GETTING YOUR MONEY $HIT TOGETHER

stop worrying about money
and live your best life

MAX PHELPS

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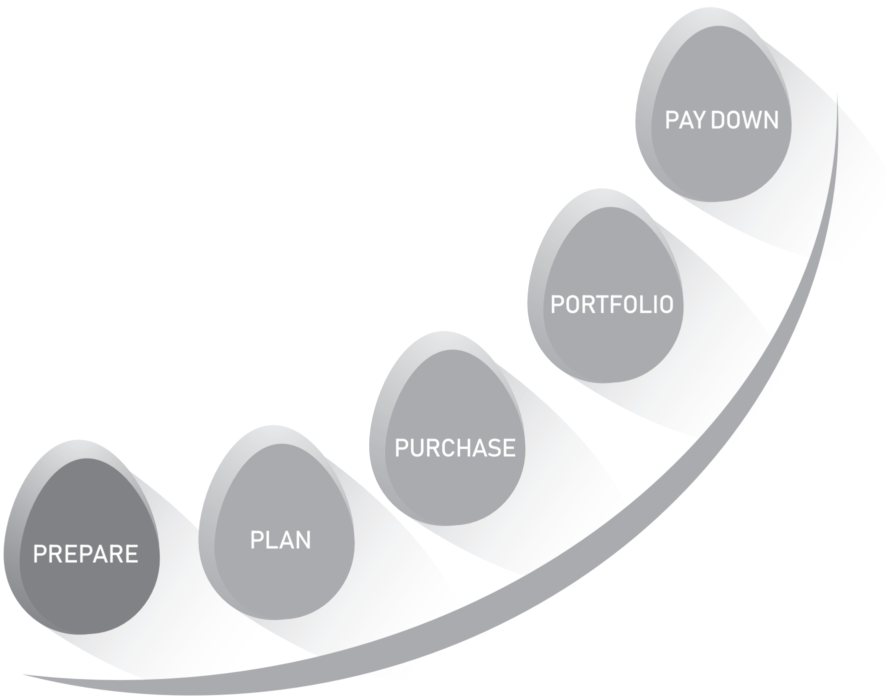
STAGE ONE

PREPARE



card-carrying TAs and who live alone or whose partners are also TAs.

First let's separate transactions into two categories: fixed and predictable versus variable:

Bills (fixed/predictable)	Everyday (variable)
Gas, electric, phone, internet, car insurance, car registration, health insurance, income protection insurance, etc.	Groceries, fruit and veg, lunches, coffees, takeaways, regular entertainment – basically anything you do every week
NO ATM/EFTPOS card	ATM/EFTPOS card

This means that anything in the everyday account is ok to spend, without worrying about what day direct debits come out, or when the next bills are due. Bills can bunch up throughout the year but are very predictable over the full year. Most people in couples end up with one everyday account each, to give them some autonomy and avoid confusion over who spent what and when.

Then we need to split our savings into a minimum of three accounts:

Future Freedom	Holiday (Annual)	Fun (Monthly)
To buy property and income-producing assets, for our future	To make memories, with awesome trips to see amazing sights and meet extraordinary people	Gifts, Clothes, toys, gadgets, mini-breaks, celebrations, beauty treatments, etc.

Remember this is the *minimum* we need – we might need another account to save for a car, for Christmas, for a wedding or for something else, but most people find it's best to do it separately to make the purpose clear. Most couples have a fun account each, but as a TA I don't need one.

Cash flows and timing to keep us on track

Having five accounts alone is not enough. It's the flow of money that makes the system stick:

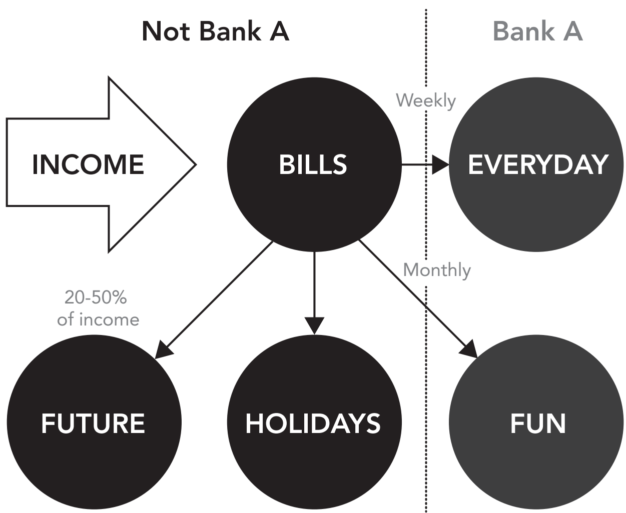


Fig. 2.1

But if you did all this with the same bank, how easy would it be to cheat?

When we explain this face to face with clients, we get a bunch of questions. What about credit cards? Shouldn't all the money be in my offset account? What if my income is uneven? How much should be in each account? What if our circumstances change? Which account should my rental income go into? Why don't they teach this in schools? We'll answer all these questions later in the book.

Saving for the World Cup

When I met with Dharmesh and Karen, they were renting and wanted to save for a house deposit, but they also wanted to enjoy going to live concerts regularly, take an annual trip home to India and – in two years' time – go to the World Cup. We went through their numbers in detail and prioritised funds.

	Yearly	**Monthly**
Income	**$108,000**	**$9,000**
Future	21,600	1,800
Hols India	2,000	167
Hols World Cup	7,500	625
Bills – Rent	26,000	2,167
Bills – Other	12,000	1,000
Fun – Concerts	4,800	400
Fun – Other	8,100	675
Everyday	26,000	2,167

Income insurance policies are not all equal, and a lot of insurance companies, insurance brokers or financial planners are afraid that people won't pay enough for long-term insurance. So, they sell the cheapest policy, which is called 'stepped premiums'. Stepped premiums are nice and cheap in your twenties and thirties, but every year the human body is more prone to wear and tear, illness and disease, so the insurance premiums go up as you get older. Through their forties and fifties, when a lot of people have still got young kids at home, big mortgages to pay, investment properties and a lot of debt, the premiums go up astronomically every year. By about age 47, after increases of 20–25% a year in the last few years, people cancel their insurances. Yet on average they still have 20 more years to work.

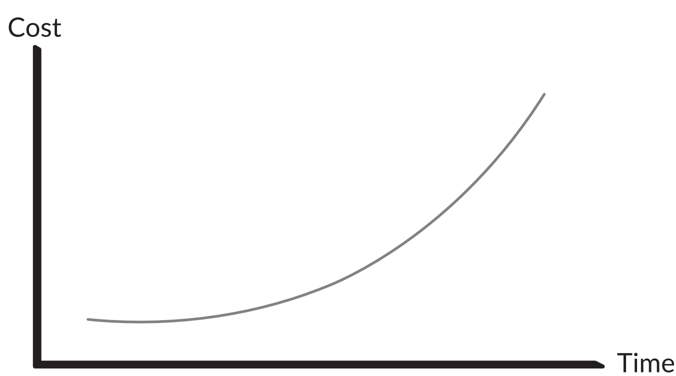


Fig. 3.1 Stepped premiums

The alternative is to pay level premiums. This is like a contract with an insurance company to say, 'I'm 29, and I'm going to need insurance until I'm sixty-five. How much is that on average for the 36 years?' Once you make that commitment, the premiums are far lower over your working life. At first you pay the equivalent of stepped premiums of someone around ten to fourteen years older than you. Starting at 29, the premiums would be similar to those of a 43-year-old; but this means that when you're 50, you'll still be paying the premiums of a 43-year-old.

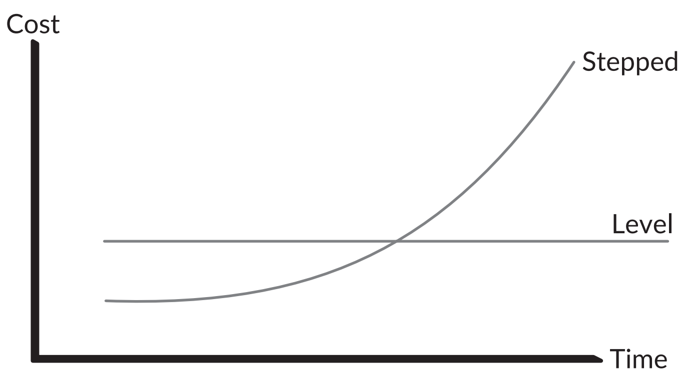
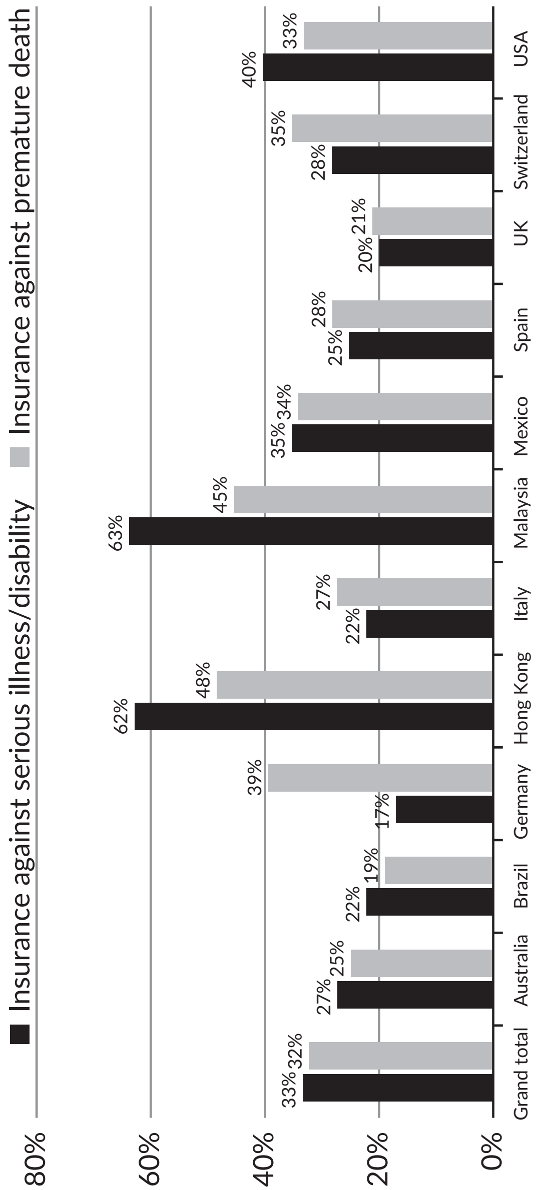


Fig 3.2 Level vs Stepped premiums

You might ask how paying an extra insurance cost is going to help you save up a deposit, but that's missing the point.

Do you insure your car? Is that car worth $4 million, or could you do that much damage to someone else's car in an accident? Imagine I gave you the keys for a



Source: Zurich/Smith School, University of Oxford, 2016

Base: Total n=11,584

Fig. 3.3 Penetration of income protection insurance varies considerably

Almost half of us think the risks of income loss due to accident or injury are less than 10%, whereas the correct figure is 44%.

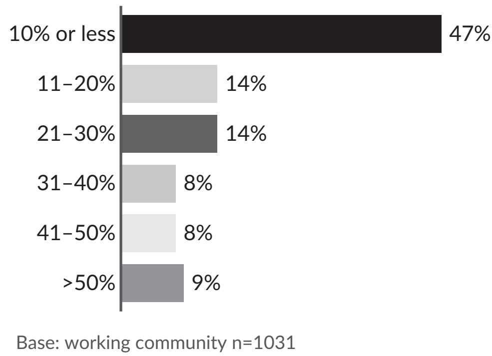


FIG. 3.4 Perceived risk of experiencing income loss due to illness/disability

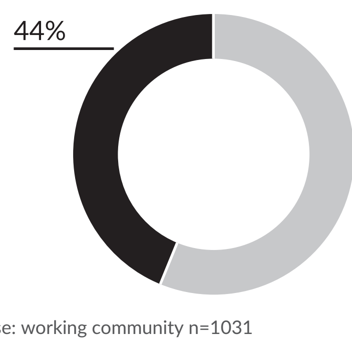
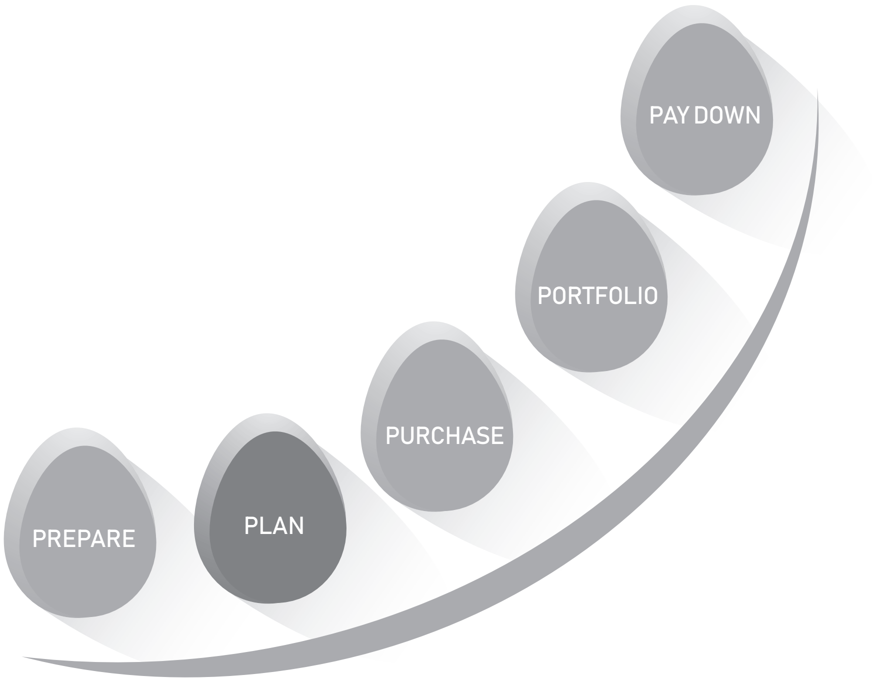


Fig. 3.5 Percentage who experience lost income due to illness/disability

STAGE TWO

PLAN



In this example of the five stages, Andrew and Zoe bought and sold at every stage. It's easy to understand how foolish it would be to do this in Australia where we have stamp duty on every purchase. They also had to pay a selling agent to sell each one. On average, you lose about 7% of the value of a property buying and selling.

A lot of people assume that property prices increase, which will cover the cost, but this may or may not be true. The table below shows some of the costs and consequences of going through those five life stages.

Family	Single	Couple +/- Baby	Family: Young kids	Family: Bigger kids	Empty nesters
Property needs	1 bed	2 beds	3 beds	3-4 Beds	2-3 beds
	1 bath	1-2 baths	1 bath	2 baths	2 baths
			Back yard	2 living	1 level
Sydney's Inner West	$600k	$800k	$1.2m	$1.8m	$1m
Buy/sell cost	$38k	$50k	$75k	$120k	$62k

For completeness, the table below is a guide for those without kids. The mature couple stage can kick in at a younger age but often involves a better-quality property, with a nicer outlook. Pets are more often a consideration for couples without kids.

Family	Single	Couple	Mature couple
Property needs	1 bed	2 beds	2-3 beds
	1 bath	1-2 baths	2 baths
			1 level
Inner West	$600k	$800k	$1m
Buy/sell cost	$38k	$50k	$62k

Costs and consequences of not thinking ahead

The biggest risk of buying property is the possibility of prices falling. Over the long run, prices have generally risen, but statistics tell us over the short run – say, two to four years – that they can fall. In Sydney right now, prices have been falling for around 18 months and seem set to fall further. The problem is the timeframe with any given life stage. Andrew and Zoe were only in their studio for two years and the two-bedroom apartment for four years. The houses lasted around 10 years each. Most people don't think beyond five years, which in property terms is actually quite short.

The first big costs are the buy costs, of around 5% of the value of the property. If you're lucky enough to get the first homeowners grant or stamp duty concession, fantastic. There are still legal fees, mortgage registrations fees, title registration fees, building inspections and other bank fees, currently around $4,000 on top of stamp duty. Selling agents typically cost around 2%

about a place that you're only going to live in for a few years?

I want to focus on the idea that your first and possibly second properties are short-term homes. How long will your first home meet your needs? We can then calculate the difference in costs between living in that property versus renting it. Depending on how much rent you would be paying if you were living in a rental property versus the rental return that you would get on an investment property, it may or may not be a good idea to move in. That would obviously be coupled with first home buyer benefits if they're available in the price bracket that you're looking at. Georgina, a research scientist, bought her first home while she was still happily living with her parents. She got a $20,000 stamp duty exemption by living in the place for six months and then moved back home and rented it out.

Let's look at the costs of living in versus renting out.

Weekly $	**Renting**	**Own to live in**	**Invest**
Rent	500	0	500
Mortgage interest	0	450	450
Other costs	0	100	100
Total/week	500	550	-50
Tax back	0	0	19
Net cost	500	550	-31

show people how to get used to buying and holding property before trying something more complex. The emotional rollercoaster that comes with owning property becomes more manageable when you've done it once or twice.

There are lots of other little niches that can work for people, but the three main ones are cash flow positive properties, capital growth properties and smaller subdivisions.

Is negative gearing worth it?

Negative gearing is very peculiar to Australia and doesn't exist in other parts of the world. First, let's understand the difference between getting a tax deduction and negative gearing.

Let's look at two scenarios, shown in the table below.

	Positive	Negative
Rent	+30,000	+25,000
Mortgage interest	-20,000	-25,000
Agent and other costs	-5,000	-5,000
Taxable	+5,000	-5,000

In the positive scenario we collect $30,000/year in rent. If mortgage interest costs are $20,000, and agent fees, rates and insurances are around $5,000, that's living at home, but calculating what they can borrow should mortgage rates increase by 2.5% or around 6%. They're almost looking at the worst of both worlds, where spending is at a maximum and the interest rate is at a maximum, despite the probability that the combination will almost never occur.

Back to Tom and Sarah. Sarah lives at home with family and has very few expenses and a credit card limit of $5,000. This is assumed to add $150/month to her expenses. She can comfortably manage on less than $1,500/month, so the bank will use their minimum plus the $150 for the credit card to assume she has $4,750/month for a mortgage as per the table below. She could potentially borrow just under $700,000. With her $100,000 savings, she could actually stretch to buying a property for around $770,000.

	Tom	**Sarah**
Gross/Year	180,000	100,000
Normal Net/Month	10,400	6,400
HECS/HELP	1,200	0
Novated Lease	800	0
Payslip Net/Month	8,400	6,400
Other Liabilities	500	
Credit Card	600	150
Living Costs	4,000	1,500
Total Costs	6,800	1,650
Net available	3,300	4,750

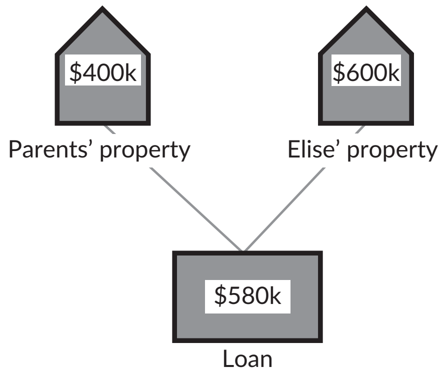


Fig. 6.1

Unlimited' is the easiest subtype to understand. Elise's parents, Gary and Julie, own their own home and an investment property worth around $400,000. Elise could have bought her $600,000 property and the bank would have used that, plus Gary and Julie's $400,000 property, as security. With $600,000 + $400,000 = $1m in property available, the bank would be happy to lend $580,000, which is what she needed. The loan would work out to 580,000/1m = 58%, well below the bank's 80% maximum, and it would be in Elise's name, with Gary and Julie as security guarantors.

What a security guarantee means is that if Elise defaults on her mortgage – not just misses a payment, but defaults – the bank has the right to sell her property and get their money back. And, in this case, if they don't get enough from her property, they have the right to sell the guarantor property too.

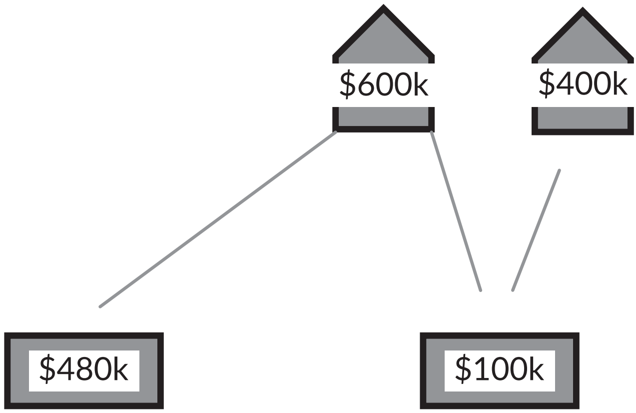


Fig. 6.2

Elise would take out one loan in her name, using her property as security. If she bought for $600,000, the bank would lend 80%, which is $480,000. This loan has nothing to do with Gary and Julie. Elise would then take out a second loan for $100,000, secured by both her property and Gary and Julie's investment property. Their risk has now been cut down to $100,000, which they may have in savings anyway, should the nightmare scenario happen. The other great feature with this structure is that as soon as the $100,000 loan is paid off, Gary and Julie are released, *regardless* of the value of Elise's property. We normally recommend this option, which only a few banks offer, and then suggest that the main 80% loan is repaid over the normal 30-year time period but that the smaller guarantor loan is repaid in five to 10 years. Elise would be confident of being independent from her parents in a shorter timeframe, and Gary and Julie would be happy with the reduced risk.

In this scenario, I deliberately set it up with Gary and Julie's investment property as security, because this option has a much lower risk than using their own home. Some banks will allow parents' homes to be used as security, but the risks have to be considered much more carefully.

I much prefer dual loan security guarantees over paying mortgage insurance, or giving gifts, as there is also a long-term benefit. If the first property could be an investment property in the future, then at that time, the loans used to buy the property would be tax deductible against the rental income (or negative geared). The bigger the loan taken out at purchase, the bigger the future tax deductions and the more cash savings would be available for the future family home. In Elise's case, she could have borrowed $600,000 instead of $580,000 if Gary and Julie were willing to sign up to $120,000 as a guarantee amount. Elise could then have kept hold of $20,000 of her savings, which could be placed in an offset account. This could have kick-started her savings for a future family home.

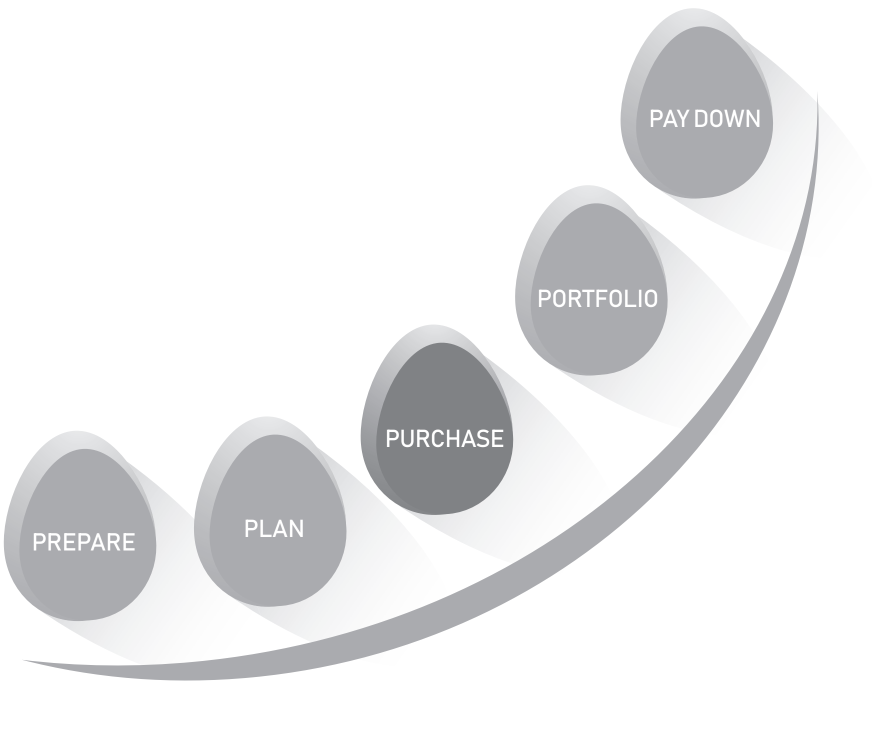
How much will my repayments be?

Assuming a 10% deposit and using NSW stamp duty figures and first home buyer (FHB) concessions, the table below outlines the deposit amounts and repayments. Repayments are shown as weekly to make it easier to compare them to rent. We've shown the interest cost, because that's the true cost – everything above that is reducing the principal. Also shown are the bank assessed repayments, assuming interest rates jump to 6%. This is what we need to afford to get loan approval, even though the actual cost will be significantly lower at current rates. Until 2016, banks typically used an assessment rate of around 1.5%–2% above current rates; but following pressure from APRA (the Australian Prudential Regulation Authority), banks increased the minimum assessment rate to around 7.25%. In July 2019, APRA have changed to allowing the banks to add 2.5% to the repayment rate. This means on a 3.5% interest rate you would need to be able to afford repayments at 6% instead of 7.25%. Banks have been rolling this out since the APRA changes.

Purchase Price	10% deposit plus costs (NSW)		Weekly interest cost (3.5%)	Weekly P&I cost (3.5%)	Bank assessed P&I cost (6%)
	FHB	Not FHB			
400,000	45,000	58,000	$250	$385	$510
500,000	54,000	73,000	$310	$480	$640
600,000	65,000	87,000	$375	$575	$765
700,000	85,000	102,000	$435	$670	$895
800,000	116,000	116,000	$500	$770	$1,025

STAGE THREE

PURCHASE



investment property in slightly different areas, which could work long term. If they were buying a home in the same area, it might make sense to offload the Alexandria unit and buy an investment property in a different area in the future.

Equity release without selling

The alternative to selling their first property is to release the equity in the property. For Rahul and Priya, they could increase their loan up to 80% of the current value, which would be $480,000 (80% x $600,000). This will give them $202,000 ($480,000 - $278,000 = $202,000) towards their next purchase without selling. At 88%, they could take an extra $48,000 = $250,000 total.

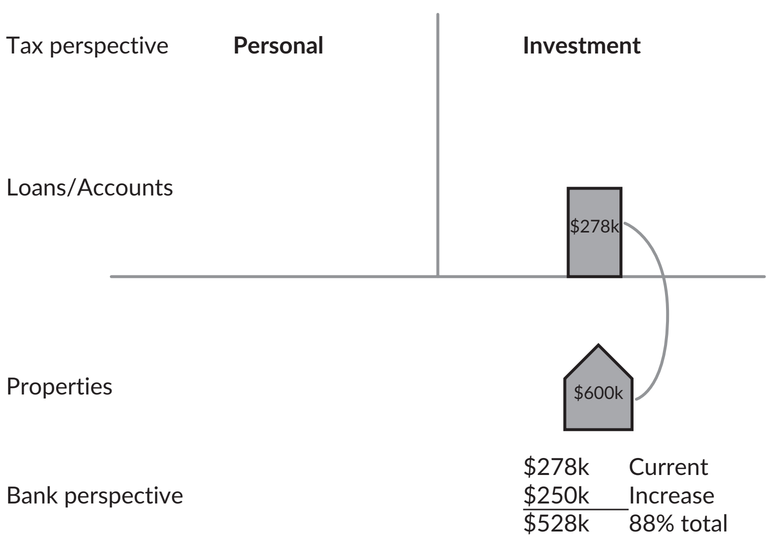


Fig. 9.1

Their example is typical of many, where releasing equity is more efficient than selling the property, yielding almost as much as selling after deducting the other costs associated with it.

Loan structure for flexibility and easier tax time

There's one right way and two wrong ways to release home equity. Priya and Rahul want to buy a property for $1m in Ryde. Most banks would simply take both properties as security and lend them an extra $1.045m to cover the purchase price plus costs, secured by both properties. That's wrong for two reasons. First, banks like to lend 80%, and the total borrowing of $1.045m + $278,000 = $1.323m is now 83% of the total equity of $1.6m. This means the bank will charge them around $15,000 in LMI. The second problem is that the properties are now linked together, which is often called 'crossing' or 'cross-securing'. This means Priya and Rahul can't sell or refinance either property in the future without impacting the other. A good value-added broker will point out the long-term loss in flexibility and control of doing this.

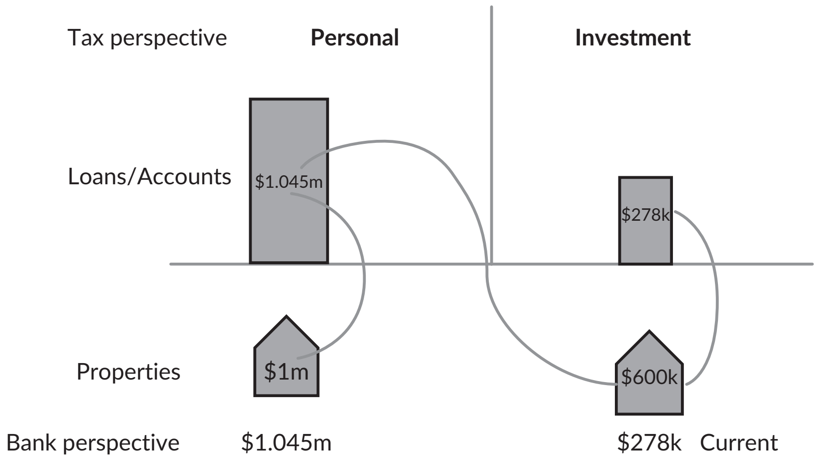


Fig. 9.2

The second wrong way would be to increase the current loan from $278,000 to $528,000 (88% of $600,000). On the one hand, it would lower the LMI bill to around $9,000, while providing enough funds to cover a 20% deposit; but on the other hand, it would make Priya's and Rahul's future tax returns difficult. Although a bank will allow them to increase the loan from $278,000 to $528,000, the ATO will see the $278,000 loan amount as used for the investment property and the $250,000 extra as owner-occupied debt because it was used to buy their home. In Australia, our tax deductibility is based on the purpose the funds were taken for, not the security offered to the bank.

The right way to do it is to get a separate loan for $250,000, secured by the Alexandria property, which we know is non-deductible. Some lenders will charge a lower interest rate on this, and tax time is now much easier. Interest charged on the $278,000 loan will be deductible, and interest charged on the $250,000 and $800,000 loans will be non-deductible. Priya and Rahul could also elect to pay interest only on the $278,000 loan and principal and interest on the $250,000 and $800,000 loans. In the short term, they might take the $250,000 as an interest-only loan until the new purchase settles. The recommended structure is shown in Figure 9.3.

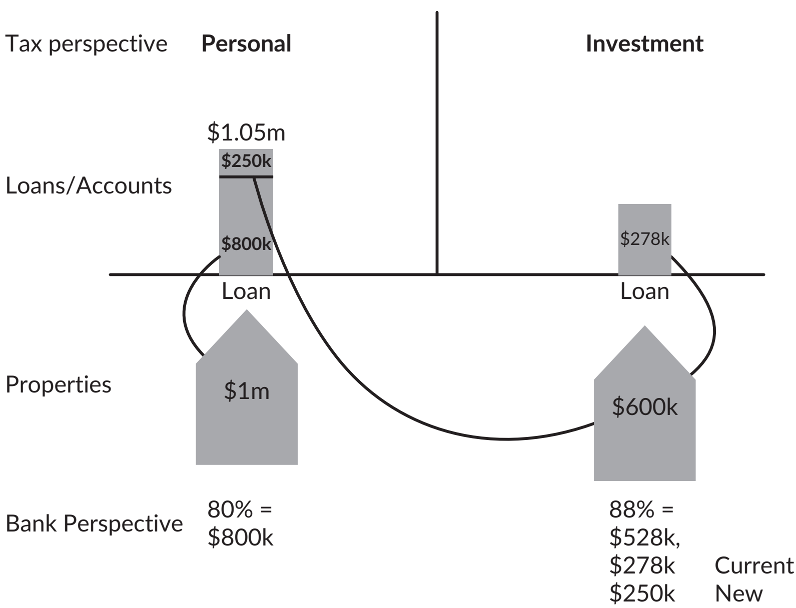


Fig. 9.3

We always recommend taking the additional loan first, even before finding a place to buy. In this example, the $250,000 would be available to redraw, partly for the 10% contract deposit and the remainder for the purchase settlement. The $250,000 loan would be paid into itself to begin with, so Priya and Rahul would have a zero-balance loan with a $250,000 limit. If it's interest only, then there will be nothing to pay until the money is used. It's also easier to get the top-up loan approved first, and this avoids delays in the purchase approval during the finance clause or cooling off period. We don't necessarily have to use the same bank for both loans. We can choose the best one for each purpose.

It's important in these examples to separate out personal and investment, so every transaction, whether for the property purchase or ongoing rent and expenses, can be separated.

How a line of credit reduces risk

A line of credit (LOC) is an unusual bank product because it's like a big overdraft secured by property. LOCs can be quite useful when we've got plenty of equity in our home for a number of reasons. The first is that they give us the flexibility to take money whenever we want. The main difference compared to a loan account is that a LOC is fully transactional. It can be used to pay bills and make other loan repayments, and it can also have a positive balance as well as a negative balance with most lenders. By comparison, a loan only has a negative balance and can't be used to make repayments on another loan.

There are two reasons why I use or recommend a LOC. Firstly, we use it for our investment property repayment account. We make sure that the rent and any transactions to do with the investment property go through the LOC. This allows us to manage the property separately from any personal accounts. When it comes time to do tax returns, we simply pull up the LOC statements and all the transactions are for the investment property.

The second benefit is that if a property is running at a slight loss, or if there's a vacancy, then we're effectively borrowing the money to cover that loss, which should be deductible. Always be sure to check with an accountant.

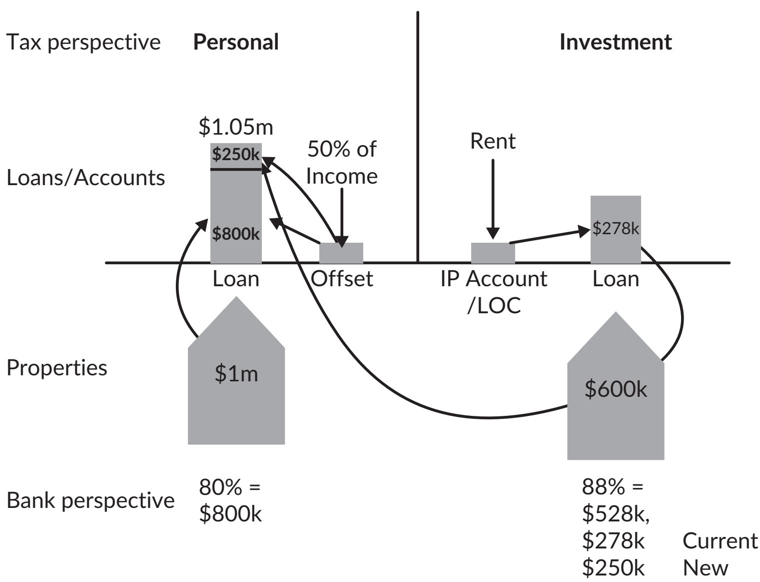
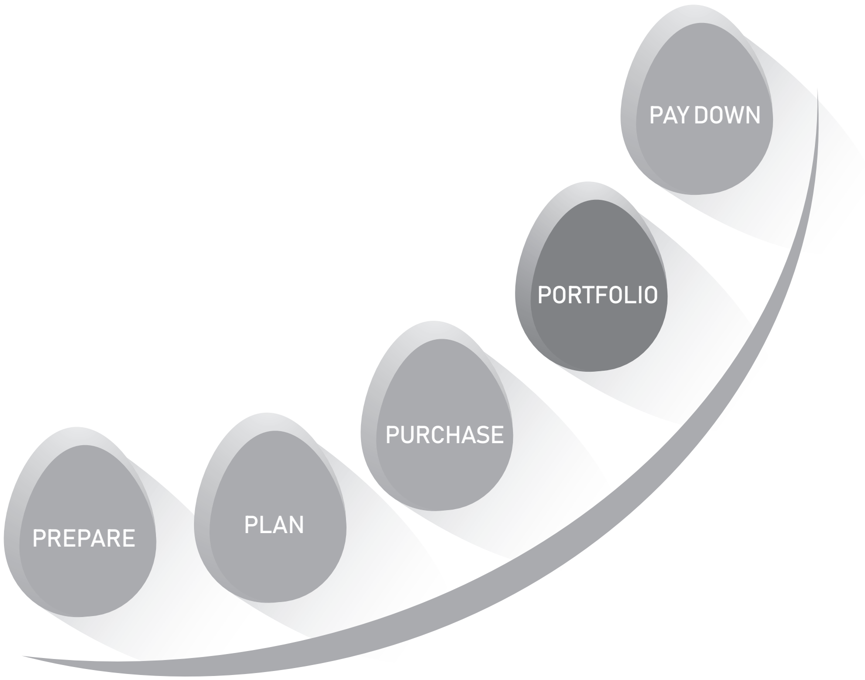


Fig. 9.4

STAGE FOUR

PORTFOLIO



year. If the property makes a profit, it's assumed that this amount is paid off the loan. Net equity after costs includes selling costs, but not CGT, although property gets a concession on that versus shares.

$585,000 property rented at $450/week (4%) yield

	Start	Year 5	Year 10	Year 20
Deposit/shares	91,744	153,684	245,332	558,592
Annual rent	23,400	25,835	28,524	34,771
Annual net loss	-3,355	-3,357	-2,251	319
Net equity after costs	55,645	184,557	341,398	764,739
Property vs shares	-36,099	30,872	96,066	206,148

$585,000 property rented at $550/week (5%) yield

	Start	Year 5	Year 10	Year 20
Shares/deposit	91,744	136,888	203,152	446,780
Annual rent	28,600	31,577	34,863	42,498
Annual net loss	-436	-109	1,396	5,555
Net equity after costs	55,645	185,568	346,252	804,655
Property vs Shares	-36,099	48,680	143,100	357,875

The second table shows that by buying a slightly higher-yielding property, the results favour property more strongly and the annual net loss is removed more quickly.

How to assess risk

We always start off risk assessment by drawing a vertical line down the centre of the page and looking at the risks on the left side of the page. It's important to explore all the things that are bothering us or holding us back. Write down all of those risks first – or at least think of them as you look at the table below.

Risks	
Individual:	
Property:	
External:	

The first set of risks we'll look at is the risks to the individual, then the risks to the property itself and what can go wrong. Finally, we'll go through the external risks, before we look at solutions.

Risks	
Individual:	
Redundancy	
Illness/injury	
Pregnancy	
Relationship	
Property:	
Unexpected repairs	
Bad tenant	
No tenant	
Accident, natural disaster, etc.	
External:	
Market fall	
Interest rates rise	
Increased living cost	

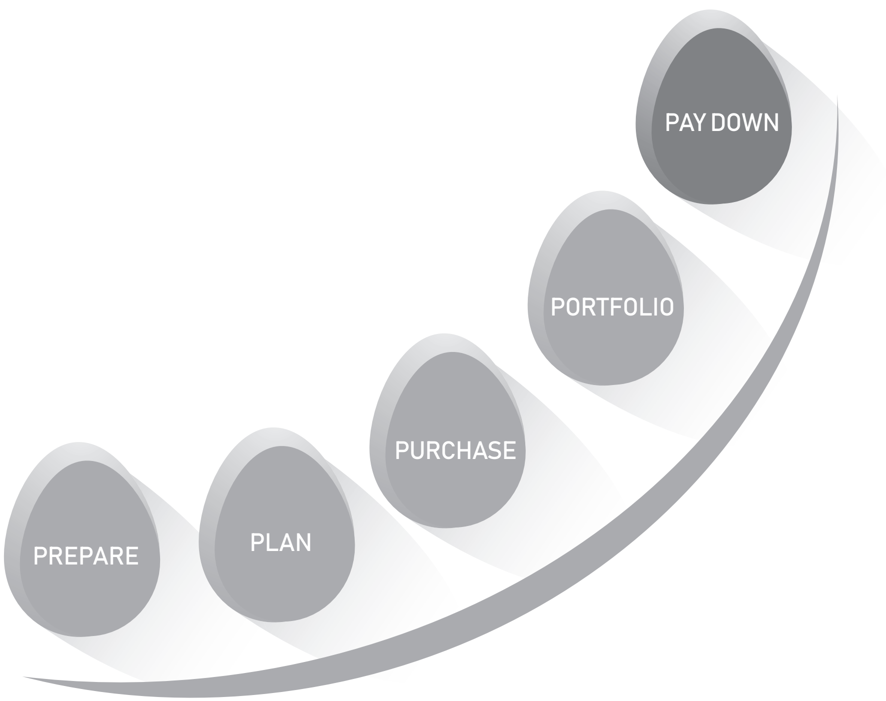
Once the list has been completed with all the risks, we can look at the solutions for each.

Risks	Solutions
Individual:	
Redundancy	?
Illness/injury	Income protection
Pregnancy	?
Relationship	Legal advice
Property:	
Unexpected repairs	?
Bad tenant	Landlord's insurance
No tenant	?
Fire/flood, etc.	Landlord's insurance
External:	
Market fall	Research/buyer's agent
Interest rates rise	Consider fixed rates
Increased living cost	Budget management

The '?' items can all be solved with a single word: 'Buffer'. With an adequate buffer, we can ride out a temporary loss of income through redundancy, pregnancy or vacancy. We can also cover unexpected repairs.

STAGE FIVE

PAY DOWN



the interest. For the investment debt, he earns money, pays interest and then pays tax. Harry earns over $90,000 and his tax rate is 39%, so let's look at the two options side by side in the table below. We will assume he can move $100,000 from one offset account to another, to change the interest bill.

	Own home	**investment**
Interest rate	3.8%	4.8%
Interest on $100k	$3,800	$4,800
Income needed	$6,230	$4,800
Tax paid 39%	$2,530	$0
Net available	$3,800	$4,800
Effective rate	6.23%	4.8%

Below is a table showing the equivalents for the other tax brackets.

Tax Bracket	**Gross Equivalent Needed to Pay 3.8%**
21.5% ($18.2k–37k)	4.84%
34.5% ($37–87k)	5.8%
39% ($87k–180k)	6.23%
47% (>$180k)	7.17%

It's important to reduce the non-deductible debt but then make sure we reduce the debt burden on our homes. We're talking about the long-term family home. Just because we live in a place doesn't

Unfortunately, average superannuation balances for retirees are only $271,000 for men and $157,000 for women, and mean averages are skewed by a small, but very wealthy, few. The median average is only $110,000 for men and $36,000 for women, or $155,000 for couples (the midpoint is higher for couples). This is in part due to superannuation not being around for their full working life.

Even if we take a 30-year-old earning $100,000/year and model their super balance to age 65, they will only get to $500,000. Salary sacrificing to the limit will take them to $1m, but all the additional contributions are locked in until at least age 60, which prevents any of it being used for early retirement.[4]

On the other hand, a couple can earn up to $74,000 between them outside of super and only pay $8,000 in tax = $65,000/year net. To earn that through property would require the following combined rent:

Weekly rent	**$1,780**
Mortgage	$0
Agent fees, bills and utilities/week	$355
Net weekly income before tax	$1,425
Annual income before tax	$74,000
Annual net income	$65,376

4 www.moneysmart.gov.au/superannuation-and-retirement/is-your-super-on-target

there's nothing much to do and she doesn't want to bother Bob all the time. They persevere for a couple of years, but Tina finally convinces Bob that she'd be happier back in the city. In the meantime, their country home value has flat-lined and city prices are up 10% to $1.65m. Let's look at the outcome for them:

	City to country	Country to city
Sale Price	1,500,000	700,0000
Sell Costs	35,000	15,000
Net	1,465,000	685,000
Buy Price	700,000	1,650,000
Buy Costs	35,000	80,000
Total	735,000	1,730,000
Surplus/Shortfall	730,000	1,045,000

Moving to the country gave Bob and Tina a $730,000 surplus, yet moving back required $1.045m, or $315,000 more than their previous surplus. Instead, they could have rented their home for more than the rent they would pay in the country. After one to two years, they could have come back, or made the move permanent, knowing it was the right thing to do.

The same goes for downsizing within the city. More and more empty nesters are looking to sell their family home and move into an apartment. For some, it's the best thing they've ever done, but others miss their gardens, their privacy and their extra space for when their kids and grandkids come to visit. If we plan to

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The Author

Max grew up in a family of nine kids, playing Monopoly and aiming not to be poor. Initially terrible at saving, during a sales and marketing career with a multinational he stumbled across an effective set-up. He spent a couple of years as a maths teacher and began investing in property in order to retire young.

Now Max is a professional property investor, with ten years of experience in finance, and qualifications in mortgage broking and financial planning. These days he spends his time coaching 25- to 35-year-olds on how to get their money shit together – to become financially secure in order to make choices about their future happiness and retirement plans. He wants them to learn from the mistakes he made, yet gain the same – or greater – success. When he takes a break, it's to travel with the love of his life and partner for twenty-nine years, Kelly. On Fridays he is with his grandson, Matthew, and he cannot be disturbed.

Max has taken the 1% Pledge and every book purchased contributes to improving education and ending poverty in developing countries.

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