CASE STUDY

Budget to get ahead

A couple with two young children want to spend less and save more

NAME: Shannon and Glen Handley
STATUS: Mid-30s with two young children, aged one and three
QUESTIONS: What is the best way to make a big dent in our mortgage? How do we most effectively budget? What is the best way to set up our two young kids for the future? We are thinking of buying an investment property to help our kids – how do we go about this?
ANSWERS: Rev up your mortgage repayments while interest rates are low and save a potential $190,000. Also pay fortnightly instead of monthly to save interest. Diversify away from property rather than buy an investment property. Exchange traded funds are diversified, low-cost funds that give you exposure to lots of companies. Take out life and TPD insurance. Use a mortgage offset account to pay down your debt, and then you can draw on it later for your kids.

Even though interest rates are low, the average Australian mortgage is $430,000 ($524,000 if you live in NSW). Repayments can soak up a big chunk of the family income. Shannon and Glen Handley, who bought a block of land and built a house, are staring at a big mortgage of about half a million dollars. The interest rate is 3.88% with Bankwest. They both work and earn good money, says Shannon, but they don't have much left over every month after paying the mortgage and other living costs. They are keen to pay off the loan early. What are the strategies to save thousands on their mortgage?

Shannon says they need a strict budget, and to cut back on impulse purchases and takeaway food and plan their outings with the kids to keep the costs down. What are failsafe budgeting rules to get ahead? Setting up automatic savings that go to the mortgage is a good idea. What is the impact of paying an extra $100, $200 or $500 a month off their mortgage?

They would like to put savings aside for their two children to help them set themselves up later. What is the best long-term investment vehicle for them? What are the benefits of term deposits or shares? Shannon says she doesn't know much about shares. She is interested in eventually buying an investment property to help her kids get into the market. "We would really like to get an investment property to help our kids in the future as well."

Both Shannon and Glen have income protection insurance but neither has life and total and permanent disability insurance. Should they take it out and should it be through their current superannuation funds? SUSAN HELY

YIANNI ASPRADAKIS

Slash up to $190,000 off the interest bill

JASON PETERSEN

Jason Petersen has been a financial planner for 12 years and is head of wealth management at 5 Financial. 5financial.com.au

By buying a home at a level where repayments should be well within their budget, Shannon and Glen have made a good start on reducing mortgage stress. And as long as they have a clearly defined budget and stick to it, setting themselves and their children up for the long term is quite achievable.

A key objective is to optimise home loan repayments, particularly while rates are low. It's important to weigh up how much extra they can allocate while ensuring they still "live". Often people become obsessed with paying down their home loan at the expense of enjoying life (in a reasonable manner).

If minimum home loan repayments are maintained at current rates, over 30 years interest payable is $353,000. By changing payments from $2400 monthly to $1200 fortnightly, the loan is reduced by four years and just over $50,000 in interest is saved.

Needing about $75,000pa to meet living costs, excluding the mortgage, Shannon and Glen could comfortably add $500 a fortnight to their mortgage repayments. The impact is significant: the loan term nearly halves to just over 15 years and around $190,000 is saved in interest. Even paying an extra $50 a fortnight cuts the loan term to 24 years and saves $75,000 in interest.

An offset account against their mortgage provides an after-tax return equivalent to the interest rate on their mortgage, currently 3.88% – a better option than investing in a term deposit.

The first rule of wealth creation is diversifying. Therefore, I'd advise against property investment at this time because buying another property further concentrates Shannon and Glen's assets in one class. In addition, property prices have increased significantly over recent years and a purchase would likely be at the top of the market.

More importantly, using equity in their home and borrowing to buy the property would strain cash flow. Before any tax advantages, a $500,000 property that's 100% geared costs about $8500pa based on current interest rates. If and when interest rates eventually return to their long-term average of 7% or more, pressure on cash flow would be substantial. The table shows the impact on this before any negative gearing benefits and assumes "perfect" tenancy. Other factors to consider include initial stamp duty and legal fees of more than $20,000, and ongoing major maintenance and refurbishment.

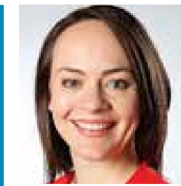
An alternative investment option is to buy shares, taking part ownership in a lot of well-known companies that we all use every day, sharing in their profit and capital growth. Trying to time the market and pick winners is challenging even for the experts, so using low-cost structures such as exchange traded funds (ETFs) can take the guesswork out of share investing and the investment can be built up with surplus cash over time.

IF INTEREST RATES RISE

Interest-only mortgage	$500,000	
Rental income	$20,000	
Expenses		
Strata costs	$4000	
Rates	$1500	
Management	$1200	
Landlord insurance	$1500	
Maintenance	$500	
Subtotal	$8700	
Net income before interest	$11,300	
Interest rate	4%pa	7%pa
Interest on loan	$20,000	$35,000
Cash-flow deficit	$8700	$23,700

It's fantastic to see Shannon and Glen are protecting a valuable asset via income protection insurance. I'd recommend they also consider life, total and permanent disablement (TPD) and critical illness cover. Insurance via super (except critical illness) can reduce pressure on cash flow.

Through effective budgeting, debt reduction and a strong investment portfolio that generates a growing income stream, Shannon and Glen will be in a stronger financial position, giving them far greater flexibility in setting up their kids financially.



Plan kids' future

CATH SHARPLES-RUSHBROOKE

Cath Sharples-Rushbrooke is a financial planner and director of independently owned Advice Services Australia, which charges a fee for service. adviceservices.com.au

I completely understand wanting to set up your children for the future – it's never too early to start planning. Here are my tips:

- Be careful about tax rates on unearned income for minors (under 18). They are subject to penalty rates of up to 68% on "unearned income" exceeding $416 a year – this includes income from investments (interest, dividends, rental income and capital gains) as well as most distributions from family trusts. These rules are in place to discourage adults from splitting their income and diverting it to their children.
- Use a mortgage offset or redraw facility. Directing savings to an offset or redraw account will reduce the interest payable on your non-tax-deductible home loan. Over time, this should assist you to become debt free faster and save thousands. Investment income is taxed at your marginal rate – weigh up the return after fees and taxes you need compared with the tax-free, guaranteed interest saving you get when using a mortgage offset or redraw. An advantage of directing savings there is that the funds are accessible for expenses such as education. It is important to maintain a disciplined budget and not dip into these savings for discretionary purchases.
- Investment or insurance bonds. These are a long-term managed investment. They are tax effective provided rules for making additional investments (no more than 125% of the previous year's investment) and withdrawals (ideally not before the 10-year anniversary) are followed. Bonds can be a useful structure for saving for children as tax is paid within the structure (at company rates) so does not need to be included in the holder's personal assessable income. There is flexibility to select underlying investments, which could include cash, fixed interest, shares, property or diversified portfolios. Disadvantages include fees, lack of control over investment decisions and potential tax consequences if funds are withdrawn before the 10 years. Always check the product disclosure statement.