Couple, two kids

Emma and Ray, both 31, have two children, two months and two years old. They have a combined income of $105,000pa ($35,000 and $70,000 respectively) and a mortgage of $550,000 on their home, which is valued at $850,000. They have a $10,000 car loan but no credit card debt and Emma has a $20,000 HELP debt. Family help means they don't need to pay for childcare, and they hold $65,000 in super.

Gearing will boost returns

Having taken the step to secure their own home, Emma and Ray are now keen to start building their wealth for the future. On their current incomes, Emma and Ray have a surplus of $7500pa and they are comfortable in using all this to invest. Leveraging this surplus will be an effective strategy for Emma and Ray to adopt, so it makes sense to look for ways to enlarge what they have to work with.

The first step any household must take is to do what good governments should do: reduce unnecessary spending. But, just as in politics, you can't always please everyone, particularly two-year-olds who may have something to say when required to cut down on treats!

Find ways to save

First, there are some quick and easy wins available that don't involve taking on any risk. For example, by changing from the main supermarkets to one of their cheaper rivals or by substituting premium brands for private label items, a $13,000 grocery bill can be cut by $3250 a year, according to the latest Choice comparisons. This alone would add $16,250 to Emma and Ray's wealth over five years.

Also look at areas such as telcos, private health insurance and other insurance. By doing their homework, Emma and Ray could reduce costs further without impacting lifestyle. Even giving up the morning coffees can add $4200 to their bottom line over five years.

A secured $10,000 car loan at a rate of 8% creates a drag on cash flow. Through a sale-and-leaseback arrangement, a novated lease structure can reduce Emma's tax liability by $1300pa. This creates a $6500 tax saving over five years.

Fixing $450,000 of their home loan at 3.99% for the next three years from their current rate of 4.29% generates savings of around $4000 over three years. By leaving $100,000 of the loan variable, they have the capacity to reduce it further over the next three years without penalty if they find themselves in a position to do so. By adding an offset account against the $100,000, and using a credit card for the bulk of expenditure (one with an interest-free period, paid off in full each month), they save a further $2100 over five years.

Note that the HELP bonus ceases on December 31. By making an additional payment of $5000, a return of $250 tax free can be generated but, of course to do this they have to find $5000 extra cash.

These are just some of the many ways to save and if you're already saving in these areas you can start looking at options such as catching public transport, taking lunch to work rather than buying ($3 a day against $12, so more than $2000 a year) and, of course, not always buying the shiny new item.

With $33,050 in savings already banked, Emma and Ray need to generate an additional $17,000 over the next five years from their existing assets and surplus of $7500 a year.

Create leverage

Emma and Ray need to take on a gearing strategy as part of their regular investment of their surplus funds to turbocharge their returns. The investments should be highly liquid so they can access capital if they need it in an emergency. (This shouldn't be touched for any other purpose – an immediate wealth destroyer.) Additionally, to reduce the impact of tax, all investments should be held in Emma's name, as she has the lower marginal tax rate.

A lower-risk strategy

Emma and Ray can draw down $20,000 from the $300,000 equity they have in their home, fix the loan and (in Emma's name) invest in a diversified portfolio of exchange traded funds (ETFs). Traded on the ASX, ETFs are cost effective and allow good diversification across asset classes and also within asset classes. They are also highly liquid. A diversified portfolio can be constructed from investment in four recommended ETFs:

- iShares MSCI Australia 200 (ASX: IOZ), Australian shares, 31%.
- SPDR S&P World ex-Australia Fund (WXOZ), global shares, 35%.
- Vanguard Australian Property Securities Index (VAP), listed property, 4%.
- Vanguard Australian Fixed Interest Index (VAF), fixed income, 30%.

A portfolio with 70% growth assets (shares and property) and 30% defensive (cash and bonds) should give sufficient growth. At the same time, the defensive fixed income assets should reduce volatility. But, assuming conservative growth of 2.6%pa for this portfolio (see table), this will leave them some $7000 short.

More risk, more return

Alternatively, Emma and Ray could invest their annual surplus in two internally geared ETFs that give them exposure to the growth assets of domestic and international shares and avoid the lower returns of income assets:

- BetaShares Geared Australian Equity (GEAR), Australian shares, 50%.
- BetaShares Geared US Equity currency-hedged hedge fund (GGUS), global shares, 50%.

These ETFs have an interest rate of less than 3%. With such a low interest rate, and an estimated grossed-up (taking franking into account) dividend yield of close to 8%, the investment will be positively geared. The Australian fund invests in the S&P/ASX 200 Index, while the US fund invests in the S&P 500 Index which includes the likes of Apple, Microsoft and Johnson & Johnson. Our estimates (see table), which assume that extra borrowing is made each year, show such a strategy should more than meet the target of an extra $17,000.

However, this is a much riskier strategy, and Emma and Ray need to be aware of the potential for a bumpy ride. As with any of these strategies, the starting point needs to be a well-defined objective so that Emma and Ray take on only as much risk as necessary.

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LIFESTYLE SAVINGS

ACTION	5-YEAR BENEFIT
Grocery savings	$16,250
Coffee	$4200
Tax on car lease (excl GST savings)	$6500
Mortgage interest saving	$4000
Offset account savings	$2100
TOTAL SAVINGS	$33,050

EQUITY LOAN $20,000 IN ETF PORTFOLIO

	YEAR				
	1	2	3	4	5
Opening balance	$0	$28,460	$37,461	$47,039	$57,229
Loan	$20,000				
Own contribution	$7500	$7500	$7500	$7500	$7500
Total investment	$27,500	$35,960	$44,961	$54,539	$64,729
Return[1]	$1760	$2301	$2878	$3490	$4143
Closing balance	$28,460	$37,461	$47,039	$57,229	$68,072
Loan balance	$20,000	$20,000	$20,000	$20,000	$20,000
Interest cost (4%pa)	$800	$800	$800	$800	$800
Net return	$960	$1501	$2078	$2690	$3343
Total net return					$10,572

[1] 2.6% growth, 3.8% income Note: tax has been ignored

INTERNALLY GEARED ETF PORTFOLIO

	YEAR				
	1	2	3	4	5
Opening balance	$0	$37,500	$56,438	$76,949	$99,184
Loan	$27,500	+$7500	+$7500	+$7500	+$7500
Own contribution	$7500	$7500	$7500	$7500	$7500
Total investment	$35,000	$52,500	$71,438	$91,949	$114,184
Return[1]	$3325	$4988	$6787	$8735	$10,848
Closing balance	$37,500	$56,438	$76,949	$99,184	$123,307
Loan balance	$27,500	$35,000	$42,500	$50,000	$57,500
Interest cost (3%pa)	$825	$1050	$1275	$1500	$1725
Net return	$2500	$3938	$5512	$7235	$9123
Total net return					$28,307

[1] 5% growth, 4.5% income Note: tax has been ignored