BUILDING WEALTH

& loving it

A down-to-earth guide to personal finance & investing

JIMMY B. PRINCE

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About the author

Jim Prince is a fellow of CPA Australia and a tax specialist. He is a former lecturer and tutor in income tax law at La Trobe University, and teaches a number of wealth creation courses for the CAE in Melbourne. He has authored several investment books including *Tax for Australians For Dummies* and has written articles for *Your Mortgage* magazine and <http://thebull.com.au>. In 2000 Jim was nominated for an Adult Learners Week 2000 outstanding tutor award.

In his earlier years Jim worked for the Australian Taxation Office and also consulted to CPA Australia 'Technicall'.

Preface

Many years ago I regularly bought lotto tickets on the off-chance that I would become an instant millionaire. For a small outlay of a few dollars I would select six numbers and hope they'd be the ones that'd be drawn out of the barrel. On one occasion, while I was watching the draw on television, I happened to get the first number. And within a matter of seconds I had the second one. When I got the third number I became a little excited. When the fourth number came out I called my wife, as this was starting to get a little serious. When the fifth consecutive number was drawn I was within seconds of becoming an instant millionaire. While I was waiting for the last number to appear, a voice from the beyond casually whispered the following message in my ear, 'Ah, sorry mate, you're not meant to win'. And what normally happens when you get such a message? I missed the last number by the narrowest of margins. If I had selected 26 rather than 27 I would have been an instant millionaire. When I recovered from the shock of missing out on the chance of a lifetime, I concluded if the lotto gods weren't going to make me wealthy, I'll need to turn to plan B and try to do it myself.

There are many ways to build up your wealth. They can range from saving and trying to do it quickly at the casino or races to the thrill and fun of building wealth from investing in shares and property. While sitting in the comfort of your chair or resting by the pool sipping a cold drink, it's possible to literally make heaps if the value of your investments—especially your share portfolio—were to rise. But you can also lose it just as quickly. The secret to wealth creation is a willingness to have a fair-dinkum go, and not to overemphasise the risks. Sure you can lose money along the way—but let's be positive here, you can also make a truckload as well.

Building wealth is similar to driving a car. When you sit behind the steering wheel there's a risk you could have an accident, and cars are costly to keep on the road. But the rewards you will gain from driving will encourage you to keep plugging along. When you invest you'll need to know what you're doing. And that will come from understanding the basics and getting good advice from the professionals. Potential investors often come to me and say, 'I'm eager to invest *but* I'm scared of losing money'. Welcome to the club. You're not the only one. Concerns that you could lose money are natural feelings you're likely to experience. Unfortunately, when you invest there's no-one out there ringing the bell to tell you whether you're on a sure winner. If it was that easy we would all be winners. I always say to potential investors, 'If you're afraid to have a go, what are the alternatives?' The answer is quite simple: put your money in a term deposit and lose it that way. Because if you persist with this strategy (although your money may be safe), your wealth is not going to grow. Regrettably, there is no cast-iron guarantee that whatever decision you make is going to be the best option. Over the years I've lost heaps and made my fair share of mistakes. But I've also made some great investment decisions. So if you do happen to make the odd mistake along the way try not to dwell on it—what's done is done. Sitting in the corner and feeling sorry for yourself or vowing never to invest again is not going to solve the problem. The solution is quite simple: see where you went wrong and move on.

This book will appeal to readers who would prefer to read a one-stop book that will conveniently cover all the major ways of investing to build wealth. It's written in plain English and explains in simple terms the core investment principles and tax issues you need to be aware of. This book is written in three parts, all centred on the general theme of building wealth:

- part I: let the games begin: getting organised
- part II: watch your money grow: building wealth
- part III: reaping the harvest: superannuation and retirement.

Throughout the book you will find numerous practical case studies and handy tips to help you understand core investment principles and to reinforce the learning process. So let the games begin. It's time to build wealth and love it. Incidentally, if you make $100 000 after you read this book, you owe me lunch!

Jim Prince
Melbourne
December 2009

Part I

Let the games begin: getting organised

There are many reasons for wanting to build wealth, ranging from a desire for security to wanting to make a heap of cash. All are valid reasons if you can manage it. But before you can kick-start the process you've got to lay down the foundations, including preparing a budget and planning ahead. If you can get this right at the outset you'll be well on the way to building wealth and loving it. In part I we examine how to prepare a budget and the key steps you'll need to examine before you start investing. This part also covers choosing a suitable investment structure and issues associated with borrowing money to help you to build up your wealth.

Chapter 1

Laying down the foundations

The first question I ask participants who attend my wealth creation courses is why they need to build wealth. The answers normally range from gaining security and freedom to a strong desire to make lots of money. All noteworthy answers if you can pull it off! To achieve these objectives you'll need to do some boring stuff like preparing a budget and planning ahead. In this chapter I chat about the key things you'll need to do before you can kick-start your wealth-creation adventures.

Your capacity to build wealth is primarily dependent on the amount of net disposable income you earn. Net disposable income is income you've got available after you pay income tax. And of course the more income you can generate the greater the opportunity to build up your wealth.

As is the case if you plan to erect a dwelling, before you can start accumulating wealth you've got to lay down the foundations. So here are some of the things you should consider doing first:

- $ prepare a budget
- $ list your assets and liabilities
- $ set your goals
- $ be prepared.

Prepare a budget

The first thing on the agenda is to prepare a budget. This is a simple financial plan that will allow you to keep track of all your expenses and income. So whenever you open your wallet or purse or get a bill (for instance, telephone, gas or electricity), jot down the details on a spreadsheet over a given period of time (for instance, 12 months). An example of how you might format this is given in table 1.1, on page 6. When you do this you'll start to find out stuff like:

- $ your spending habits
- $ the different types of expenses you incur
- $ the amount you spend each week
- $ the dates when bills become due for payment
- $ your ability to pay bills on time
- $ what bills you'll incur in the future
- $ what to cut back if you get into financial difficulty.

Next you should record all your cash inflows (as illustrated in table 1.2, on page 7) — for example, your net salary and wages and any investment income you derive (such as dividends, interest and rent) — plus the dates you expect to receive them. You'll generally find these cash inflows will tend to be fixed and regular. You should also record any one-off payments you're likely to receive (for example, a tax refund). It will then become a simple exercise of comparing your cash inflows with your cash outflows (see table 1.2, on page 7).

Having this valuable information on hand will give you some degree of certainty and control over your financial affairs. It'll provide you with information like the amount you can save over a given period and how much you can afford to borrow. A budget will also help you plan ahead to cover potential shortfalls (deficits) you may occur in the future, and what to do with any surpluses you may accumulate.

Handy tip

If you want some more information about how to prepare a personal budget, visit Wikipedia's personal budget site at ‹http://en.wikipedia.org/wiki/Personal_budget›.

List your assets and liabilities

After you've got your budget up and running, the next thing on your 'to do' list is a stocktake of all your assets and liabilities. This will help you keep track of what you own and owe and can come in handy if you're looking for a loan (see chapter 4). It will also give you confidence that you're in total control of your financial affairs. Make sure you keep your records in an orderly manner: you'll need to access these documents when preparing your individual tax return (otherwise your accountant is likely to charge you heaps trying to fix up the mess). Your accountant and/or a financial planner can help you with this exercise.

Table 1.1: cash outflows

Date	Amount	Monthly total	Internet	Phone	Electric	Gas	Water	Car rego	Insurance	House loan	Rates	Medical	Food	Spending	Credit Card
05-Jan-00	$273			$273											
14-Jan-00	$660		$60										$600		
29-Jan-00	$396				$396										
30-Jan-00	$1704									$560		$223	$600	$100	$221
		$3033													
05-Feb-00	$101					$101									
11-Feb-00	$581			$181							$400				
14-Feb-00	$60		$60												
14-Feb-00	$600												$600		
20-Feb-00	$160						$160								
28-Feb-00	$1609									$560		$223	$600	$100	$126
		$3111													
05-Mar-00	$849			$207				$642							
14-Mar-00	$660		$60										$600		
31-Mar-00	$1824									$560		$223	$600	$100	$341
		$3333													

Table 1.2: cash inflows

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
Net salary and wages	$3916	$3916	$3916	$3916	$3916	$3916	$3964	$3964	$3964	$3964	$3964	$3964	$47 280
Interest			$56			$62			$65			$68	$251
Dividends				$1250						$1456			$2706
Rent													
Tax refund								$1347					$1347
Total cash inflow	**$3916**	**$3916**	**$3972**	**$5166**	**$3916**	**$3978**	**$3964**	**$5311**	**$4029**	**$5420**	**$3964**	**$4032**	**$51 584**
Less													
Total cash outflow	$3033	$3111	$3333	$3322	$7072	$3902	$4416	$3974	$2899	$2809	$3274	$4893	$46 038
Surplus	$883	$805	$639	$1844		$76		$1337	$1130	$2611	$690		
Shortfall					-$3156		-$452					-$861	
Net cash inflow/outflow	**$883**	**$805**	**$639**	**$1844**	**-$3156**	**$76**	**-$452**	**$1337**	**$1130**	**$2611**	**$690**	**-$861**	**$5546**

Record your assets

Your assets can range from your favourite frypan, furniture and personal belongings to your most prized Rolls Royce, shares and property. With respect to wealth-creating assets like shares and real estate, keep proper records and constantly monitor whether they're making money for you. While doing this exercise keep in mind, 'the first rule to building wealth is not to lose it!' These are some of the things you'll need to record:

$ *Shares.* Next to each company jot down the date you bought them and the purchase price. You can get this information from the buy contract notes you receive from your stockbroker (see chapter 8). You can quickly calculate how your share portfolio is performing by simply comparing the purchase price with its current market price. Online stockbrokers have watch lists that can automatically do this for you. You should also record any dividend payments you're likely to receive in your budget statement (see table 1.2).

$ *Property.* Record the date you bought any property you own and the purchase price. You can get this information from the contract of sale. Also keep track of any improvements you make to your properties and the dates you do them. You'll need this information to calculate whether you've made a capital gain or capital loss for tax purposes (see chapter 13). A ballpark way of assessing whether a property is a good investment is checking how long it takes to double in value. Ideally you would like to see this happen every seven to 10 years. I chat about this in more detail in chapter 12.

$ *Term deposits.* Keep details of the amount you've invested, the maturity date and rate of interest you've locked into.

You should also record the amount of interest you receive in your budget statement (see table 1.2). I discuss investing in fixed-interest securities in more detail in chapter 5.

- *Managed funds.* Keep the regular statements your managed fund sends you and check the opening and closing balances. This will tell you whether you're making money or losing money. The rate of any potential growth will depend on the investment strategy you've selected (which can range from capital stable to growth), and the fees you'll incur to manage your money. I chat about managed funds in chapter 6.
- *Superannuation fund.* Super funds are required to issue regular 'benefit statements' setting out the opening and closing balance at a particular date (usually on 30 June). As super funds are managed funds, any potential growth will depend on the investment strategy you're relying on to grow your money (which can range from capital stable to growth) and the fees you're paying. By the way, it's possible to check online how your super fund's performing on a daily basis: the superannuation fund you belong to can show you how to do this. I chat about superannuation in chapters 15 and 16.
- *Your prized collectables.* They can range from your jewellery, stamp or coin collections to antiques and paintings. Keep detailed records, especially for items that cost more than $500, as you're liable to pay capital gains tax if you make a capital gain on sale. I chat about collectables in chapter 2.

Handy tip

As cars depreciate with age you're technically losing money from the moment you buy one, unless it's a much-sought-after vintage or classic that car buffs are willing to pay heaps to own.

Keep track of your liabilities

To meet all your legal obligations you should list, combine and prioritise all your financial commitments. Liabilities are normally listed in the order they're due for repayment. Payments due within a short period (for instance, one month) are called current liabilities. They can range from your household bills (such as gas, electricity and telephone) to ongoing credit card, mortgage and loan repayments. On the other hand, payments not due within 12 months are called long-term liabilities. Incidentally, as credit cards normally charge you a high rate of interest on cash advances, try to pay these loans off as quickly as possible. Also take full advantage of any interest-free period on purchases (for instance, up to 55 days) that your credit cards may offer you.

Handy tip

Under Australian tax law you can set up a Capital Gains Tax (CGT) asset register to help you keep track of all your CGT assets (rather than keep a pile of documents). If you want to record your CGT assets in this register, the information must be certified by a registered tax agent or a person approved by the Tax Office. For more details read the Australian Taxation Office publication *Guide to capital gains tax* (NAT 4151) and particularly the section titled 'Keeping Records — Asset registers'. You can download a copy from the Tax Office website ‹www.ato.gov.au›.

Set your goals

Setting goals are your blueprints to building wealth (for instance, to derive income and capital growth). It pays to have clearly defined objectives in mind to inspire you to do something. To get the ball rolling, consider writing down what you wish to accomplish within a certain time frame. The tricky bit is the nuts and bolts you'll need to put into place to achieve these goals.

For example, one core objective could be to accumulate sufficient capital to fund your retirement. To do this you'll need to know the amount you'll have to accumulate; how long it will take; and how you intend to get there. A qualified financial planner can help you with this exercise. For instance, one option could be to make regular contributions to your superannuation fund. You might consider 60 per cent of your final average salary a reasonable sum to fund your lifestyle in retirement. The capital you'll need to accumulate is generally 15 times your desired pension. So if you're seeking a $50 000 pension, according to the formula you'll need to have at least $750 000 in your war chest. Once you've set your goal — a $50 000 pension — it becomes a question of what you'll need to set aside each week, and choosing an appropriate investment strategy that'll help you get there. Superannuation funds normally provide calculators on their respective websites to help you do this calculation (for instance, check out HESTA <www.hesta.com.au> and Westpac-ASFA Retirement Standard <www.superannuation.asn.au/RS/default.aspx>).

When you set your goals make sure they're realistic and achievable. Setting a goal to make $10 million in five years may sound like a great idea. But trying to do it within certain financial constraints (for instance, you only earn $60 000 per annum) can quickly bring you back to reality. To kick-start the process it pays to set achievable targets first (for example, save a specific amount within a given period), then raise the bar and start again.

Be prepared

There is an old Boy Scout motto that you should try to keep in mind and that is 'be prepared'. And to this we can also add 'you've got to be in it to win'. In your endeavour to build wealth you should constantly be on the lookout for any good investment opportunities that could pop up unexpectedly. To ensure you're first in line it's important that you're able to access cash at short notice. It's no use saying, 'Well, I would have bought it if I had the money'. That may be so. But if you want to build wealth you have to plan ahead so that you'll not be put into this unfortunate situation. Remember opportunities can often only knock once.

There are many ways you can do this. For example, establish a line of credit that can remain dormant until you need to access those funds and/or take out a personal loan (see chapter 4). Another way of raising funds quickly is to sell shares you own. In chapter 7 I emphasise it normally takes no more than a few seconds to sell them and you'll normally get your money back within four days. Incidentally, one way of killing two birds with one stone is to sell your duds — those shares that are losing you money. If you do this it will give you an opportunity to recoup your losses by getting into something better. And to add icing to the cake, you'll crystallise a 'valuable tax loss' that you can deduct from a capital gain you make in the future (see chapter 9 and the case study at the end of this chapter).

The insurance policies you had to have

In the course of building up your wealth there's a risk you could suffer a financial loss. There are many different types of insurance policies you can take out to protect your assets, income and personal health. The main ones are:

⇛ property insurance to cover loss or damage to your property

⇛ house and contents insurance to protect your personal belongings

⇛ car insurance to cover theft or damage to your car

⇛ income protection insurance to cover loss of income

⇛ rent insurance to cover loss of rental receipts if you own a rental property

- ⇛ life insurance to provide benefits in the event of death
- ⇛ personal accident and illness insurance to cover trauma, injury and sickness
- ⇛ health insurance to cover medical and hospital expenses.

If you want to know more about taking out insurance you can visit the Insurance Council of Australia website ‹www.insurancecouncil.com.au›. And to find insurance brokers where you live, check out the National Insurance Brokers Association ‹www.niba.com.au›.

Make it happen

Last but not least is your enthusiasm to have a go and try to make it happen. As they say in the classics, he who hesitates is lost. I always emphasise to participants who attend my wealth creation courses that wealth creation is not rocket science. You need to have confidence that you can do it and that will come from understanding the fundamentals (see chapter 2). This is especially so if you plan to invest in the sharemarket, where share prices fluctuate daily, or real estate, where you'll need a substantial sum to own a property outright. So it's essential that you develop a positive attitude and don't overemphasise the negatives. Speaking from personal experience, one of the worst feelings is to look back in five years' time and see all the missed opportunities that have slipped through your fingers. Along the way you'll most likely make the odd mistake—unfortunately we all make mistakes—but chances are you'll also make some great buys. If you do make a mistake, see what you did wrong and move on.

Getting help: financial planners

If you're a complete novice or you're totally overwhelmed and confused about investing, a financial planner can steer you in the right direction. Financial planners are licensed professionals who can help you prepare an appropriate investment plan to help you achieve your objectives. They can also explain the different asset classes that are currently on the market and help you choose to suit your age, risk profile and goals. In return they'll charge you a fee for their services. There are a number of ways you can be charged for the advice they give you (for example, one-off fee, hourly basis, commission-based). So you should check this out at the outset. Also, before you commit yourself to any particular financial planner you should ask them:

- whether they are properly licensed
- whether they will be providing you with independent advice
- whether they are associated with any particular financial institution
- whether they will get any commissions and benefits for putting you into certain financial products. If so, how are they calculated and why will they be recommending these products to you—are there alternative options to compare and contrast?

For more details visit the Australian Securities and Investment Commission (ASIC) website <www.fido.gov.au> and read 'Choosing your adviser'. If you want to contact a financial planner you can visit the Australian Securities Exchange website <www.asx.com.au> and read 'Find a financial planner'. You should also visit the ASIC website <www.fido.gov.au> and go to 'financial tips and safety checks' and read 'Financial Planners' Code of Ethics and Rules of Professional Conduct'.

Case study: be prepared for the unexpected

One afternoon while Richard was happily counting all the money he was making on the stock market, his wife casually dropped a bombshell into his cosy bunker. She informed him she needed a new car, as the old one was on the verge of going to the big car yard in the sky. His immediate response was a firm 'NO!' But his wife knew he had a weak spot. While Richard was watching his football team on television his wife raised the topic again, just as his side was on the verge of a meritorious victory — and in a brief moment of insanity he said 'yes'. Before Richard could change his mind, his wife raced off to talk turkey with a number of car dealers she had discreetly lined up. The next day she informed him she had just bought the car she always wanted, and presented him with the bad news: a $30 000 bill!

When Richard recovered from the shock of having to part with such a large sum, he set himself the task of funding the transaction. As the new car would be ready in two weeks' time, he had some time up his sleeve. Richard's plan of attack would be to sell some shares. As shares can be sold in a matter of seconds, he knew he could get the necessary funds by the due date (see chapter 8). His main concern was which companies to sell. There's an old investment adage that you should 'cut your losses and let your winners run'. Richard could either sell his non-profitable companies and take a capital loss, or sell those companies that were making him money. If he sold the good stuff he could miss out on the possibility of making more money and would be liable to pay capital gains tax (yuck). As Richard had a few duds in his share portfolio he decided to take a capital loss. This is because he will gain two significant benefits: he will get rid of the dead wood and incur a capital loss that he can deduct from a current or future capital gain. By doing this he'll effectively save having to pay tax on any capital gain he makes (see chapter 9).

As Richard had a principle that you should avoid reducing your capital base, he decided to take out an interest-only loan and replace the duds he sold with quality blue chips that hopefully

Case study *(cont'd)*: be prepared for the unexpected

will recoup the money he lost (see chapter 4). By doing this he'll be buying an investment that will derive income, and the interest is a tax-deductible expense! On the other hand, if Richard had borrowed the money to buy the car outright, the interest would not have been tax deductible as the car is for private use. Richard will use the dividends he'll derive to help meet the interest repayments, and his cash flow will not be greatly affected (see chapter 4). To add icing to the cake Richard will be buying a quality investment that has the capacity to deliver capital growth. He's hoping this strategy would counter the fact that cars depreciate in value the moment you drive them out of the car yard. He also knew he had the option to quickly sell the shares and discharge the loan if necessary. In the meantime, if the shares increase in value — depending on how much they rise — Richard can sell a portion to repay the loan in full!

There is, of course, an element of risk that Richard could lose money if the cards don't fall his way. But as they say in the classics, nothing ventured, nothing gained. I chat about risk in more detail in chapter 2.