseas. If you decide to work overseas when you are twenty five years old and stay there for many years, then a level premium would not be worth it. You will be paying more initially then the policy will be cancelled when you go overseas.

I believe that most young people would be better off taking out a stepped premium payment initially. You can always elect to change it to a level premium at a later stage when you are more certain about your future residency situation.

Taking out cover when you are younger also minimises the possibility of exclusions being placed on the policy. An exclusion is where the insurance company, excludes' a pre-existing illness or injury from being paid under the policy. In my case if I wanted to take out a new insurance policy (TPD, Trauma or Income Protection) there would be an exclusion clause because I incurred a back injury in 1995. The insurance company would only issue me the policy provided I waived my rights to claim for a back-related injury. This exclusion would not apply to a life insurance policy as you can't die from a bad back.

While you are young and enjoy good health obtaining a policy will be relatively straightforward and economical.

Professional Indemnity Insurance

You will need this cover if ever you assume a position of responsibility in a professional business. Professional Indemnity Insurance provides protection to professional practitioners (medical, legal, accounting, financial planning etc.) against potential negligence claims made by their patients/clients.

I won't go into the various business insurances as hopefully when or if you are ready to make the leap into self employment you will have developed a good relationship with a competent insurance broker who can guide you in this area of risk minimisation.

13 Estate Planning

‘Where there is a Will — there is a Relative’

– Ricky Gervais

It may seem a bit premature to think of planning your estate — your Last Will and Testament and an Enduring Power of Attorney.

My advice would be for you to see a solicitor as soon as you enter the workforce and have these documents prepared.

You may be thinking, ‘What do I need to do this for? I don’t have any material possessions of any real value to warrant the expense of this exercise.’

Wrong. It is highly likely your employer superannuation fund will have automatic Life and TPD insurance. This could be as much as \$250,000. In addition to this, if you take my advice and arrange for separate TPD and Income Protection insurance, there is suddenly some serious money that will need to be administered in the event of serious illness or accident.

Your Last Will and Testament outlines how you wish your estate to be distributed upon your death i.e. who do you want the \$250,000 Life insurance in your employer super fund to be paid to?

Your Will is a dynamic document that should be revisited as your circumstances change — marriage, children, divorce etc. Before I was married everything went to my parents and my wife had the same arrangement for her parents to be bequeathed everything. After we married, everything went to the surviving spouse and in the event we both died everything was split between my wife’s and my parents.

When children came along, we changed our Wills so that in the unfortunate event of both my wife and I dying, the estate would be held in trust for the children of our marriage (this is how it still remains in our Wills). If we were all killed in some freak accident, then our estate would now go 50/50 to our surviving parents.

You can see how Wills need to be updated to reflect where you are at in your life cycle.

Your Will is a legal document that is only invoked upon your death.

An Enduring Power of Attorney (EPOA) covers you in the event you are incapacitated to such an extent you are rendered incapable of managing your own affairs. Without an EPOA the State will act as your financial guardian. I have witnessed this first hand with a client and it is the most frustrating experience for the caregiver.

If you take out \$1 million in TPD cover and Income Protection that pays you \$4,000 per month until age sixty five, who do you want to administer this? A public servant in the Department of Justice - Office of Adult Guardianship or your parents?

Again, the EPOA is a dynamic document. You may initially appoint your parents to be your enduring power of attorneys, but when you marry you can switch this to your partner/husband.

My wife is my POA and vice versa; and in the event we are both incapacitated our Plan B is that two trusted friends will act as our POA's.

It is essential that you take the time to prepare these documents — after all, an ounce of prevention is worth a ton of cure. Coping with a death or incapacitation of a loved one is traumatic enough without also having to deal with the frustrating bureaucratic red tape that accompanies a situation where there are no legal instructions (Will or EPOA) in place.

Remember:

'Everyone gets organised at some point, they just might not be around for it.'

– Sue DeRoos.

14

Inflation / Stagflation / Deflation — How the Various ‘ations’ Impact Your Investments

*‘Some idea of inflation comes from seeing a youngster get his first job
at a salary you dreamed of as the culmination of your career’*

– Bill Vaughn

How true this quote is. When I first entered the workforce in 1977 as a bank clerk, my starting wage was \$5,000. Thirty-six years ago this was an average starting income.

If you enter the workforce as a university graduate in 2013, it is most likely your starting salary will be \$45,000+. Today’s \$45,000 probably doesn’t buy anymore than the \$5,000 I received in 1977. The insidious nature of inflation is it gradually erodes away your buying power.

In the developed world we have really only known inflation (rising prices and wages) and are not overly familiar with the other conditions an economy can become subject to — deflation and stagflation. When the underlying economic conditions change it invariably alters the investment landscape.

Like insurances, the economy is a fairly boring topic so I will attempt to give you the basics and explain why it is important to know what is happening in the economy so you can adjust your investment strategy accordingly.

Just to re-cap, there are four basic areas to invest in:

1. Cash/Fixed Interest
2. Property
3. Shares
4. Gold

Each of these investment classes will respond differently depending on what the prevailing economic conditions are.

Inflation tends to favour property and shares. Over the long term, rising costs filter into the value of businesses and the prices of housing. For example, let’s say it takes

10,000 bricks to build the average home. In 1970 a brick may have cost \$0.50, whereas in 2013 it is \$5.00 per brick. The construction cost in 1970 totaled \$5,000 and now it is \$50,000. This example holds true for the cost to develop land — to hire earthmoving equipment and the wages for an operator in 1970 may have been \$20 per hour compared to \$200 per hour in 2013.

The combination of increased development costs and rising prices for building materials is gradually reflected in the long-term increases in general property values.

With shares, they are traditionally valued on an average P/E of 15 (as mentioned in the Share chapter, this does vary, but for the purpose of this example I will use the average).

Inflation assists in lifting the dollar value of a company's profit. This means that a company may have been making a \$1,000,000 profit in 1970 and is now making \$10,000,000 (this has the same buying power as \$1 million in 1970). In theory the company's share value will rise from \$15 million in 1970 to \$150 million in 2013.

Gold tends to lag in stable economic times and can fall well below the inflationary trend for a period of time. At some point it will play catch up (the five-fold increase since 2000 is evidence of this) but you will have to be patient with gold during stable economic times. It really does a lot better when there is turmoil in the world.

Cash loses much of its buying power in periods of sustained inflation. As mentioned in the Cash chapter, \$50,000 would have bought two homes in 1970 whereas now \$50,000 is merely a deposit for one home.

In some countries they have experienced hyper-inflation — this is where the cost of goods rise rapidly. In some third world economies prices have been known for grocery items to change in the space of hours. Property is the best investment in a period of hyperinflation.

Stagflation tends to favour gold and property. The last period of stagflation was in the 1970's when gold rose over twenty times in value. Property values fell but gradually rose. Shares were smashed on the rocks and the famous headline in *Newsweek* magazine in 1979 was '*The death of equities (shares)*'. After a decade of shares going nowhere, investment professionals had all but given up hope on shares ever rising again. Cash was earning up to 16% in the bank and while shares and property were falling in value it was a good place to be but to capitalise on the depressed prices in these two asset classes money needed to be switched from cash into property and shares.

Deflation is the environment when 'Cash is King'. Japan has been going through

a deflationary cycle since 1990. The Japanese share market and property market have both fallen up to 75% in value. Falling prices beget falling prices. People think prices are going lower so they stand back and wait and when this lack of demand drives prices lower, they think prices will go lower again. The deflationary spiral becomes hard to stop. This is why Central banks are so committed to trying to stop deflation taking hold in an economy. The wealth-destroying effect of deflation can seriously undermine the confidence of a society.

The following are the descriptions and symptoms of each of the economic conditions:

Inflation

(the following is a revised version of the definition on www.investorwords.com)

Inflation is the overall general upward price movement of goods and services in an economy (often caused by a increase in the supply of money), usually as measured by the Consumer Price Index (CPI). Over time, as the cost of goods and services increase, the value of a dollar is going to fall because a person won't be able to purchase as much with that dollar as they previously could (\$50,000 in 1970 bought a whole lot more than \$50,000 today). While the annual rate of inflation has fluctuated greatly over the last half century, ranging from nearly zero inflation to 23% inflation, the Reserve Bank of Australia (RBA) actively tries to maintain a specific rate of inflation, which is usually two to three percent but can vary depending on circumstances.

Stagflation

Stagflation refers to an economy that is experiencing no (or even negative) growth as well as inflation. Stagflation typically means that people's employment situations are not improving but their overall cost of living is still increasing.

The last prolonged period of stagflation occurred in the United States in the 1970's. The overall economy was struggling but inflation (driven by oil and energy prices) continued to rise.

This is where I think we find ourselves today. Energy costs (essential expenditure of electricity and fuel) are rising but the broader economy of non-essential expenditure consisting of services (restaurants, consultancy etc.) and retail (clothes, shoes, white goods etc.) are struggling. Before the GFC people were prepared to borrow to fund a higher lifestyle than they could really afford. The economy (businesses of all shapes and forms) expanded to share in this higher level of spending. Now the consumer is not as willing to go deeper into debt and this withdrawal of spending power is causing

contraction in the business sectors that provide non-essential expenditure items — Clive Peeters, Borders, Angus & Roberston have gone into receivership; WOW electrical closed its doors and numerous restaurants have folded.

Deflation

In economics, deflation is a decrease in the general price level of goods and services. Deflation occurs when the annual inflation rate falls below 0% (a negative inflation rate). This should not be confused with disinflation which is a slow-down in the inflation rate (i.e. when inflation declines to lower levels). Inflation reduces the real value of money over time; conversely, deflation increases the real value of money. This allows the consumer to buy more goods with the same amount of money over time.

Economists generally believe that deflation is a problem in a modern economy because of the danger of a deflationary spiral. Deflation is correlated with financial depressions — including the Great Depression — as banks defaulted on depositors. Additionally, deflation may cause the economy to enter a liquidity trap (people stop spending money leading to a lack of cash circulating in the economy). However history indicates that not all episodes of deflation correspond with periods of poor economic growth.

One of the newsletters I subscribe to is The Elliot Wave Theory written by Robert Prechter. He is firmly of the belief that the world is headed into a prolonged period of deflation. His rationale is that the enormous amount of debt in the developed world must be repaid or defaulted on. Prior to the GFC, consumers earned \$100 but spent \$105 (the additional \$5 went on the credit card or home equity loan). Now they earn \$100 and spend \$95; with the remaining \$5 going towards repaying the debt or rebuilding savings. The economy has now lost \$10 (the \$5 borrowed and the \$5 saved) in every \$100.

Due to this shrinkage in the economy, those who borrowed heavily may find they are now earning less (a small business-owner or permanent employee who has their hours reduced) and they can no longer meet the loan repayments. The loan is defaulted on and the bank may have to write-off some or the entire loan as a bad debt. As a consequence of the bad debts incurred, the banks become more cautious in their lending criteria and this resulted in less money circulating in the economy. Inflation is a function of money supply and credit. At present the central banks have created money supply (printing dollars/yen/euro) but the banks aren't lending and consumers do not want additional credit. Hence the argument from Prechter that we are currently in a deflationary spiral.

To make up for the loss of money in the economy (due to reduced consumer spending and cautious bank lending) the Government in its wisdom injected a financial ‘stimulus’ into the system. Our national economy is estimated to be worth around \$1 trillion (this is a million x million dollars). Let’s say the withdrawal of consumer spending and bank lending shrinks our economy by \$100 billion to now be worth \$900 billion. This 10% shrinkage means the economy experiences a recession (it is receding). This is politically unacceptable so the Government dreams up various ways of injecting the missing \$100 billion into the economy — Pink Batt schemes, building over-priced school halls, National Broadband Network and so on. Hey presto; the economy is still valued at \$1 trillion and the country has avoided a recession and the government can proudly say what a good job they have done. What they don’t mention is they now have to extract an extra \$100 billion in taxes to pay for this stimulus. Eventually tax rates rise (the resource tax, carbon tax, tobacco tax increases etc are part of the government debt repayment plan) to fund these debt obligations. Higher taxes mean you receive a lower after tax income. This in turn generates a further reduction in consumer spending power. The debt crisis creates a vicious cycle.

This is how the deflationary cycle can take hold. The events I’ve outlined above are happening in the US, Britain, Japan and Europe.

Japan is trying to blast itself out of its 23-year deflationary funk with the greatest money printing experiment ever embarked on by a developed economy. When you are damned if you do or damned if you don’t, the political class will always choose the option that makes them look like they are doing something (even if it is futile).

The US is printing money to paper over the enormous cracks in their economy (huge levels of government — Federal and State — debt and annual budget deficits of \$1.5 trillion) and it is only a matter of time before the US economy faces its destiny with economic reality.

The US is also trying to steady the economic ship and produce a low level of inflation to restore some balance. Unfortunately they do not have a history of doing this successfully and it is for this reason that Prechter is very bearish (pessimistic) on the outlook for the global economy over the next decade. Time will tell, but it is always wise to err on the side of caution for the time being and see if we can take advantage of any downturn in markets to buy assets at deeply discounted levels.

15 Superannuation — The Pros and Cons

‘Money grows on the tree of patience.’

– Proverb

This proverb sums up the approach you must adopt with superannuation.

The word superannuation can be broken into two parts — Super and Annuation.

1. Super means very large, great or extreme.
2. Annuation is an extension of the word annuity. Annuity means ‘The annual payment of an allowance or income.’

By definition, superannuation means a very large allowance or income (pension payment).

To acquire the capital necessary to generate a significant retirement income requires time. Most people spend their entire working life achieving this goal.

Therefore superannuation definitely fits the category of ‘money that grows on the tree of patience.’

It is for this reason that those under forty years of age see very little purpose in contributing much towards superannuation. The rewards are so far in the distance they do not have the patience necessary to see the long-term benefits.

Your employer must pay 9% of your salary into a superannuation fund. This is a good start. The superannuation fund will have a portfolio mix of shares, property, fixed interest and cash.

The benefit of having money contributed regularly into superannuation is you are following a risk minimisation technique of ‘dollar cost averaging’. This means that you are not investing all your money at once but progressively investing money into the markets.

Make sure the superannuation fund your employer chooses has minimal administration fees.

Let's say you won lotto and suddenly had one million dollars to invest. In this case you would want to be very careful as to timing when you invested into the markets. If you invest at a high point and the market goes down your million shrinks in value.

However, if you save a million during your working life, you need to save approximately \$1,000 every fortnight for forty years. During this forty-year period markets will rise and fall. Regular contributions mean you will be buying regularly during these high and low periods and smoothing out (averaging) your investment.

The marvel of compound interest is another benefit of long term investing into superannuation.

The tax benefits of superannuation are:

1. Contributions are taxed at a maximum of 15%. If you are earning \$100,000 per annum your top tax rate will be 38.5% (inc medicare levy). Therefore if you elect to contribute some of your salary into superannuation it will be taxed at 15% compared to 38.5% if you receive it as personal income, e.g. a contribution of \$5,000 will pay \$750 tax in superannuation and your net investment is \$4,250. Whereas \$5,000 in personal income will pay \$1,925 tax (38.5%) and you will receive a net income into your bank account of \$3,075. The price you pay for immediate access to the money is \$1,175 (the difference between super \$4,250 and personal income \$3,075). The tax system is designed to encourage you to save for the longer term - the government uses tax incentives to encourage people to be self sufficient in retirement and less reliant on the social security system.
2. The earnings the superannuation investments generate are also taxed at 15%; e.g. if you have \$100,000 invested in super and it earns 6%, the earnings of \$6,000 are taxed at 15%, equating to \$900.

Outside of superannuation the same earnings of \$6,000 forms part of your taxable income. If we assume a tax rate of 38.5% you would pay \$2,310 in tax.

Remember the law of compound interest — with superannuation you have \$5,100 (\$6,000 less \$900 tax) compounding for you compared to \$3,690 (\$6,000 less \$2,310 personal tax) outside of superannuation.

In summary, the major benefit of superannuation is the ability to dollar cost average (smooth out your investment entry points) and have more after-tax dollars available to participate in the law of compound interest.

The negatives of superannuation are:

1. The government's favourable tax treatment of superannuation means it has a far greater say in how funds are contributed and accessed. There is the risk the rules to accessing a lump sum on retirement will be changed and only a pension will be paid to you. This is the way retirement plans work overseas and there is concern with an aging population Australia will eventually follow the same course.
2. Access will not be available to you until at least aged sixty and possibly longer. Therefore patience is required.
3. A poorly managed super fund can cost you far more in lost capital than the tax benefits you received.

Overall the concept of superannuation as a long-term savings vehicle is fine, provided you are comfortable with the inaccessibility aspect.

As mentioned in a previous chapter, there will always be something competing for your dollars — mortgage payments, education expenses, overseas holidays etc. but where possible if you have a period where you can save a few dollars you may want to give consideration to investing them into superannuation. You will reduce your tax bill and also be allowing your money to be influenced by the power of compound interest.

16 Sources of Knowledge

'If I have seen further it is only by standing on the shoulders of giants.'

– Sir Isaac Newton

In order for you to make intellectual progress in your endeavours, you must use the knowledge and understanding gained by the major thinkers in those areas that interest you.

When my financial planning career began in 1987 I really had no idea about the workings of markets. There was a share boom happening at the time and the 'entrepreneurial' sector was the darling of the market — names like Christopher Skase, Alan Bond, Laurie Connell and other lesser-known entrepreneurs. As a young man who harboured dreams of creating wealth, I revered the achievements of these 'businessmen'.

The 1987 share market crash was my first lesson in how markets work. Booms always bust. After the 1987 crash the entrepreneurial sector returned to earth with a thud and in the cold light of a market bust the antics of these so-called businessmen were laid bare. Skase became a fugitive and Bond spent time in jail.

With hindsight it was all so obvious to a novice planner what had happened but prior to the 1987 crash there was hardly a dissenting voice among the mainstream media and investment institutions.

I have observed this pattern being repeated a few times throughout my career in financial planning - the property trust boom and bust of the early 1990's; the tech boom and bust of late 90's/2000 and the sub-prime debacle.

During all these periods, the majority of so-called market experts (mainstream economists, investment institutions and market analysts) never picked the 'bubble' conditions that were developing.

In their professional opinion we would always have 'a soft landing'. No-one wanted to upset the apple cart of fees by calling the conditions for what they were.

A 'bubble' is when too much money flows into one market sector and over-inflates the value of that sector. Consequently, as the temporary wealth effect of the bubble spreads, it lifts the prices in other asset classes. For example the sub-prime lending fiasco initially inflated US house prices. Householders felt wealthy so they borrowed against the assumed wealth stored in the value of their home and invested in the share market.

Again, with hindsight everyone is wise to what happened and why. There were those who predicted the meltdown in the sub-prime sector but their voices were drowned out by the noise of the boom. Even the highest financial authority in the world, the Chairman of the US Federal Reserve, scoffed at the naysayers.

To give you an analogy, imagine you are at a great party and it is really pumping - music blaring, people drunk and having a really good time. Now imagine a lone sober person entering the party and wanting to remove the alcohol and turn down the music. How popular do you think that person would be? Do you think the people at the party would be happy? No. Do you think the pub supplying all the alcohol would be happy? No.

The same holds true for 'market parties'. Investors become intoxicated on the instant hit of wealth. The investment institutions that sell this much-desired wealth product sure as hell do not want the party to end and ruin their bonuses.

What I have learned is that the advice of experts and commentators who have a vested interest in keeping the party going or getting it restarted (after the boom has busted) is not worth the paper it is written on. Economists who are employed by banks, stockbrokers, investment institutions, high-profile financial planners, market analysts and mainstream media economic commentators are vested in perpetuating the good times. There is little value in standing on their shoulders as you will not see much further than the rest of the herd.

The intellectual giants whose opinions I have come to respect are:

1. John Mauldin - www.johnmauldin.com - Mauldin publishes two free weekly newsletters - 1) Thoughts from the Frontline and 2) Outside the Box. He also has written a few books. His book *Bulls eye Investing — How to invest in a smoke and mirrors market*, has been particularly informative. His latest book *Endgame: The End of the Debt Supercycle and How It Changed Everything* is an excellent read on how we have managed to arrive at this debt crisis. I have also been reading his weekly newsletters for the past nine years and he is consistently accurate in his long-term views of where the economy and global markets are headed.
He was the first person I read who warned about the sub-prime crisis. He was writing about it a year before it happened. This is the problem with forecasting

— you can see events leading to a certain conclusion but you do not know the timeframe or when they will play out. The longer a boom continues the more the doubters are dismissed as just plain old pessimists who never see the good in anything.

The reason why the mainstream commentators receive media attention is they tell the herd what they want to hear and may temper their view with a slight hint of caution just to sound a little bit authoritarian.

Mauldin is balanced in his views and is very optimistic on the prospects of the biotech sector.

The *Thoughts from the Frontline* newsletter is his opinion on markets and the economy. The *Outside the Box* newsletter is a copy of an article Mauldin has read throughout the week that he believes will be of interest to his readers. *Outside the Box* has given me exposure to the opinions of other commentators (who Mauldin obviously thinks highly of) and these articles are often very thought-provoking. Mauldin likes to challenge peoples' thinking so he will often publish opposing views on a particular subject.

I remember him saying, *'If you want to test the veracity of your argument put it out in the public forum. If your theory is shown to have holes in it, then you have learned something. If it doesn't have holes in it, then other people have learned something.'*

2. Bill Bonner — www.bonnerfamilyoffice.com This is a paid subscription to the Bonner Family Office. Bill Bonner is the author of a number of books and is the publisher of a free daily newsletter titled *The Daily Reckoning*. He is a good friend of John Mauldin's. Several years ago a valued client suggested I should read *The Daily Reckoning* and I've been grateful ever since.

What began as a curious read turned into a genuine admiration for Bonner's forthright views on the economy, the government's mishandling of the issue and the impact this would have on markets. Bonner is very much a contrarian thinker and judging by his writing style he does not suffer fools lightly.

To give you an insight into his contrarian thinking, back at the start of 2000 when the share market was still riding high on the tech boom and gold had fallen nearly 70% in value from its 1980 high, he said, *'The best investment for the next decade will be to sell US shares and buy gold.'* At the time the majority thought he was mad.

What the herd does is extrapolate the past into the future and assume because the share market has risen 1500% in the past twenty years then it will do the same for the next twenty years; and conversely gold has fallen 70% in value for the past twenty years so it will continue falling.

Had investors taken Bonner's advice they would have made 500% on their money. Those who stayed in US shares have made 12%. Just to put some dollars on this — if you had \$100,000 in the year 2000 and invested in gold, the value today would be \$500,000. The same \$100,000 invested in US shares would today be worth \$112,000. This is a powerful demonstration on why it is so important to be in the right asset class for the prevailing economic conditions.

Bonner freely admits that not all of your portfolio should be put in the one basket. An investor should attribute a higher weighting to those asset classes that stand the best chance to profit from the current and predicted economic climate.

I was impressed enough from the free newsletter that I subscribe to his inner circle — *The Bonner Family Office*. The monthly cost, in my opinion, has been value for money. The idea behind *The Bonner Family Office* is to share the insights into how the Bonners manage their personal fortune and where they invest personally. His views make sense to me.

I like his reasoning and his lateral approach to economic and market issues. He is not trying to sell a product. What I am buying is his intellect and strategic thinking. He is more negative than Mauldin on the outlook for the global economy. He is of the opinion the debt bubble is still yet to fully burst and government meddling is only delaying the 'day of reckoning'.

He is still very positive on gold, however, and believes the price will rise further at some point in the next decade when the '*debt hits the fan*'. He is of the opinion that the US share market will face a substantial correction when 'the debt and fan' have their destiny.

3. Robert Prechter — www.elliottwave.com — Prechter is the founder of Elliot Wave Theory. He is a US-based commentator who bases his forecast on socionomics (society trends) and mathematical formula (Elliot Wave Theory). I first heard of Prechter in 1987. He had been in the forecasting business since the mid-1970's and had established an excellent track record for predicting key turning points in the market.

In 1987 he was warning investors that the share market would face a substantial correction in April 1988. In fact it corrected in October 1987. Missing the market crash by six months took a little shine off Prechter's halo and I didn't hear anything about him until the last few years. From what I can gather he continued with his regular newsletter and has written several books.

His latest book was published in 2003 and was titled *Conquer the Crash*. The content of the book focused on his predictions for an impending crash in markets due to the excessive credit and optimism in society. He was about four or five years too early in his prediction, however the snippets I have read on how events would unfold have been reasonably accurate.

I do not pretend to understand the mathematical formula (based on Fibonacci numbers and waves within cycles within super-cycles) however I can pick up the gist of what the charts are indicating and the rationale behind his forecasts on the markets future direction. In general I have found the information to be reasonably accurate and will maintain my subscription.

I value his opinion enough to subscribe a reasonable amount per month. The subscription provides a newsletter three times a week on the short-term movements in the share market, bond market, currencies and precious metals (gold and silver). Each month there are two publications: Elliot Wave Theorist (this is a longer newsletter written by Prechter) and a Financial Forecast.

Admittedly all of the publications are heavy-going and I managed to glean enough from them to assist me in formulating my views on market trends.

Prechter is by far the most negative of market commentators. He is recommending his subscribers cash up as he genuinely believes share markets are headed for a fall of over 90% in value. Hard to fathom perhaps, but the accuracy of his previous predictions means I do not discount this possibility and is the reason why I have adopted a cautious outlook.

4. Jeremy Grantham — www.gmo.com — GMO stands for Grantham Mayo van Otterloo. Jeremy Grantham is the CEO of this well respected Boston-based investment firm. He has been in the investment business for forty years and is spoken about in revered terms. He writes a free quarterly newsletter that can be accessed via the GMO website.

In the late 1990's (the tech boom) Grantham publicly said the valuations were not rational and would not invest client funds in a 'hot market'. He paid a

heavy price for this principled stand. His assessment of the market was correct, but he was a couple of years too early in his call (greed can drive markets for much longer than seems possible). As the market continued to rise his funds underperformed and clients left his company in their droves. Billions of dollars were withdrawn from GMO funds and this had a dramatic impact on his personal earnings (the firm is paid a percentage on the funds they manage).

In time his stand was proven correct and over the course of the last decade the billions (and many more dollars) have returned to GMO funds. Being right cost him in the short term but has paid substantial long-term dividends with an increased reputation and financial position.

His quarterly newsletter offers a thoughtful insight into the economy and the implications for markets.

GMO provide long term (ten-year) forecasts on the predicted future returns for ten different investment markets. In looking back at their 2000-2010 predictions they were exceptionally accurate for seven out of ten markets and the other three were not too far off the mark. Pretty impressive. Can you imagine how difficult it would be to be asked to predict the annual rate of return from ten different markets over the next ten years?

There are others I have read from time to time are Doug Casey, John Hussman and Richard Russell. But the ones above will give you a good balance of information from mildly cautious (Mauldin and Grantham) to Prechter who is downright pessimistic (or will history judge him to be a realist?)

17

Be Aware of False Prophets

‘Beware of false prophets, which come to you in sheep’s clothing, but inwardly are ravening wolves’

– Biblical quotation

During your life there will be plenty of people who will offer you advice. Family, friends, co-workers and even people you hardly know.

Some of this advice may prove to be helpful; other times it will be absolute waffle and in some cases downright harmful.

To make progress in life you need to seek advice, words of wisdom, counsel or guidance from people with greater knowledge than you possess. Your formal education (school and university) operates on this very principle. It is simply not possible to be knowledgeable on every topic, so you seek out sources that possess the knowledge you wish to obtain.

The advice from your family, social and professional network should be weighed up against the value you place on that person’s opinion. How do they conduct their life — with honesty and integrity or are they a little bit loose with the truth? How have they achieved their professional success? What are their personal relationships like and what are their life experiences? (It always amazes me that a Catholic priest is called on to give marriage guidance!)

It is up to you to determine whether the advice you receive has merit or not.

The advice I am talking about so far is the free advice you will be offered.

The free advice offered by your network of contacts can be very well meaning but erroneous (think of the father in the Telstra ad when he advised his son about ‘keeping the rabbits out of China’) and if you follow the advice it could have embarrassing consequences. This is where you have to have a good filter.

Beware free advice which can also prove to be very costly e.g. a friend saying, ‘You should invest with my mate Bernie Madoff.’

If the free advice sounds reasonable, undertake a more detailed independent investigation to ascertain the merits of the advice.

The other type of advice is the stuff you pay for – legal, accounting, financial, medical, psychological, motivational, fitness, life coaching, business coaching etc.

However, paying for advice doesn’t necessarily mean it is sound advice. You must exercise cautious judgment as not everyone you seek a professional opinion from is competent.

A good example is the ‘scalpel-happy’ doctor who always insists on operating before trying other simpler and less invasive methods. If concerned patients accept him at his word and don’t do their research on what other treatments are out there, they’re at risk of suffering an unnecessary and extremely painful operation. Not to mention the cost

There are some excellent professionals — lawyers, accountants, doctors etc. but it pays to have a questioning mind so you can evaluate their level of competence. If in doubt seek a second and even a third opinion.

The false prophets I dedicated this chapter to are primarily the dreaded and numerous ‘consultants’. I was once told, ‘A consultant is someone who takes your watch and charges you to tell you the time.’ In my experience there is a fair bit of truth in this statement.

I recall we engaged a business coach at a cost of \$10,000 and while some value was delivered, I do not believe we received \$10,000 worth. The areas they highlighted for improvement were the ones I was already aware of. They just took my concerns and turned them into the basis for their report.

Another trap for the unwary are the self-help gurus (motivational speakers). I have read a number of books on positive thinking and have found them a useful source of inspiration. The difference between buying a book and signing up for an expensive seminar or ongoing motivational training is enormous.

With a book you can at least read a few paragraphs or chapters before you decide whether to invest \$30–50 or not.

However the many hundreds or thousands of dollars to attend a seminar, workshop and/or participate in ongoing ‘training’ is deducted upfront. Whether the program is of value or not will not be known until the end.

Seminars are often run as ‘enticers’ and the real sell is to commit you to signing up for a more expensive workshop or some form of ongoing training/information program. This is where the real mother lode is for the promoter.

By all means look, listen and learn from people whose opinion you respect but be very loathe to sign up for expensive programs.

Several years ago a self-proclaimed property ‘guru’ named Henry Kaye (do a Google search) ran some ‘How to get rich in property’ seminars. People paid \$15,000 or more to attend and receive the magic formula for success in the property market. Kaye actually used the seminars to sell the attendees over-priced properties he had a vested interest in. The authorities eventually caught up with him but it was far too late for many investors who were doubly duped (paid \$15,000 to be manipulated into buying an over-valued apartment).

The prophets, spruikers and gurus are in all walks of life — motivational, life coaches, business coaches, property investment, share trading, futures trading, health and well being, financial planning and the list goes on.

The benefit the public has today is they can access blog sites that provide some feedback on whether the person conducting the program is credible or not and if the program offers value for money.

The people conducting these programs are usually exceptionally good public speakers with impressive powers of persuasion (after all that is their job) — so before being tempted to sign up, go away and do some research in the cold light of day and make an informed decision on whether or not to put pen to paper.

If you want lasting change in your life it has to come from a genuine desire within to alter your habits. This takes discipline, time and a real commitment to stay the course.

Perhaps a particular program will help equip you with the necessary tools to implement the changes you are looking for in your personal, financial or business life but just make sure you are receiving value for money from a credible source. Otherwise these false prophets will be making real profits at your expense.

18 Starting a Business

'We were young, but we had good advice and good ideas and lots of enthusiasm.'

– Bill Gates, founder of Microsoft Corporation

You do not necessarily have to be young to start a business, but you most definitely need to have a good idea, a ton of enthusiasm and very good advice.

A business is like an addition to the family. You live it, you breathe it and it consumes a lot of your waking (and sometimes sleeping) hours.

Self-employment and a business is not the same thing. In my opinion self-employment is where you 'buy yourself a job' e.g. a tradesman leaves an employer and sets up as a contractor or you buy a franchise and work twelve hours a day in it.

You have a genuine business when you generate revenue without the need for you to be there e.g. Lorna Jane migrated from self-employment (making and selling the leotards herself) to having a fully-fledged retail business. Another is Ralph Lauren who began selling his own ties in the Empire State Building and is now an international fashion business. Boost Juice is yet another example.

Not everyone makes the transition from self-employment to businessperson. There are a variety reasons for this:

- a. a large percentage of start-up business ventures fail due to lack of planning and back-up capital;
- b. some do not have the drive or skill sets necessary to take a business to the next level;
- c. some are quite happy being a sole operator and not having to deal with staff;
- d. everyone has different levels of ambition and once a certain level of income is attained they are content; and/or
- e. some people are in business for a certain lifestyle e.g. running a café by the beach.

Going into business can be exciting and a little nerve-wracking, but most of all it is a lot of hard work.

When you leave full-time employment you will forgo some or all of the following benefits:

1. A regular income
2. Employer funded superannuation contributions
3. Sick leave entitlements
4. Annual Leave entitlements
5. Long service leave
6. Maternity leave
7. Study leave
8. Possibly a company car
9. Possibly annual bonuses
10. Possibly employer-funded education expenses
11. Possibly employer-funded attendance at conferences

The trap most people fall into when considering a business is they look at replacing their income only and forget to place a value on all the other benefits they receive.

If you look at the above list of benefits and applied it to an employee with an income of \$100,000, my estimate is the other benefits (super etc.) could add up to a further \$25,000 - \$50,000. Therefore the total employment value is \$125,000 - \$150,000.

The employed income and added benefits could be for working a forty-hour week whereas self employment is generally significantly more than 9am to 5pm. In addition to the time you spend in the business there is also the extra time you spend on the business (book work, business planning, managing cash flows etc.)

I am not trying to scare you off from ever starting a business because there is an enormous sense of achievement (and not to mention wealth) in creating and building a successful enterprise.

What I am trying to do is ensure you are not one of the sad statistics for small business failures. My guess is a good percentage of people who go into business think it will be easy being their own boss and believe there are all these 'tax perks' associated with owning a business. They underestimate the capital, attention to income and costs, discipline and effort required to operate and manage a business successfully.

You could be a brilliant lawyer, engineer, plumber etc. but if you are lax in maintaining records on the time you spend with clients and are tardy in sending out invoices, your business will soon run into cash flow problems. The staff, landlord,

electricity bill, phone bill all need to be paid – these are concerns you do not have when you are an employee.

Being good at a particular profession or trade is only one of the ingredients for business success (this is the ‘good idea’ component of Bill Gates’ quote).

We will look at the other ingredients a little later on, but first let’s assume you have settled on your good idea for a business. There will be three options available to you to implement your business idea:

1. Buy an existing business
2. Purchase a franchise (new or existing)
3. Establish your own

Buying a business

This option can be appealing, as some of the hard work has been done – income being generated from existing clientele; fixtures and fittings in place; advertising; brand establishment etc.

However there are a lot of traps to be aware of when buying an existing business and you should move very cautiously before committing to buy an established business.

1. Why is the business owner *really* selling? If you are not convinced as to the real reason for selling then either walk away or ask to work in the business for a trial period to satisfy yourself as to the bona-fides of the business. If the owner is reluctant to commit to the trial period, then walk away. Remember that Donald Trump said some of his best investments were the ones he did not make.
2. Are the assets of the business valued accurately? Often times the assets (fixtures, fittings, phone systems, computers, cars etc.) are marked up for the purpose of the business sale. Make sure you receive a fully itemised list of all the equipment and the value attributed to each item. You can obtain a copy of the depreciation schedule (from the latest tax return) to see if there are any indiscrepancies in the valuations of the assets.
3. Do the sales fluctuate with the seasons? For example in Cairns the tourist season is June to September and if you looked at this period in isolation it would give you a distorted picture of the business. The other reason to look for cyclical impacts on cash flow/sales is to be able to manage your finances for the slower periods (allocate funds from the busier periods to cover the quieter

times). Also is the business highly dependent on a small number of clients? If so you are vulnerable to the loss of one or two clients. I recall an accountancy practice that generated the majority of its fees from one client – a property developer. In the good times they did really well but when that client went broke, the accountancy business struggled to survive. The other trick I have seen is where a business owner has more than one outlet and in order to sell the under-performing outlet they put the sales from the other shops on the books of the outlet they are trying to sell. In other words they falsify the sales history to make it look much better than what it really is. To satisfy yourself as to the accuracy of the figures, you can request a trial period or simply sit outside the business and count the number of people who enter and actually buy something.

4. Are the expenses accurate? Make sure all expenses have been recorded. Identify which costs are fixed (as these are the ones you will have to pay irrespective of whether sales rise or fall) and those that are variable (these are the areas you may be able to trim expenses — wages (can staff numbers be reduced with better technology); cheaper phone plan; email rather than postage. Also if you have to borrow for the business acquisition you must factor in the interest costs into your expenses.
5. Are the profits real? Go back through past tax returns to determine whether there is a trend in profit growth. Look to see whether the profit is in line with industry average.
6. Are you paying a fair price for the business? Most businesses sell for a multiple of profit plus the costs of stock and other assets (depreciated value of fixtures and fittings). The multiple applied to the profit will depend on the particular industry — some sell for one and others for up to six or seven times recurring income.

As mentioned in the Share chapter — P/E's (the multiple paid for a business earnings) expand and contract depending upon the prevailing social mood.

This is where you have to do your research and know what the going price is and how that compares to the historical average.

Like any investment you must make sure the price being asked for a business is not being inflated due to boom conditions.

Be prepared to walk away if the price is not right.

Purchase a Franchise

The *theoretical* benefit of a franchise is you are buying a proven business model backed by a head office that will provide marketing assistance, business guidance, negotiation of leases, bulk buying and brand awareness.

Depending on how well known the brand is will depend on the cost to acquire a franchise e.g. McDonalds can cost in excess of \$1 million whereas a mowing/cleaning/dog washing franchise may be \$10,000–\$20,000.

In addition to the upfront expense to acquire a franchise you must pay an annual royalty fee of 7%–12% of gross revenue to the franchisor (this is to cover head office expenses and a contribution to marketing).

Statistics indicate franchises have a better success track record than independent small businesses. However, buying a franchise does not guarantee business success. You must still work smart and hard to ensure the business runs profitably.

Prior to committing to buying a franchise you must undertake the usual due diligence and do not just accept the figures and projection the franchisor provides you with (these can be slightly inflated to make the business proposition look attractive). Talk to other franchise owners so you can gauge whether the business system is all it is promoted to be.

The Bank of Queensland has franchised out some of their branches. I believe the cost is in the vicinity of \$250k upwards for a five year period. In New South Wales some of the franchisees were seriously disappointed in the support they received from BoQ and took legal action due to the amount of money they had lost on this business model. BoQ won the first legal case, however the reason I mention this is that even an established and respected brand is not without its issues and it pays to remember ‘caveat emptor’ — buyer beware.

Establish your own business

Starting your own business from scratch avoids the risks of buying a business and a franchise i.e. paying too much for something that does not deliver.

Starting a business from scratch will require the following:

1. Access to enough money to keep you afloat until the business begins generating its own cash flow.

2. Discipline and energy to enable you to persist through the initial start-up phase (the lots of effort and expenses but very little reward phase).
3. Adapting your product/service to suit the market — this trial and error phase is essential to developing your business. You can learn a lot from your failures so do not be afraid to try new things (provided they do not place you in financial jeopardy).
4. Finding out what the price of your product/service should be. At what price will the consumer think your product/service is fair value? — no good starting a coffee shop and charging \$7 for a flat white when all your competitors are around \$4.
5. What is the most effective and economical way to market your product? Is it print media, social media, TV, trade shows or a combination of these?
6. Locating a suitable premise and lease conditions.
7. Recruiting staff.

As you can see, going into business (either established or new) requires careful thought and planning. The reason most businesses fail is due to lack of planning and failure to understand that the ‘buck’ (financial responsibility) stops with the business owner. Also they fail to appreciate cash flow requirements and account for expenses (especially their tax obligations).

Having an in-depth appreciation of the financial structure of your business is crucial. Knowing where your money is coming from (revenue) and where it is going to (expenses) is essential to your business success.

There is an old saying: ‘there is no new way to go broke — it is always too much debt.’ Be careful to not over-borrow or commit to significant ongoing expenses (e.g. lease on elaborate premises). Being locked into expenses (interest costs and/or leases) can place your business in jeopardy if the economy softens and demand for your product or service shrinks.

For some entrepreneurs the financial side of the business is boring and they would much prefer to spend their time on the areas of the business they are far more passionate about (who can blame them as they did not go into business to be an accountant). Big mistake. It is the boring stuff that you must have a good grasp of.

In my opinion you must teach yourself the financial basics otherwise you will run the risk of becoming one of the statistics for business failure.

In addition to your basic knowledge on finance and law, it is vital you seek expert guidance from a competent accountant and solicitor.

There are a number of ways to structure the ownership your business:

1. Sole Trader
2. Partnership
3. Proprietary Limited Company

As to which is appropriate for you will depend on your situation and ambitions. A good accountant will guide you through a process of elimination to decide on the best structure.

Getting the business structure correct is essential as it will save you a lot of money in later years. Some people start out as a sole trader and find the growth in their business means they should have a company structure (Pty Ltd company) for tax and asset protection. To transfer the business into the company structure will likely incur stamp duty and capital gains tax. These costs could have been avoided if the company structure had of been chosen originally.

Remember before you sign *anything* always seek professional advice. This is where a good lawyer will be invaluable in checking the fine print and alerting you to the responsibilities you will be entering into if you sign the document/contract. Better to know what you are liable for than to have a nasty surprise at a later date.

Good advice will cost, but not paying for advice could cost you a whole lot more.

The other form of advice that will be invaluable is that of a trusted mentor. Seek out successful business people (preferably in the same line of business) who can pass on their insights and wisdom. Better to learn from other people's mistakes than make them yourself.

The other types of advice that you may seek from time to time are:

1. Small business advisory services run by the State Government
2. Specialist business consultants

Successful, well-run businesses do not happen by accident. They are the product of ideas, energy, innovation, a determination to strive to improve, a willingness to learn and develop; and finally, a genuine desire to add real value to their clients lives.

19

Summary

*‘Don’t fear failure so much that you refuse to try new things.
The saddest summary of a life contains three descriptions:
could have, might have, and should have.’*

– Louis E. Boone

Well darling I think this is enough knowledge for now. There is a lot to digest and comprehend. Anything you are not sure of, please ask me and I will be happy to explain in more detail.

The information in this book took years to learn, months to write and probably will take you days to read and digest. However I sincerely hope the knowledge stays with you for a lifetime.

In summary:

1. Life isn’t fair. Do not compare yourself to anyone else. Being envious of others is destructive energy.
2. You are unique. Focus on being the best person you can be and build yourself an amazing life. Gandhi once said: *‘You must be the change you want to see in the world.’*
3. Invest in yourself. This will be the best investment you could ever make. The more you grow, the more you will be given opportunities to take your skills to another level. In time your talent will be recognised and you will be rewarded handsomely.
4. Don’t be greedy — remember that, ‘The financial graveyard is littered with the corpses of the greedy.’
5. Remember what the ‘big print giveth, the small print taketh away.’ To avoid any nasty surprises at a later date, always have your lawyer check the finer details of any contract you enter into.

6. A poor person always pays twice. Buy quality and it will last. People with a ‘cheap’ mentality will end up spending more over the long term as they continually replace the cheap item with another cheap item. They pay penalties on overdue accounts because they don’t have the cash.
7. Develop a savings habit early and watch the power of compound interest work for you.
8. Borrow to a level that will enable you to sleep at night.
9. With any investment you must focus on the downside risk. Most people only dream of the riches they will accrue if the investment is successful and forget to assess what they stand to lose if the investment goes wrong. You know you’ll be happy if the investment goes up, but how will you feel if you lose money? If you can manage the downside risk then you have increased your odds of making a successful investment.
10. Seek advice from people you respect and have been successful in the area you are interested in obtaining further information on.
11. Organize your Estate Planning and Insurances. Putting these issues in order will be the first step in building the correct framework for your business affairs.

In the words of Doug Firebaugh:

‘Every day do something that will inch you closer to a better tomorrow.’

Building a successful life is an incremental process. Occasionally you get lucky and if that luck is a function of hard work then accept it as a just reward. If the luck is pure happenstance then acknowledge the kind hand of fate rather than take credit for it — this will keep you grounded. Overconfidence can bring fleeting success but it is a major impediment to lasting success.

As you know, Bill Bonner is one of the people whose opinion I respect. The following is an extract from one of Bill’s newsletters, which I thought was a fitting conclusion to this book:

‘There’s no such thing as starting off on a level playing field. Every child is born with certain advantages and disadvantages. Inherited wealth without the proper context, and without education, could be a major disadvantage!’

‘The characteristics that make you who you are...and your children who they are...are a part of your family legacy. Financial wealth is a part of it too. Like your athleticism, your musical ability or your gift for math. But money does not define a legacy; it’s merely a resource.

‘The ability to use that resource to live a self-fulfilling and productive life — that’s a true legacy.’

To my darling girls I hope this book has given you the resources to empower you to attract and retain sufficient wealth into your life so you can live on your terms.

Little by little you *will* build an amazing life and I sincerely hope *A Parent’s Gift of Knowledge* assists you in your life’s journey. This is our legacy to you.

All our love always and forever,

Mum & Dad xxxxxxx



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