Wealth creation

Note

This booklet has been written to assist Australian investors improve their financial literacy. Information within the booklet is not intended as advice and it is recommended that investors consult with appropriately qualified professionals, such as financial planners or accountants, before making financial decisions.

While all published information has been checked, no person should rely on the contents without first making their own inquiries, and/or obtaining professional advice tailored to their specific personal circumstances.

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About the Author

Cameron Cooper has 18 years' experience as a journalist, including senior business and finance writing assignments in Australia and Asia. He is a business contributor to The Australian and a range of leading corporate publications. Cameron is the former editor of Business Asia and is based in Sydney.

Introduction

Creating wealth is not easy. Successful investors need discipline, patience, a little luck and - perhaps most of all - knowledge.

This booklet introduces long-term strategies used to build wealth. It is designed to improve your understanding of investing. Setting yourself on the path to financial independence involves more than owning a parcel of shares or buying an investment property. To ensure financial security, your investments should be part of a comprehensive approach.

Are you maximising your superannuation nest egg? Do you have a diversified share portfolio spread across different industries? Are managed funds an appropriate investment option? Should you consider borrowing to invest? How can you minimise your tax? Remember, it's your money to grow - or lose.

This booklet will help you answer those questions and more. In a fast-changing world, the stakes are high for investors. Superannuation legislation has undergone significant changes. Terms such as wealth management and margin lending are increasingly a part of everyday language.

And the Internet has altered the way people think about, and act on, investment strategies. Of course, some things do not change: spreading risk across various asset classes is still the golden rule.

This booklet is a sequel to Smart Investing: A Basic Guide and Smart Investing II: A Strategy Guide and draws from and updates those publications. It is assumed readers already have some knowledge of investing.

The fact you are reading this booklet is a good sign. It means you are serious about getting your finances in order, or topping up your investment pool. Taking time to understand investing will dramatically increase your chances of success.

Here are three points to consider:

1. You don't need a lot of money to get started as an investor.
2. It's never too early to start thinking about your financial needs for retirement.
3. And it's never too late to start financial planning and saving.

First, you must establish your goals. What do you want for the future? Where do you want to live? How many children do you want? Are expensive overseas holidays important? At what age do you want to retire?

Work out your goals and try to assess at what age they are attainable. But be realistic. Are you comfortable taking risks? Do you tend to waste money? Are you really prepared to make sacrifices? Each investor's strategy will differ depending on their objectives and age.

The next step is to decide who is going to invest your money. Experienced investors with substantial cash reserves may want to invest directly. Less-experienced investors may seek the aid of professional financial advisers. Regardless, acquiring as much information as possible is essential.

Determining a suitable mix of investments - from cash, fixed interest, shares and property - is one of the most critical investment decisions you will make.

Australians must factor superannuation into the equation. Compulsory employer contributions and generous tax concessions mean super is likely to be the most important factor in determining your lifestyle after retirement.

Preparing a financial plan, setting investment goals and assessing risk can be complicated, and it's an ongoing task. Set aside time to review your portfolio at least once every six months.

Personal Finance Dos and Dont's

- **Do** have a clear picture of your financial position.
- **Do** know your investment goals.
- **Do** assess the long-term benefits of superannuation.
- **Do** analyse the pros and cons of the main investment classes.
- **Do** understand the key features of managed investments.
- **Do** be aware of the tax implications of investing.
- **Don't** forget to seek advice from licensed investment advisers.
- **Don't** ignore the costs and risks associated with investing.
- **Don't** choose a financial adviser without researching their credentials.
- **Don't** rush into new investment trends such as margin loans without due consideration.
- **Don't** forget to monitor your investments and review your investment goals.

The Four Major Asset Classes

- **Cash funds** invest in cash or cash equivalents such as bank bills, certificates of deposit and treasury notes. These products allow you to earn interest on your money and provide peace of mind. Unlike shares or property, there is no risk your capital will be eroded by negative returns.

- **Fixed-interest** investments include government and corporate bonds. They generally offer a better return than cash investments, but access to your money is restricted during the investment term. Compared with shares or property, fixed-interest investments are low risk.

- **Shares** are securities that can be traded on the stock market. Over time, shares have outperformed all other asset classes but they are also more volatile. A popular way to invest in a diverse range of shares is through managed funds.

- **Property** assets include all types of real estate such as residential, commercial or industrial. Property investments can be made directly, through syndicates, trusts or managed funds. Property generally outperforms cash and fixed-interest deposits over the medium to long term however it also exposes investors to higher risk.

Preparing a Budget

Many investors forget a simple truth - before you can spend money, you must save. And before you can save, you need a comprehensive budget. To do this you need to account for all your income and expenses. Review your bank and credit card statements, cheque butts, receipts and tax return for the previous 12 months. Wages will, for most people, be the main item in the income column. There may also be interest from bank accounts or investments, dividends from shares, rental from property and so forth. On the expenses side, pencil in major items such as mortgage repayments or rent, personal and car loans, and credit cards. Next are utilities such as water, electricity, gas, phone and Internet access. Don't forget the day-to-day necessities: groceries, petrol, public transport, clothing and recreation. Then there are discretionary items such as pay-TV, gym membership and holidays.

If there is money left over, it's time to start investing. If not, you must make some adjustments. Many financial institutions now have budget calculators on their websites that can do the sums for you, but remember that the results are only as good as the data you feed into them.

Reducing Debt

Clear the slate before embarking on an investment strategy. Pay off all of your high-interest debts, such as credit card bills or expensive lay-by items that are hanging over your head. Here are some quick tips to cut debt:

1. Spend less than you make. The rule of thumb is simple: if you can't pay for it today, you can't afford it.

2. Differentiate between bad debt and reasonable debt. The former incurs high interest rates (such as credit cards); the latter refers to home mortgage interest rates or debt that comes with tax advantages (such as margin loans).

3. Be sensible. While aggressively paying off bad debt, don't risk missing minimum payments on items such as your mortgage.

Credit Cards

Australians are piling up credit card debt at a record rate. Credit cards can be a legitimate payment system for responsible investors seeking rewards from loyalty schemes. But too many people choose the wrong plastic. Are you a disciplined, punctual payer or one who relies on credit as a de facto loan? That judgment made, there are two main types of credit cards: interest-free days and carry balance cards.

Interest-free days cards usually incur higher interest rates but offer up to 55 days' grace for payments. They are ideal for users who are chasing loyalty points and pay the entire debt each month.

Carry balance cards often charge a lower interest rate but may not offer a window within which customers can avoid paying interest. These cards are better for consumers who carry debt from month to month.

TIP

If you do a lot of travelling, choose credit cards with attractive loyalty structures and frequent-flyer points. On the other hand, most department store cards have very high interest rates. Cut them up.

Spreading Risk

It's a time-honoured investment truth: do not put all your eggs in one basket. Adhering to this strategy allows investors to ride out the ups and downs of the various asset classes. Balancing share and property portfolios, for instance, makes sense. Similarly, try to diversify within an asset class. A major share price fall for one or two companies will have less impact on your overall investment wealth if your portfolio is diversified.

Risk Profile

A financial planner is obliged to determine your risk profile. This assessment is vital in determining your short- and long-term investment goals. The aim is to achieve the highest investment returns possible while maintaining financial peace of mind during periods of market volatility. Your risk profile may change dramatically with age, marriage, children and retirement.

TIP

Save through direct debit payments. If you don't see the money, you won't be tempted to spend it. Many billers offer discounts for direct debits.

Compound Interest

Financial advisers love compound interest - with good reason. Compounding is when you earn interest on your interest. Instead of withdrawing dividends or interest made by your lump sum, you add it to your investment. The longer you leave your money, the more powerful the compound interest effect. So the earlier you start saving, the more you make from compound interest.

Case Study

From the day Sam is born, his parents put $1 a day under the bed for a rainy day. At age 65, there is $25,000 under the bed. Had that $1 a day been put into a bank account at, say, 3 per cent interest, that money would have grown to $75,000. But if it had been invested wisely, accruing an interest rate of 10 per cent, it would grow to a hefty $2.75 million. It's the power of compound interest.

Case Study

Brent saves $1000 a year as a DJ when he's 15 and invests the same amount annually in the stock market for 10 years earning 12 per cent a year on average. After 10 years, he has joined a band - a bad one - and spends most of his meagre income on travelling and partying. But despite no longer adding to his annual investment, he keeps his nest egg invested.

Roxanne, a dedicated partygoer, has never saved a dollar and wakes up broke one morning aged 40. She then pumps $10,000 every year into investments for the next 25 years earning an average of 12 per cent a year just like Brent.

At 65, who has the bigger nest egg? Brent! His 10 years of saving $1000 per year - a mere $10,000 in total - nets him $1.6 million.

Roxanne, on the other hand, scrounged for 25 years to invest a quarter of a million dollars out of her own pocket and ended up with just under a million dollars. The message? You're never too old to save, but the earlier you start the better.

Superannuation

Superannuation, a tax-effective investment tool, is a potential lifeline for later life. The increasing average age of Australia's population means the onus will increasingly fall on individuals to fund their own retirement. Means testing for the aged pension will become tougher, so sorting out your own superannuation is crucial.

But there is some good news. Under the government's compulsory superannuation system, employers contribute 9 per cent of an employee's wages and salary into a super fund. This percentage is expected to increase in coming years. The bad news is that, for many employees, this level of contribution is unlikely to provide sufficient retirement funds.

Talk to a financial adviser about topping up your super. And don't take employer super contributions for granted, especially if you are a casual or part-time employee. Some bosses pay too little or even none of their required contributions. Check with your super fund that you are registered as a member.

Choice of fund - if you have it - is also critical. For those nearing retirement who definitely need their super money as soon as they quit work, a low-risk (but lower return) fund might be the best option. If you have much of your working life ahead of you, it is worth considering a medium- to high-risk fund that increases growth prospects.

Types of Super Funds

- Employer or corporate funds: for people working for a particular boss or company.
- Industry funds: for those working in a particular industry or under a particular industrial award. Some industry funds now allow anyone to join.
- Retail funds: available to any member of the public.
- Self-managed funds: open only to you and up to three other people.

An Age-Old Dilemma

Australian Bureau of Statistics figures reveal that the number of people aged over 65 is expected to grow from 2.3 million in 1999 to between 6.2 million and 7.9 million by 2051. The proportion of the population over 65 years should rise from 12 per cent in 1999 to about 25 per cent by 2051.

TIP

The days of a job for life are gone. If you have worked for many different companies, you probably have a number of super accounts with relatively small balances. Consolidate them into a single fund to reduce administration costs.

Choice of Fund

The stalemate continues in Australia over choice-of-fund legislation for superannuation. The Federal Government wants employees to be able to channel their employer contributions into their fund of choice, and for members to be able to move super benefits between funds. The Government's original proposal - allowing employers to grant their employees either unlimited choice or limited choice - did not receive support in the Senate. At the time this booklet went to print in 2003, a range of issues remained unresolved. If choice of fund is implemented, it should allow employees more scope to consolidate their super and to direct contributions into a fund that better meets their investment goals. Some employers are already offering employees freedom of super choice.

Salary Sacrifice

Many financial advisers suggest using salary sacrifice to top up a superannuation pool, particularly for high-income earners. Under this strategy, employees opt to get a portion of their salary paid into a superannuation account. The money going into the superannuation fund will be taxed at a rate of 15 per cent instead of the employees marginal tax rate (which is generally higher). The strategy is most effective for those on the top marginal tax rate. It is worth noting however that savings in super accounts will not be available to you until retirement.

TIP
For employees contemplating salary sacrifice, check whether your company puts the money straight into a super fund or whether it is paid into the fund periodically. Some employers keep the contribution until the end of the year. This means the employee makes do with a lower income and misses out on interest earnings.

Case Study

Martin earns $75,000 a year and invests $1000 a year as a retirement nest egg. Due to his 48.5 per cent tax rate, he has to earn $1942 in gross salary to make this investment ($1942 minus $942 tax is $1000). A better option would be if he increased his superannuation contributions through salary sacrifice by $1176. He would have the same result of $1000 invested for retirement ($1176 minus a contribution tax of $176) and he would be $766 better off in gross dollar terms.

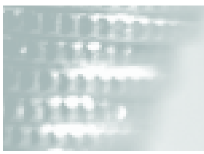
TIP
Superannuation policy-holders should check annual statements carefully to see how their super savings are performing. A fund's annual report will reveal the types of investments it has made, and how each type of investment has performed. Super is a long-term investment, so do not judge the fund on yearly figures that may appear in newspapers or magazines.

Funding Retirement

Retirement dreams can turn into a nightmare without sufficient funds. Many people overestimate how far their savings will go after they quit full-time work. Putting a dollar figure on what is required varies from person to person. The estimate depends on factors such as the availability of part-time work and how long you will live. The calculation must take into account factors such as investment earnings, inflation rates and the health and aged-care costs you will incur.

Financial planners typically recommend that retirees have sufficient savings to fund 60 to 70 per cent of their pre-retirement income. A study by the Association of Superannuation Funds of Australia shows that to achieve a gross income of 60 per cent of pre-retirement income, 9 per cent employer super contributions over 40 years might be enough. But many people will retire long before they have received 40 years of super contributions.

Consider making additional super contributions in your 40s and early 50s. A financial adviser can help you calculate how much super you are likely to accumulate based on your current salary and saving habits. They can also predict how long these savings will last.



Controlling Your Super

Super funds are usually tagged according to expected levels of return and risk. The main fund labels are 'growth', 'balanced', 'capital stable' or 'capital guaranteed'.
'Growth' funds invest most or all of your super money in shares or property.

They aim for higher returns over the long term at the risk of larger losses in lean years. Investors in such funds should expect losses every five to seven years.

'Balanced' funds invest in shares and property but also have a portion of their assets in fixed-interest securities and cash. They aim for strong returns, but less than growth funds in an effort to minimise losses in bad years. These funds are ideal for a five-year term.

'Capital stable' funds inject most money into fixed-interest and cash. Expect low risks - and lower returns over the long term. These funds suit a three-year term or less. 'Capital guaranteed' funds can legally invest only in deposits with an Australian deposit-taking institution (such as a bank or credit union) or in investments in a capital-guaranteed life insurance policy. These funds are ideal for a one- to two-year term.

Self-Starters

Self-employed people need the discipline to make their own regular contributions to a personal super fund. Under new legislation introduced on July 1, 2002, self-employed people can claim a full deduction on the first $5,000 worth of contributions, plus 75 per cent of additional amounts depending on certain age limits.

TIP

Some super funds take a percentage of the money in your account or of the amount contributed. Other funds take out a dollar amount per week. Percentage fees will probably cost you more than dollar deductions, especially as your balance grows.

DIY Super

Self-managed, or Do It Yourself (DIY) super may be an option for high-income earners or those with substantial assets. The law allows you to set up your own private super fund. But experts suggest you need at least $150,000 to justify the costs.

Poor returns from mainstream super funds might tempt some people to go it alone. But you must realistically appraise whether you can do a better job than experienced fund managers. Self-managed funds allow you to be trustee of a fund, which means you are responsible for deciding how your money is invested. But all funds must observe strict rules and procedures. If you access the money before retirement age to use for your own immediate benefit rather than to fund your retirement, you are likely to face substantial penalties.

TIP

Surveys show that up to half of all Australians don't know where their superannuation contributions go. And the Australian Taxation Office (ATO) says thousands of people have lost track of their super, adding up to billions of lost dollars. The ATO has a special help line (13 10 20) to help people track down their money. You can also log on to www.ato.gov.au for more details.

Five Steps to Creating a DIY Super Fund

1. Obtain a trust deed, which provides evidence of the existence of the trust and sets out the fund's rules.

2. Appoint a trustee under the terms of the deed. The trustee can be a company or a group of individuals. Be aware of the legislative obligations imposed on you as a trustee.

3. Open a bank account for the sole use of the fund, and document an investment strategy for the fund.

4. Admit members to the fund. Once members have been admitted, the trustee can accept contributions and invest the money.

5. Advise all interested parties of the details and performance of the fund.

Fixed interest

When people refer to fixed interest investments they are generally talking about bonds. A bond is a fixed interest financial asset, usually issued by governments and companies in order to raise money. They are seen as a relatively safe investment as the issuer would have to go bankrupt for you to lose your money. Bonds can have terms of up to 30 years and are better utilised as a long-term investment.

Some bonds pay you a fixed amount at a specified end date whereas other bonds pay each month, year or quarter. The most common way individuals can access the bond market is through a managed fund that specialises in bonds. These bond funds will generally provide a reasonable return for a low level of risk.

Bond returns are mostly income however capital growth or loss can occur due to changes in interest rates. Bonds pay a fixed coupon, which is a set percentage of the face value of the bond. The market value of the bond changes with the market rate. Bonds will experience capital growth when interest rates trend down and when rates are heading up, bonds will incur a capital loss.

Shares

Australia's love affair with the share market continues to blossom. More than 50 per cent of the population holds shares directly or through a superannuation fund. The share market is a proven way to build wealth, but it is not foolproof. Share markets can - and do - collapse. Stock prices can fluctuate for reasons ranging from company developments (such as profit reports), economic changes (such as interest rate rises) and international conflict (such as wars or disasters). Shares are a relatively high-risk investment over the short-term. However, over the long-term, stocks generally provide a tax-effective and growing income stream that performs above the rate of inflation.

Diversify

Throwing all your money into property only or shares only is a far riskier proposition than allocating your investments across a range of asset classes. Similarly, it is wise to try and diversify within each asset class. When investing in shares, for example, choose a range of companies representing various sectors of the economy.

The crash of IT stocks in the late 1990s and early 2000 shows the importance of diversification. Over-hyped and over-priced IT stocks drove the market into a frenzy. Investors counted their lucky stars and their cash - until the market crashed. If you hold shares in only one or two companies - regardless of the sector - you might be too exposed. Many experienced investors hold shares in 10 to 15 companies across different industries.

Did You Know?

- There are two broad categories of companies listed on stock exchanges in Australia and around the world - industrial companies (covering sectors such as the media, food, beverages, banking, tourism and health); and resource companies (such as gold, coal and diamond miners).
- Most Australians invest in shares indirectly through a managed fund or other managed investments rather than directly through a stockbroker.
- Australian companies make up only about 2 per cent of the world's share markets so a diversified portfolio will need to include some international shares.
- So-called blue-chip shares are no guarantee against losing money. Large companies can go down the gurgler. Think HIH in Australia, and Enron in the United States.

Dividend Imputation

Investing in shares has tax advantages not offered by other investment classes. Dividend imputation allows shareholders to receive a tax credit. Known as a franking credit, it is calculated from the tax that Australian companies have already paid on the dividends they are distributing to the shareholder. More information is provided in the tax section.

Choosing a Broker

Before approaching a broker, make sure you have carefully considered your financial objectives. As with any investment choice, research the market.

Ask your accountant or a professional financial adviser about brokers. The Australian Stock Exchange (www.asx.com.au) offers a referral service on stockbrokers and online brokers. You can also search the Australian Securities & Investment Commission's (www.asic.org.au) databases to check broker licences.

TIP

Avoid dumping shares in favour of another asset class simply because stocks might be in the doldrums. This flip-flop strategy rarely works. The danger is that you could sell near the bottom of the share market to buy in near the top of the real estate market. It's a lose-lose situation.

Managed Funds

Australians have hundreds of billions of dollars invested in managed funds, but many investors remain confused about how they work. Managed funds pool your money with that of other investors. Investors receive units, which rise and fall in line with the changing value of the fund's assets. Funds can provide investors with diversification and access to markets that investors may not otherwise have been able to enter, such as international equities, commercial property developments and technology infrastructure. Typically, superannuation investments use managed funds.

Poor-performing global share markets adversely affect the performance of managed funds - and can lead to investor discontent (events such as terrorist attacks and international conflicts have indirectly hurt managed fund portfolios in recent years). But managed funds are long-term investments and usually offer good returns over the long haul.

The Strategy

Managed funds typically invest across the four main asset classes: shares, property, fixed interest and cash. Some funds may target only one of those sectors, while others (sometimes referred to as 'balanced' or 'multi-sector' funds) hold diversified portfolios with a mixture of investment asset classes.

Returns from managed funds can be delivered in the form of capital growth and income returns. Capital growth occurs when there is an increase in the unit price of the fund. If the underlying assets generate income, the fund receives the money and it is paid out to unit holders in the form of a distribution.

The Advantages

- A professional fund manager manages investments.
- You don't need in-depth knowledge about a particular company as you do with shares.
- Diversification across a variety of asset classes means one under-performing asset is less likely to have a major impact on the value of your overall investment.

The Disadvantages

- The use of professional fund managers incurs additional fees.
- You can control the type of assets in which you invest, but you don't have absolute control over the exact assets in which your fund invests.

Case Study

Sophie is a 55-year-old nurse with $200,000 in surplus cash. She wants to invest the nest egg over the next 10 years before retiring. She has a mortgage of $225,000 and no other significant investments. She examines two options with her financial adviser:

1. To repay $200,000 off her mortgage.
2. To invest $200,000 in a managed fund.

Option 1

Sophie will save about $1,375 per month. If this is saved in a deposit account at, say, 2 per cent interest (a conservative figure) she will accrue $183,000 in 10 years.

Option 2

Assuming the fund grows at 7 per cent on average for 10 years (which historically is an achievable return), Sophie will have a fund worth $393,000 in a decade.

The Upshot

By paying off her mortgage - the least risky choice - Sophie will reduce her wealth-generating capabilities in the long term. Investing in the managed fund comes with risks but can potentially create significantly more wealth.

Derivatives

The most common derivatives are warrants, futures and options. They are known as derivative products because they "derive" their value from the price of an underlying share, bond, currency or commodity.

The Australian Stock Exchange operates markets in a range of warrants and options that are linked to the shares of major Australian companies. The Sydney Futures Exchange also trades futures contracts linked to listed shares.

Derivatives allow investors to protect themselves from the risk that market prices will fall. They are financial contracts that call for money to change hands at some future date, with the amount to be determined by reference items such as the level of interest rates, share prices or exchange rates.

Fund managers often use them to increase or reduce their exposure to the stock market without having to actually buy or sell shares. Derivatives markets were initially created to allow investors to "hedge" or protect the value of their investments from future price fluctuations (see information about hedging opposite).

Derivatives can also be used as an aggressive investment strategy. Rather than using them to adjust exposure levels on previously held investments, the contracts are the investment. This speculative use of derivatives offers much higher returns. But higher returns mean higher risks. Investors can lose more money, more quickly if the market moves against them. Derivatives are a sophisticated investment strategy and a full explanation of their scope is not possible in this booklet. Speak to your financial adviser for further information.

Hedging Your Bets

Hedging is one of a raft of financial instruments used by international investors, including options, warrants, bonds and futures. Hedges are, in simple terms, pools of managed money. And hedging is a complex way to minimise investment risk against a change in market prices. For example, a currency hedge is a financial tool that enables an investor to change foreign currency for a certain rate in the future.

Options are popular. They involve one party paying another party an agreed amount for the right to buy or sell an asset at some stage in the future.

Options to buy are known as "call options"; options to sell are "put options". This tool is a good way to limit risk with interest-bearing investments.

A warrant, which is a type of option, has become very popular in Australia. They are essentially long-dated options issued by a third party - usually a large investment house or bank. The purchaser of the warrant pays a premium for the right to buy a certain number of shares at a point in the future.

Warrants are commonly issued "free" alongside the shares of new investment trusts when launched. Futures were originally used by farmers to set the price of their produce in advance. Before they planted a crop they would negotiate to sell their goods at a certain price at harvest time. After the harvest, goods would be sold at the pre-agreed price regardless of movements in the market. Futures on agricultural goods, metals, oil and gas, bonds and currencies are now traded on exchanges throughout the world.

Case Study

XYZ Trading Company plans to borrow money within the next year but is nervous about a possible rise in interest rates. It purchases an option to borrow the money at a set rate of 8 per cent. If interest rates rise, XYZ Trading will exercise the option when it is time to borrow the money. If interest rates fall, the company will not exercise the option and just allow it to expire, taking a relatively minor loss (the price paid for the option). In this case, options were used as an insurance policy.

TIP

If you want to speculate via derivatives you should only do so with money you can afford to lose. Alternatively, if you are looking for a less risky way to use derivatives, you might consider investing a small part of your portfolio in a professionally managed futures fund.

Property

For many people, a home is their biggest investment. A diversified investment portfolio should include exposure to property. There are two main ways to invest in property - buying a residential property as an investment, or through listed or unlisted property trusts.

Investment Properties

Volatile share markets and low interest rates have led to a surge in residential investment properties in Australia. An investment property can generate rental income in the short term, and capital growth over time. But be aware of the imposts. Real estate incurs large up-front costs such as stamp duty, insurance and legal fees. Also remember that, unlike shares, you cannot liquidate a proportion of your property if you need access to funds.

Then there is the possibility of rising interest rates. If you decide to buy, choose your location carefully. The adage about location, location, location holds true. Well-located property in popular areas - such as the inner city or beach destinations - will continue to be an excellent long-term investment. Check that the area is well serviced by schools, transport and shops. And remember that newer homes or apartments are cheaper to maintain. If you're investing in a unit, body corporate fees can vary dramatically from property to property. Swimming pools and lifts add significantly to management costs. Buying off-the-plan properties that require deposits well in advance of construction increases risk.

TIP

Real estate agents often try to woo buyers with rental guarantees for serviced apartments. But you can be sure that they have been factored into the property's purchase price, which means you are probably paying too much.

TIP

When buying an investment property, take advantage of the resources of your real estate agent. Most agents subscribe to a computerised property index service and can access a list of the most recent prices paid for neighbouring properties. Also research prices in the area you are buying by using the Internet and talking to competing real estate agents. Doing your homework to ascertain the right price to pay for a property could save you thousands.

Home Equity Loans

Home equity loans allow you to borrow against your mortgage. In effect, a home equity account gives you a revolving line of credit secured by the value of your house. This allows you to use the funds to buy a second property, shares or other investments. Depending on the equity available, it may be possible to buy the new property without contributing any cash at all. The purchase price of the new property, plus the stamp duty and associated legal and borrowing costs may be able to be borrowed, using the existing home as joint security with the new property. The interest rate is generally higher than a standard variable rate. Using your family home as equity comes with risks. If your investment dramatically collapses, you end up with a worthless investment and a significantly reduced equity in your house.

TIP

New properties are often a better bet for investors. They attract tax benefits through generous depreciation allowances. They are easier - and cheaper - to maintain. And they usually have better rental demand than similar, older properties.

Listed Property Trusts

Listed property trusts are an important market and continue to grow in popularity. They are ideal for small investors who want exposure to property but cannot afford their own home or commercial property. LPTs are a pooled investment. Units are listed on the Australian Stock Exchange and owners of the trust can trade their units in the same way as regular shares.

LPTs enable investors to diversify their portfolio across major assets such as offices, shops and hotels for a relatively small initial outlay. Dividends and capital gains are part of their attraction. LPTs also offer tax-deferral advantages. They suit investors who are looking for consistent income and the potential for long-term capital growth from a property investment.

Unlisted Property Trusts

If you do not know which property trust to choose - or do not have enough money to spread your risk by investing in a number of them - you could consider an unlisted property securities fund that invests in a range of listed trusts. Some unlisted trusts also invest directly in properties as well as holding a portfolio of listed property trusts. A potential disadvantage with unlisted trusts, especially those directly owning property, is that there may be a delay in redeeming your units (i.e., withdrawing your money) if lots of other investors want their money back at the same time.

Property Investment Dos and Dont's

- **Do** buy in suburbs less than 8km from the CBD
- **Do** buy in areas likely to attract young professionals, which increases rental prospects.
- **Do** consider insurance to cover rental loss or default.
- **Do** check the local council for development applications. Planned infrastructure developments such as roads or shops could either ruin or add value to your property.
- **Don't** take out loans that prevent extra repayments on the mortgage.
- **Don't** let overblown ads for interstate property deals tempt you into buying in an unknown market. Ask why developers have to resort to interstate buyers to sell their 'once-in-a-lifetime' properties.
- **Don't** assume all properties will automatically generate capital growth each year. Values also travel sidewards and backwards.

Syndicates

Property syndicates are a genuine investment alternative. An investor with more than $10,000 can buy a share in a multimillion-dollar commercial or industrial property syndicate and gain exposure to potentially lucrative lease arrangements. The downside is that selling these types of property can be time-consuming and costly. Also, during times of economic downturn, properties can be vacant for extended periods regardless of management expertise. Syndicates generally have an agreed life of five years or more at which time its property assets are sold and the proceeds distributed to investors. The syndicate's promoter manages the property on behalf of the investors for a fee. The key is to do your research to find a good syndicate. Carefully assess the reputation of the promoter and fully understand your contractual commitments.

Borrowing to Invest

Australian household debt has quadrupled over the past decade as people borrow money to fund their homes, other investments and their lifestyle. Borrowing money can be a sound strategy for buying something you can't afford, so long as you remember that debt must eventually be repaid and that you will incur interest on the borrowed money.

By injecting borrowed money into your own savings, you can increase the total amount of money working for you. Most people 'gear' - that is, borrow money to fund larger investments than would otherwise have been possible - through credit unions, banks and building societies to buy a home.

Increasingly, however, Australians are in the risky business of borrowing for leisure (expensive holidays) and lifestyle choices (a new pool or home entertainment system).

This is known as an inefficient debt. Draw a distinction between efficient and inefficient debt. Inefficient debt involves borrowing to buy goods, services and assets that do not generate income, which depreciate in value and offer no tax advantages. Think cars, holidays and furniture, for example. Efficient debt involves borrowing to buy assets that generate taxable income and which have the potential to increase in value. You can use the income generated by the asset to help repay the loan, and you get a tax deduction on the interest cost of the loan. Think property and shares.

Margin Lending

Margin lending is a hot investment trend. Also known as gearing, it is a potentially risky strategy for inexperienced investors. Margin loans let investors borrow a percentage - usually 30 per cent to 70 per cent - of the market value of shares or managed funds. The investors are required to supply the balance.

Unlike other loans, margin loans don't require regular repayments or a set period for repayment. And the interest accrued is generally tax-deductible.

If you take out a margin loan, it is important to understand margin calls. A margin call is made when a lender's loan-to-value ratio exceeds an agreed level. If stocks lose value, borrowers are expected to top up the account - usually within 24 hours - to maintain the equity level.

If you can't meet a margin call, the lender will sell enough shares or units to re-establish the loan-to-value ratio. This type of sale is bad news as investors are forced to sell when their investments have dropped in value. Borrowers can minimise the risk of margin calls by ensuring they have a diversified portfolio of shares and by borrowing conservatively. Margin lending is generally better suited to investors with high cash reserves. For retirees or those nearing retirement who are content to protect rather than grow their investments, margin loans are a risky option.

Case Study

Tess has taken out a margin loan, with gearing at 70 per cent. She has $60,000, and borrows another $140,000. Tess invests the total $200,000 in a portfolio of shares approved by a margin lender.

The entire $200,000 portfolio is the security for the loan. Tess does not take possession of the assets, but she does receive all dividends, distributions and franking credits. Say her $200,000 portfolio drops in value by 10 per cent to $180,000. Her loan of $140,000 has risen to 78 per cent of the portfolio value. She will receive a margin call asking her to deposit an additional $20,000 to bring the loan-to-value ratio back to 70 per cent. On the other hand, if the value of her portfolio rises by 10 per cent to $220,000, Tess's ratio will drop to 64 per cent and she can either leave the extra invested, or cash up the extra $20,000 and lower her loan to $120,000.

TIP

Do not fully gear into a stock market investment. Advisers recommend you keep some money in reserve in the event of rising interest rates, a share market collapse or a change of personal circumstances.

Three Reasons to Gear	Three Reasons Not to Gear
1. You can engage in a higher level of investment, such as property and shares, than might otherwise be possible. And if the market conditions are right, you can generate significant wealth. 2. If the cost of borrowing exceeds the income generated by the investment, this can be written off as a tax deduction. 3. Share investment borrowings can bring imputation credits that can be used to reduce the amount of tax you pay.	1. Assets don't always provide the returns you expect and market conditions change. Rising interest rates, for example, can affect your ability to meet loan payments and could lead to the loss of your asset. 2. Gearing can multiply your losses on a poor investment choice, particularly if taking a short-term view on a volatile investment. 3. If you want to sell an asset and pay off a loan earlier than expected, there may be penalties that apply.

Tax

Tax loopholes are rare these days, but there are still legitimate tax-minimisation strategies that can help you accumulate wealth. One strategy is to maximise tax deductions via efficient debt and purchase of depreciable assets. Another excellent strategy is to build an investment portfolio in which most returns come from capital gains rather than income. This is due to the fact that capital gains tax is lower than income tax and if you never sell your assets you will never incur this tax. Capital gains tax (CGT) is incurred on any capital gains that arise from the sale of an asset bought after 19 September 1985. You are liable for CGT if your capital gains exceed your capital losses in any income year.

Your home is not regarded as an investment so no CGT will be incurred if it is sold. Investment properties are subject to the tax (when sold) but if you acquired the property on or after October 1, 1999, and held it for at least one year, only half of the capital gain is taxable. This means that if you are on the top income tax rate of 48.5 per cent you will only pay 24.25 per cent tax on any capital gain you make on the sale.

A Super Partnership

Partners can also open the way for tax benefits. You can claim on superannuation you contribute on behalf of your spouse (including de factos) if they have a low income or do not work. Taxpayers can claim an 18 per cent tax offset on super contributions of up to $3000 made on behalf of their low-income or non-working spouse. The maximum rebate allowed is $540.

To be eligible for the claim, your spouse must be receiving in total $10,800 or less in assessable income and reportable fringe benefits a year. A lower offset is payable for spouses earning up to a total of $13,800 assessable income.

Contributing to your own superannuation investments can also offer tax benefits. The tax advantages of salary sacrificing are explained in the Superannuation section of this booklet.

TIP

Think about putting income-based assets in the name of the partner who earns the least. Any income earned will be taxed at the partner's lower tax rate.

Negative Gearing

Most investors are familiar with negative gearing. This entails borrowing to invest in an income-producing asset that produces less money than the cost of borrowing. With a rental property, for instance, an investor is negative gearing if repayments and interest payable on the loan used to buy the property exceeds the annual rental income that the property generates. This is a common scenario - and not necessarily a bad thing. Resulting losses can usually be claimed as a tax deduction against other taxable income such as wages. The logic is simple. Your property is being partially paid off by tenants and the tax office while the home is appreciating in value. The danger occurs if market conditions change rapidly. Suppose interest rates spiral, which drives up your repayments, while your rental income stays stagnant. Similarly, capital losses can occur if property market values fall or do not increase as much as expected.

Bogus Schemes

Financial publications are full of advertisements for investment schemes offering ways to slash your tax bill, particularly at the end of the financial year. Such schemes typically involve investments in ostrich farms, vineyards, olive groves ... you name it. The main attraction of these schemes, in theory, is that the interest you pay on any money you borrow to invest can be paid in advance and then claimed as a tax deduction. This may allow people to significantly reduce their tax bill in a given year.

However, these schemes are risky. Potential investors first need to determine whether the scheme has a realistic chance of being commercially successful. If the scheme fails you will not recover your original investment and will still be liable to repay any money you have borrowed. Even the tax benefits are dubious, particularly for investments without a tax or product ruling by the Australian Taxation Office (see below). While most agricultural or horticultural schemes offer a deduction on the initial outlay, each dollar that is received back is taxed as income. It is also worth noting that the Australian Taxation Office has in the past disallowed the initial tax deduction claimed by the investor - effectively wiping out the tax advantage.

Product Rulings

The Australian Taxation Office (ATO) has introduced "product rulings" that confirm the availability of the tax benefits that a particular tax scheme offers.

Product rulings provide certainty on claimed tax benefits, but only if the promoter implements the arrangement exactly as outlined in the product ruling application. A favourable product ruling does not mean the ATO is in any way guaranteeing a scheme's commercial viability.

Franking Credits

A significant tax benefit stems from franking credits - a tax credit on your dividends from shares. Franking credits are designed to ensure that shareholders do not have to pay tax on dividends twice. If the company in which you invest pays tax at the full corporate rate of 30 per cent, you in turn get a tax credit on your dividends for the tax the company has already paid. Taking into account this franking credit, your tax is recalculated based on gross income. If your marginal tax rate is less than 30 per cent, you will receive the dividend and a tax refund. Some companies do not pay the full tax rate, which means their dividend payments are only partly franked. Factor this into your choice of shares.

Case Study

Shares versus rental returns: it's a perennial question, but many people forget the tax implications. Consider the situation for Michael, who is taxed at the top rate. He receives a $700 dividend through franking credits, with tax credits of $300. He reports $1000 on his personal tax return and pays $485 in tax but has a $300 imputation credit to offset it. The upshot is that he pays $185 tax on a $700 dividend for a return of $515. Michael's alternative is to get $700 of rental income. He pays $340 income tax and ends up with only $360 net after tax.

The Internet

Information technology and the Internet are great news for investors - and fraudsters. While the Internet is a tool that enables research into investment opportunities and access to online services such as online banking and share trading, be conscious of the pitfalls. The types of online investment fraud mirror those perpetrated over the phone or through the mail. They are old tricks through a new medium. Pyramid deals and offshore scams targeting vulnerable investors are proving just as successful on the net. Remember the maxim: If the deal sounds too good to be true, then it probably is. To invest wisely using the Internet, adhere to normal safe and sound investment principles. Do not make an investment based solely on what you read in an online newsletter or bulletin board posting. Verify claims made over the Internet about companies or products.

TIP
Install software security to prevent hackers accessing crucial personal details such as credit card numbers, online passwords and personal identification numbers (PINs).

The Cons

The Internet is crammed with online investment newsletters. Some are legitimate e-magazines that offer valuable information to investors. Others are a con. They claim to provide unbiased information and tout best-value stocks. Be aware that some companies pay the people who write online newsletters cash or securities to recommend their stocks.

This is not illegal, but laws require newsletters to disclose who paid them. But many fraudsters fail to do so. Web-based bulletin boards are similarly dangerous in that they offer an outlet for con artists to pump up a company in which they might be involved.

The Pros

The Internet offers access to a rapidly growing range of services that can help investors plan and implement wealth-creating strategies. Investors can use the Internet to:

- Access educational material provided by financial institutions.
- View research and commentary by stockbrokers or fund managers.
- Search for investment products and services that suit them.
- Order prospectuses for managed funds.
- Use a wide range of helpful calculators and forecasting tools.

For modest fees, investors can use the Internet to:

- View live stock market data and prices.
- Buy and sell shares.
- Use computer software to keep track of their portfolios.

Wealth Management

Wealth management is among the fastest-growing sectors of the financial services industry. Record numbers of Australians are participating in some form of investment. The result has been an unprecedented need for personal finance and investment advice. In addition, wealth management products and services are now mass-market focused and not the exclusive domain of the wealthy.

Wealth management refers to the discipline of building and preserving wealth in order to achieve financial objectives. A wealth management company manages assets for individuals or institutions. This consists of providing services in one or more of the following: fund management, financial advice, investment advice, insurance advice, accounting services and legal and estate planning. Typically, the process starts by deciding on your investment policy and assessing your risk profile. Other factors such as taxes, inflation, debt and financial commitment have to be considered together with your financial goals. It should be an ongoing process that involves reviewing your current circumstances, developing a financial plan, and then systematically implementing the plan in order to achieve your short- and long-term goals.

Wealth management strategies are one of the key reasons that investors have flocked to Internet services to research and manage their portfolios. The Internet provides a means of self-education about products such as managed funds, superannuation and insurance.

Could you use some help?

Credit unions have one of the largest customer bases in Australia's competitive retail finance sector. More than 3.5 million members are spread throughout metropolitan, rural and regional areas - and the numbers continue to grow.

Credit unions can assist members on a wide range of investment products and services, including managed funds, wealth management, superannuation, pensions and annuities, tax issues and budget planning, often through alliances with specialist wealth management firms. Whether it's advice on buying a house or car, budgeting, or savings and investment, credit unions are there to help. Credit unions are committed to helping their members take control of their finances - and anyone can join.

Join a credit union today

Just ring 13 11 28 for further information or go to www.cu.net.au

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