your money your future

FINANCIAL PLANNING NEWSLETTER

A familiar face offers valuable advice

Baby Boomer John, 65, looks back on a lifetime of financial decisions to provide some valuable tips to future generations.

Remember when you spent a small fortune on that trip to Hobart after the Wrest Point Casino opened? The holiday pay lasted barely one hour on those roulette tables! Four decades on and I'm pleased to report that trip didn't set you on a path to financial ruin.

Without completely giving the game away, let me share some of what's happened to our world over the past 40 years. Firstly, you survived! Those teenage years didn't cause any irreparable damage although your knees and hips are paying the price for your Kamikaze approach to footy.

Our country has flourished – almost twice as many people call Australia home today than in 1973, most people earn in a month what you earnt in a year, and the average price of a house and land package in the early 70s (approximately $20,000) wouldn't cover the deposit of an average home loan.

Many of the headlines you read in the morning paper in 1973 are just as relevant today – "Crisis in the Middle East", "Prime Minister Under Pressure" and "Petrol Prices Soar".

It's a similar story when it comes to finances. The fundamentals of 1973 remain the same today, but as you think about the future, let me share some of the wisdom I've gathered over the past 40 years:

Live within your means: This seems fairly obvious but credit facilities will become easier to access as you enter your 30s. Even your grandkids have credit cards! Cleaning up the mess of easy credit debt can put your long-term plans back many years.

Minimise debt: The loan from your father to buy that mint-condition Ford Falcon GTHO may have made sense at the time but it would drag on for years before you paid it off. And let's not even start on the financial commitment to purchase that first colour TV in 1977! Keep your debt to a minimum and make paying it off a priority.

Develop a savings plan: Remember the old State Bank savings book for which Nanna would give you 20¢ to deposit each week? It was the one successful financial decision made for you in the first 20 years of your life. Consider the money that goes into a savings account an essential part of your budget. There'll be plenty of rainy days, and any leftover will provide a solid foundation for that retirement nest egg.

Start investing: Don't expect me to share the previous 40 winners of the Melbourne Cup or share tips that could make you a billionaire. Start to think about how best to invest those savings – the earlier you start, the more you'll have when you retire. Don't forget to manage the risk too. It's ok to put some in shares, but also look to spread it around via term deposits, property or managed funds.

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A familiar face offers valuable advice continued

Protect what's most important: "Life insurance? What do I need life insurance for?" It may seem far-fetched now but insurance will pay for itself many times over. Hospital expenses, the odd minor car crash and a couple of 'life episodes' are sure to arise; when they do the peace of mind provided by insurance is invaluable. Speaking of health, stay out of the sun and watch that expanding waistline and try to lay off the bacon and eggs once in a while!

Establish credit: It is vitally important to start establishing credit while in your 20s. A clean credit report will make life much easier in the future, especially when your partner starts dropping hints that she'd much prefer to send Junior 1 and Junior 2 to the local Grammar School and you'll need a loan to get started. And let's not even start on Junior 3, 4, 5 etc … just kidding!

Choose your life partner carefully: Yes, you'll meet a nice girl or boy and settle down, but it'll be touch and go there for a while. For plenty of the boys from your school years, things won't end quite as happily. While you don't have to see eye to eye on every financial issue, someone with similar goals and values as you will make life much easier. If you plan on combining your finances with your spouse, communication and honesty are especially important.

One last tip – enjoy life! Money is supposed to be used, in part, for your enjoyment. Travel, entertain, take some regular golf trips, splurge here and there; you can do it all. But don't wait. Life is here and now, and you'll be amazed how quickly the next 40 years will fly by.

Good luck!

Money tips for those going it alone

Whether you are single and carefree or supporting a family on your own, there are many things you can do to maximise your available cashflow.

Money management for many single 20-somethings isn't terribly complex. Earn money, spend money, wait for next week's pay, repeat. But that's not necessarily going to set you up for the years ahead.

1. Learn about money

Take some time to improve your financial knowledge and literacy – the Internet is full of sound wisdom when it comes to all facets of money management.

2. Think beyond today

It's going to be hard to pay off a mortgage if you can't put aside enough money for lunch. Start setting some short-term savings goals. Maybe put aside 10 per cent of your pay as a start.

3. Dollars and sense

It may sound boring but making a budget is the best way to get into the habit of living within your means. It may mean one less coffee per week or taking a packed lunch to work.

4. Kill the credit

You are better off without that credit card. If you have one, make it an absolute priority to pay off the full amount. If you really need a credit card, looks at options with a debit facility.

5. Put those pennies to work

Your first job may not see you earn a fortune, but it's still possible to start investing with a relatively small amount.

For many single parents, having enough money is their number one concern. If you shoulder the challenge of being a sole breadwinner, it's essential to make responsible financial decisions.

1. A clean record

If the worst happens and you separate from your partner, a clean credit report will help you establish your own financial foundations. When the bills arrive, pay them on time.

2. Budget, budget, budget

Preparing a household budget and sticking to it will not only help you meet the basic day-to-day needs of your children, it will also help you save for future expenses such as school fees.

3. There's help out there

You're never alone. Know what you're entitled to and make the most of Government assistance with things like childcare or medical payments.

4. Rainy days

Having some emergency funds put aside is vitally important for single parents with more than one mouth to feed. As the saying goes, "plan for the worst, hope for the best".

5. The long run

Life insurance should be a priority. If something were to happen to you, your children must have their basic needs met.

Investor confidence grows with market

After several years in their bunkers, Australian investors are beginning to look beyond the safe haven of cash in the search for better returns. Shares have started the year with strong gains, the residential property market is showing signs of recovery and superannuation fund returns are the healthiest in years.

Suddenly, growth is back on the agenda and it is not hard to see why. Interest rates for bank term deposits have fallen below 4 per cent, less than the dividend yield on bank shares. And unlike shares and property, bank deposits offer little opportunity for capital growth.

Experienced investors know that long-term wealth accumulation depends on total investment returns from income and capital gains to keep ahead of inflation.

Over the past 20 years, shares and residential property have provided a total return of about 9 per cent a year[1]. Roughly two-thirds of that return comes from capital gains, but the income from quality shares and property also rises over time. By comparison, interest rates on term deposits fluctuate depending on the interest rate cycle.

Time to think long-term

Now that the pendulum is swinging back towards growth, it is a good time to check whether your investments are on track to deliver the returns you need to reach your long-term savings and lifestyle goals. The place to start is at the finish line.

No matter what your age or stage of life, the ultimate goal is a long and comfortable retirement and that takes some planning. Everyone's aspirations and circumstances in retirement will be different. First you need to think about the lifestyle you hope to lead in retirement and what that would cost.

As a general rule-of-thumb, advisers suggest you will need about 65 per cent of your pre-retirement income to maintain your current standard of living in retirement, assuming you retire at age 65.

As a starting point, the Association of Superannuation Funds of Australia (ASFA) estimates that a single retiree needs $41,000 a year and a couple needs $56,000 a year to lead an active and comfortable lifestyle[2]. This includes things such as private health insurance, a reasonable car, domestic travel and the occasional overseas trip. A more modest lifestyle costs less, but more than the Age Pension currently provides.

The next step is to work out the savings needed to achieve your goal. Most people focus on the amount they need to accumulate by the time they retire, but that is only part of the equation. The retirement lump sum you need to aim for will depend in part on the return you earn on your savings after you retire.

Growth boosts retirement income

Take the example of a single person retiring at age 65 and aiming for a comfortable lifestyle on $41,000 a year. If their savings are invested for a return of 5 per cent a year in retirement they will need a lump sum of $765,000; but if they earn a 7 per cent return they will need only $630,000. The lump sum required by a couple aiming for $56,000 a year would be $1 million with a 5 per cent return and $865,000 with a 7 per cent return.

In other words, if you invest your entire nest egg in conservative cash and fixed interest investments you will need a much larger lump sum on retirement than you would if you left some of your money in growth investments such as shares and property. Either that, or resign yourself to living on less.

A question of balance

While it is prudent to reduce exposure to higher-risk growth assets as you near retirement, that does not mean excluding them entirely. Getting the mix right is a balancing act. Your adviser will be able to help you work out the best mix of growth and income investments to fit your life stage and risk tolerance.

According to the Australian Bureau of Statistics, the average 65-year-old Australian can expect to live another 19 years if they are male and 22 years if they are female[4]. That is a long time to be living on your savings, especially when you consider that the average retirement age is actually closer to 55, not 65[5].

Saving for retirement does not stop at age 55 or 65, it is a life journey. By maintaining an appropriate balance of growth and income investments your savings will continue to work hard while you take it easy in retirement.

1 Russell Investments, ASX, Long-term Investing Report 2012, viewed 22 March 2013, http://www.russell.com/AU/_pdfs/market-reports/asx/ASX_Report_2012.pdf

2 ASFA Retirement Standard, February 2013, viewed 22 March, 2013, http://www.superannuation.asn.au/resources/retirement-standard

3 SuperGuide, viewed 22 March, 2013, http://www.superguide.com.au/how-super-works/a-comfortable-retirement-how-much-super-is-enough

4 ABS, viewed 22 March, 2013, http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/4125.0main+features3110Jan%202013

5 ABS, viewed 22 March, 2013, http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/6238.0Main%20Features3July%202010%20to%20June%202011?opendocument&tabname=Summary&prodno=6238.0&issue=July%202010%20to%20June%202011&num=&view

Weighing up the dream of home ownership

The unbreakable bond the fictional Kerrigans had with their airport-perimeter house in iconic Aussie flick The Castle took The Great Australian Dream to extremes. Yet in the real world, the pendulum appears to be swinging the other way for many who avoid the time-honoured goal of owning a home in favour of renting.

Deciding between a mortgage or a lease is increasingly a matter of personal preference as much as a symptom of strained finances. There are pros and cons to renting just as there are pros and cons to owning your own home; the decision to rent or buy is rarely made on the economics alone.

Gen Y unlikely to commit

For commitment-shy Generation Y, the notion of owning a quarter-acre block with a house that will inevitably need money spent on maintenance and time spent on the garden is not always desirable. Add to that the increased flexibility and freedom that comes with renting and it's hard to make the case for ownership.

If they are not renting, then Gen Y are likely to still be in the family home until they start their own families, social demographers say.[1]

Once they leave the nest Gen Y may be more inclined to rent than buy, at least until the residential market shows a consistent ability to add capital gain, providing them with increased financial incentive. The past two years have seen the median value of homes dip from a peak in 2009–10, and experience a modest growth in 2010–11 before declining 3.3 percent last financial year.[2]

Sluggish house prices not all bad news

Property analysts RP Data suggest a bleak picture with an average yearly increase in home values across Australia of just 1.9 per cent for the past five years.[3] By the time the extra costs of owning a home are factored in, such as interest and council rates, insurance and repairs, investing in a house may not produce a positive capital value.

On the reverse side of the coin, however, sluggish house prices have led to a few inner-city suburbs being cheaper to buy into than to rent in. Plus, those who take the plunge are building equity in an asset that tenants are not.[4]

In the past year, Australian rental rates have climbed 4.2 per cent for houses and 2.9 per cent for units. Coupled with low interest rates for mortgages and depressed house prices, it is easy to see why renting could be even more of a turn-off for those who value the security of knowing they will never be evicted by a landlord.

For people in the wealth accumulation years, stability can be a deciding factor in the debate whether to rent or buy. The anxiety caused by the thought of having to uproot young children and change schools can be very stressful for families.

Green shoots appearing

While some analysts predict it will be a long time before the housing market can expect to make up foregone capital gains, some green shoots have begun to emerge this year.

March's RP Data – Rismark Home Value Index revealed that dwelling prices in Melbourne, the country's second largest housing market, firmed 1.5 per cent in February. This compares to an average 0.3 per cent around the nation. January also saw an average Australia-wide jump of 1.2 per cent.[5] Clearance rates in Melbourne and Sydney are also beginning to improve.

Making an objective assessment

While it's difficult to make a purely financial decision about whether to rent or buy, there are some ways to be objective in your assessment.

Commonly used in the US and UK, a 'back of the envelope' buy-to-rent ratio can be applied to figure out if homes on the market are fairly priced. It works by comparing a property for sale with a similar rental property in the same location. The ratio is obtained by dividing the sale price by the yearly rent figure for the second house. A price of $700,000 divided by yearly rent of $35,000 equals a ratio of 20. The rule-of-thumb that applies is that price-to-rent ratio of 16 to 20 typically indicates it is better to rent, 1 to 15 indicates it is best to buy, and 21 or more is a clear signal to avoid buying and rent instead.

Of course, this formula is simplistic and doesn't take into account ongoing costs of owning a home.

Timing a decision to rent or buy can never be a precise science given the variables involved. It is best to identify what matters to you most and this will usually provide the answer you are looking for. At the end of the day, The Great Australian Dream is different for everyone.

1 B. Salt, 'Beyond the Baby Boomers: the Rise of Generation Y', KPMG Advisory, Page 14, viewed March 26, 2013. http://www.bernardsalt.com.au/pdf/Beyond_the_Baby_Boomers.pdf

2 ABS House Price Indexes: Eight capital cities, December quarter 2012, viewed 26 March, 2013, http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/4173F64CDC56E771CA257B08000E0C39/$File/64160_dec%202012.pdf

3 RPData, 'Buy vs Rent summary report', Page 9, November 2012, viewed 26 March 2013, http://media2.apnonline.com.au/img/media/pdf/RP_Data_Buy_vs_Rent_Report_Oct_2012_FINAL.pdf

4 RPData, 'Buy vs Rent summary report', Page 9, November 2012, viewed 26 March 2013, http://media2.apnonline.com.au/img/media/pdf/RP_Data_Buy_vs_Rent_Report_Oct_2012_FINAL.pdf

5 RPData, March 1, 2013, viewed 26 March, http://www.rpdata.com/research/growth_trend_continues_with_capital_city_dwelling_values_rising_0.3_percent_in_february.html

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