Roadmap to wealth - in the nick of time

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By Kieran Clair

Derek* would like to retire at age 55, but with only three years to go, will his hard work to date pay off? This month, Derek's plans get a health check from two leading experts.

PERSONAL SNAPSHOT

Age: 51
Household income: $81,000

Summary of goals:
» Retire at 55 years old
» Pay down home loan
» $70,000 per year income

Considerations:
» Nearing goal retirement age
» Loan application rejected

Even the professionals can use a little help sometimes. Derek has more than 30 years experience in the finance industry and, like many of us, is wondering if a lack of funds might dash his dream of early retirement.

His parents were conservative money managers but fortunately Derek ventured beyond his father's moderate advice.

"My family is very old school. Mum and dad said, 'do your best to pay off your mortgage and then just keep working'. In fact I haven't even told my mum that I invest in property because she just wouldn't understand. She's not of that mindset. I haven't even told her I've got one, let alone five."

Derek has a 12-year-old son and a wife who's a stay-at-home mum with no affection for finance. All of their investment properties are solely in Derek's name for tax reasons.

As the single income earner and the sole decision maker, Derek has tried to build a portfolio that'll set them up for the end of his working life. Derek earns a gross income of $81,000 per year and says there's approximately $500 per fortnight of surplus cash after the necessities are taken care of.

Apart from their home in Port Macquarie, Derek currently has a five-property portfolio. His first buy was in Queensland.

"There was a three bedroom duplex in Kuraby that we bought - it started from there. They were developing a complex of about 20 or 30 different size units. We had the lady come to our place one night and explain it all. It was our first taste of investment. I was a bit sceptical but it looked good on paper and it turned out to be our best investment. It's never been vacant, it's been good."

Derek graduated from there to a cash flow positive proposition that's taking advantage of the shift towards an ageing population. In 2004, Derek acquired two one-bedroom units in a retirement complex located in Maroochydore on the Sunshine Coast.

"It's an over 55s complex where 85 per cent of their pension is paid towards rental. Because it's only two units on the one title there's not much buyer demand for that but it's great cash flow so I've always planned to keep it."

Derek stuck with the sunshine state, locking away a four-bedroom home in Bentley Park outside of Cairns for $264,000 in 2005. The home was recently revalued at $300,000 and achieves a rental return of $330 per week.

Derek fancies longer term investing so it was disappointing that his next investment home in Chinchilla was sold at a loss after a rollercoaster rental ride.

"It immediately rented for $350 per week, however after a couple of years, the rent dropped to $220 per week. I actually sold it in 2008 for $245,000. I'm not sure whether that was a good idea, as Chinchilla has taken off again.

"Chinchilla was starting to cost me a fair bit each week because the rent dropped significantly. That really started to hurt so I thought 'well I'd better get rid of it, it's in a mining town'. Then a couple of years later it picked up and it's booming again."

Although bitten, Derek is far from shy. He fronted up to the regional Queensland mining centre of Blackwater and picked up a four-bedroom house for $380,000. If he thought the last rental ride was stomach churning, he had to steel his resolve and take a few ginger tablets for the next one.

"The weekly rent went from $600 to $800, back to $750 then up again to $800, again to $900 and has just been reduced to $650."

While he enjoys the property's cash flow positive status, nerves are setting in about the town's location. According to Derek's research, Blackwater has a vacancy rate of 5.2 per cent and 73 properties available for rent. He's unsure whether to sell or sit tight.

His final portfolio keeper was in his home state of New South Wales, where a three-bedroom Kempsey home set him back $210,000 in 2009. This property has also proved a test for Derek. The dwelling was originally rented for $250 per week but is currently sitting vacant and now listed for sale. Derek has reduced the asking price to $200,000 but can't decide whether he should just hold and wait for the market to improve.

Unfortunately Derek's other property fling also proved to be less than profitable. Rented at $260 per week, the home in Melton, Victoria looked good for capital growth too.

"I bought that for $215,000 and it got valued at $270,000 at one stage but then it dropped back. It was vacant for six months and that was starting to kill me. I phoned up the agent and they said Melton was really oversupplied."

Derek decided to place it on the market and sold the home in late 2012 for $252,000.

He'd like to continue his investment adventure, but a chance to purchase an older home in St Marys, approximately 40 kilometres west of Sydney, highlighted a fiscal hurdle. The property had potential for a granny flat at the rear and would've provided excellent cash flow but the lender wouldn't agree because of serviceability issues. Part of the problem is an existing line of credit Derek has in place.

"I've got this line of credit of $170,000 that's available for my next purchase and when he (the mortgage broker) did his servicing he allowed for that to be fully drawn and I still couldn't meet serviceability."

Derek's criteria is to try, whenever possible, to hold for growth. By his own admission, he doesn't have the imagination, skill or time for renovation.

The plan is to pay off his home loan before tackling other debts. He thinks an annual after-tax return of $70,000 per annum would be great. He believes a modest lifestyle would suit him and his wife, with a little adventure thrown in.

"What I'm after is some suggestions and advice on what I should be doing and what I shouldn't be doing - just a few tips... whether they think 55 is realistic or whether I'm dreaming."

BRAD CALLAUGHAN - FIND BETTER PERFORMERS

I would firstly like to say congratulations. Not many investors make it past two properties and although your portfolio isn't exactly where you'd like it, the most important part is making a start and pushing through the barriers.

Your portfolio is centred on cash flow property in high-risk areas. Although the properties perform well on the rental side, the risks are quite high. The investment in Blackwater is much like any other in a mining area. For high returns there's always high risk. You need to research what mines are operating there and which company operates them. Blackwater has experienced strong growth and you still have a good rental.

Selling this property won't help you reach your goal. Given you have a lease until March 2014, I'd hold out until December and re-evaluate where the area is at and its vacancy rate. I'd also speak to agents in the area to get a feel for growth patterns.

On the whole, your portfolio seems to be underperforming. Your underperforming properties are Kempsey, Bentley Park and Maroochydore. As part of re-evaluating your portfolio, you should look at which assets should be sold. I'd suggest selling the Kempsey property. It's tying up a large amount of equity and decreasing your loan-to-value ratio (LVR) and borrowing power. It hasn't performed well and the area doesn't look set for growth.


Kempsey

I'm not familiar with Bentley Park, but this property hasn't performed well either and its negative return hasn't been worth the growth. There are better performing properties on the market. I'd suggest researching areas such as outer regions of Sydney and Melbourne. I would, however, suggest you keep Maroochydore. The cash flow is fantastic and there's an upside of growth given the area and style of property.

You have explained you bought the properties in your name for tax purposes. The majority of your properties have cash flow positive yields and are therefore not at a loss. You aren't gaining any tax benefits from owning the properties in your own name and, in fact, you're paying tax on the extra profit you're adding to your taxable income. Your depreciation wouldn't be as valuable now and you'll also have to wear the brunt of the capital gains and can't share this with your wife who has no income.

I would've also liked, given your current situation, if you'd purchased your new principal place of residence (PPOR) in your wife's name only. Your wife has no risk and therefore can hold your PPOR safely away from your investment activities.

Your retirement goal of 55 given your current age of 51 isn't out of the question. Your first port of call will be to sell your underperforming properties and look for better performing properties that will have greater growth as well as the income you require.

You have stated that recently your broker said you couldn't obtain a loan for a new purchase. Your LVR isn't bad and you've given me an equity figure of $625,000, which gives you a large borrowing capacity, but your issue will be servicing. Firstly, approach another bank. Having the majority of your loans with one bank limits your borrowing power significantly. Now you've sold the underperforming properties you'll need to get your new borrowing capacity. This will allow you to buy better performing properties this year up to your borrowing cap.

For growth property I'd suggest looking at the outer regions of Sydney. The southwestern and western growth corridors of Sydney lead to some great investments and, given your limited borrowing capacity, you'll get more property for your dollar. It isn't hard to find properties that have a six to seven per cent yield and strong growth prospects.

You've also noted you've looked at granny flat options in the past, but you couldn't obtain finance. These are great for cash flow and will help your retirement strategy, but can be limited in growth and normally require building the flat and updating the front house to receive the desired amount of rent. However, with the right type of investment, this can be the cash cow for retirement you're looking for.

You'll also need to focus on debt reduction over the next four years. To obtain the cash flow you require, you need to pay down as much debt as possible. You'll be able to sell some of your properties to help pay down debt in the coming years. As you own all the properties in your own name, you'll need to strategise the sale of your properties to reduce your tax. When the time comes it'd pay to speak to an accountant on the subject.

As part of your investment strategy going forward, I'd like to see you use your superannuation to create a self-managed super fund (SMSF) to invest in two growth properties. These will be the properties you can sell tax-free at 65 and use the funds to pay down further debt, given your retirement income will be from property rental.

JANE HORN - UNLOCK YOUR SUPER

It's great to see financial professionals putting their hand up for assistance and direction on what to do next. While we may have a great deal more knowledge than some in our areas of specialty, it's important to appreciate you can get too close to see objectively what needs to be done.

Overall, you've done an excellent job at building a property portfolio while on a single income and with children.

I do see further opportunities for you to work on over the next few years and if you end up pushing out the actual retirement date by a year or two, then that's not so bad - especially if it means achieving absolute certainty with regards the goal of $70,000 per annum income. A lot can happen in three years.

Your home shouldn't be included in the portfolio balance. It's not an investment, doesn't provide an income and, if needed, it's absolutely the final draw card when everything else has gone.

It's time you start switching gears from a growth focus to a really strong positive cash flow focus, streamlining wherever possible. The higher your average income rate (after all costs) from investments, the less reliant you need to be on capital gain and therefore the more flexibility and control you have.

I'd question the validity of borrowing yet more money given you only have three years to get all existing debt and investments to a point of paying you the required income of $70,000 per annum after tax. It's likely you'd need to sell a property to reduce debt and/or be solely reliant on capital growth that mightn't eventuate at the right time.

It's time for you to add a layer of strategic planning. Your prime focus should be to build your investment assets via superannuation - not outside superannuation. Longer-term super is a far more tax effective environment, therefore you don't have to accumulate so much wealth to achieve your goals. For instance, a $70,000 income via super ends up being tax-free income versus losing up to 32.5 per cent in tax on income earnt outside of super. It's hard to beat a zero tax rate that barely costs anything to achieve.

Debt reduction is also going to be one of the keys over the next few years, along with rental increases. It's excellent to see your home mortgage is a line of credit (LOC), ensuring you retain control and flexibility over your money, so you can use all available (legal) cash flow strategies to knock your PPOR mortgage down as quickly as possible.

Currently, your average tax rate is 30 per cent and so an easy saving can be achieved through salary sacrificing (and employer contributions) to super, up to the maximum of $25,000 per annum. Even without being strategic in super this will still save you a further 15 per cent in tax, plus reduce your average tax rate outside of super.

Maximising the use of super is a golden opportunity for you. Forget the negative noise about rules changing and sharemarket volatility as a whole. They're just fear-based distractions preventing you from taking positive action that'll assist you to achieve your goals. The core fundamental reasons and strategies that truly work within super haven't changed since it commenced.

That is, it's critical for the government to provide a tax effective savings environment for retirement so people are encouraged to take action toward achieving financial independence. The government can't afford not to! It could never afford to pay everyone a pension. Even the current proposed changes confirm this.

From an investment strategy viewpoint, wherever investors have focused on certainty of investment (i.e. property and defensive stocks), there has always been long-term success.

Through strategic investment decisions focused on your goals - income generation that continues to grow in its own right, tax effectiveness, all with capital growth - you can easily get your super fund to truly work for you.

Some quick conservative calculations indicate you could get your super fund to $460,000 in three years' time without selling any property. You need to take an active role in this area to ensure appropriate set-up and investments that suit you.

If the super portfolio is generating a seven per cent income on $460,000, that's $32,200 per year and equals almost half of your income requirements. Noting the income from super will end up being tax-free, the rest of your income will be derived from your property portfolio.

You do have a couple of properties with LOCs. This enables easy access to capital, however you need to be mindful you can't draw out the money for personal use - it needs to be for investment use otherwise you're creating a non-tax deductible loan.

One of your pressing concerns is about the sale or not of the Kempsey property, with a pending capital loss. The loss increases further due to the original purchase costs. Is this one of those expensive lessons we all learn at some point? Were your original objectives and goals specific and clear enough for the property? Did you stick to your investment rules when you purchased that property? Will it achieve the income and growth return you need for it to suit your objectives?

These are questions to put to an independent assessor. If the answer is no then definitely sell as there's no point retaining any investment that holds you back from achieving your goals and objectives.

The Blackwater property purchased for $380,000 and paying rent of $650 per week is still a gross income of 8.89 per cent. That's still pretty good, even with roller coaster ride. Focus more on the longevity of the mine and what other services that town is providing before making any decisions.

** Real name withheld at subject's request*

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