Mortgage Elimination and Wealth Creation

A Case Study of School Parents Les and Fiona

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Like most school parents, Les and Fiona were just keeping their heads above water after mortgage payments and school fees and upon Les's 40th birthday they took time out to reflect upon their achievements thus far and to consider their future. Les lamented that when they got married they had a vision of being financially independent by the time they were 55 so they could travel the world and take life easy. "They both had professional jobs and heaps of spare cash back then but somehow it just evaporated once children came along and they saddled themselves with a mortgage etc".

Fiona added that 'it was quite disconcerting to realise that they had owned their house for 15 years but had not reduced their mortgage and that they would be paying it off for another 25 years at the rate they were going'.

Through visiting Les's grandfather in the retirement village over the past 12 months, Les and Fiona were becoming increasingly aware of the fact that so many people are living well into their late 80"s and 90's which made them wonder how much money they would really require to provide them with a comfortable and independent retirement. They were conscious of our aging population and concerned about the sustainability of the age pension system.

Determined not to give up on their dream, Les and Fiona decided to take the advice of friends who had been in a similar position and engaged our services to run a financial analysis of where they might end up financially at age 55, and beyond and to see what they might be able to do to improve their situation.

Their financial situation was similar to a lot of 40 year old school parents. They had a house valued at $600,000 with a $300,000 mortgage, combined superannuation of $210,000 and a combined income of $125,000. By virtue of the fact that they had not reduced the mortgage over the past few years it was evident that they were living on the edge although they believed they could save $100 per week if they could see the point in it. Les and Fiona understood the tax advantages of salary sacrificing into superannuation but were not interested in locking away their savings in case they needed it. Their children were aged 5 and 7 and they wanted to fund their education through to University.

They had owned their house for 15 years but had not reduced their mortgage.

Prognosis

The first reality bite was that their youngest child will not be finishing uni until Les and Fiona turn 55 at the earliest. The second is that school fees and costs of living are only going to increase as the children grow. Hence there is little chance of any real savings (in the traditional sense) for the next 15 years unless there is scope for substantial salary increases or they commit to serious belt tightening.

In fact, if they don't increase their mortgage repayments, Les and Fiona will still have $178,000 outstanding on their mortgage in 15 years time when they turn 55. (The brown bars in Graph 1).

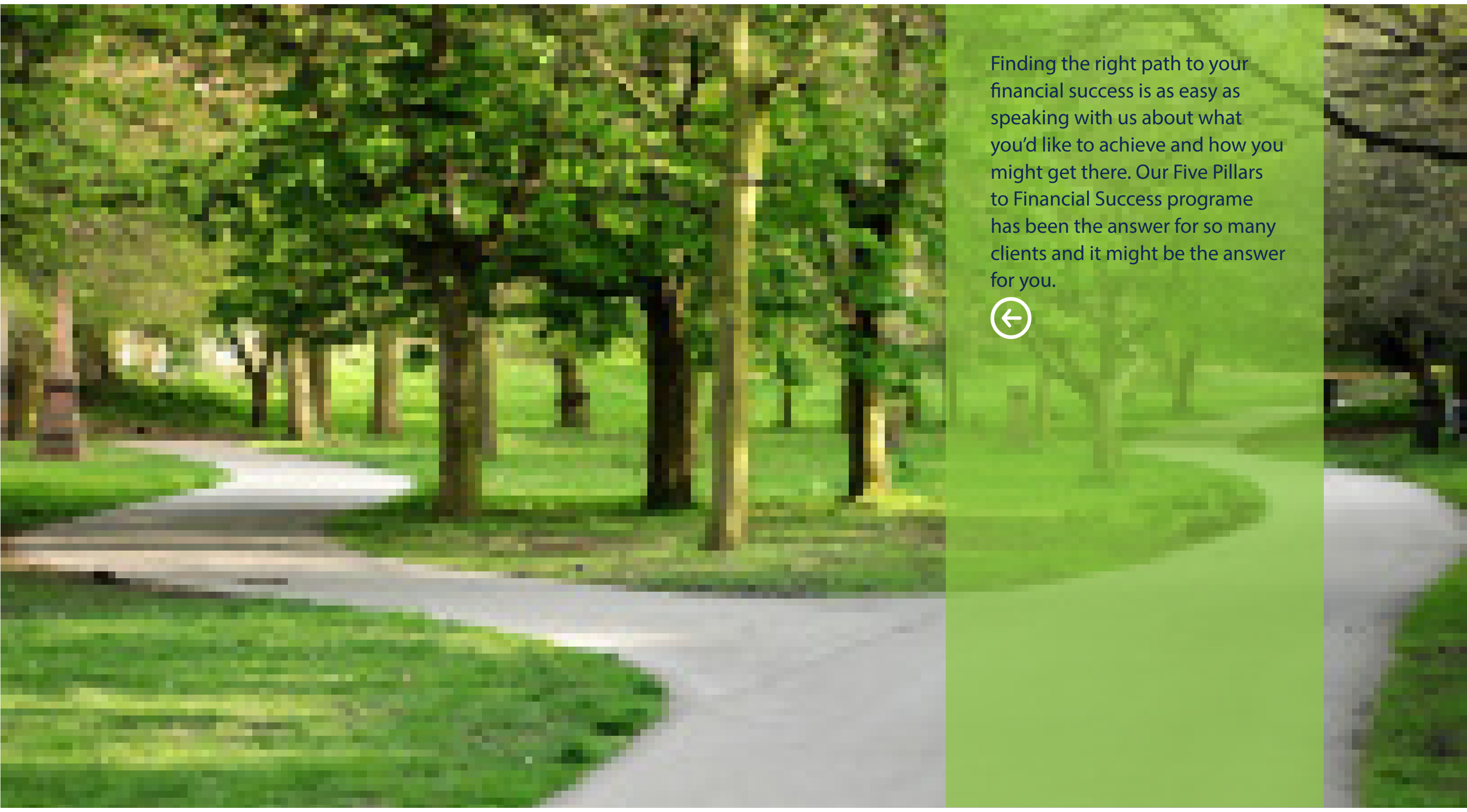
The next reality bite is that people born after 30/06/64 cannot access their super until age 60 so they won't have any savings available at all at age 55 unless they commence an investment plan outside superannuation.

The good news is that their super will be accumulating in the back ground and should be in the order of $808,000 (assuming 9.5% employer contribution and 6% net earning rate) by the time they turn 55.

So, while they won't be able to access their super at age 55, it is worth noting from a holistic perspective that their net worth is likely to be in the order of $630,000 at age 55 (i.e. $808,000 super less the mortgage of $178,000). This is equivalent to $404,000 in today's dollars assuming 3% CPI. Such a nest egg would provide Les and Fiona with an annuity (a return of income and capital) of around $20,000 per annum (indexed by 3%) from age 55 through to age 85 assuming a net return of 6%. This is significantly below the benchmark of $58,000 that ASFA (the Association of Superannuation Funds of Australia) advises is needed to provide a comfortable standard of living in retirement and certainly won't allow any expensive travel.

From a planning perspective, it is also worth noting that people born after 31/12/1956 cannot access the age pension until they turn 67 which means Les and Fiona will have to devise a plan that will enable them to live off their own investments for 12 years from age 55 to 67 before they can get any age pension support.

Therefore, any dream of taking life easy and travelling at 55 is likely to remain just that unless they get serious about financial planning and commence a Mortgage Elimination and Wealth Creation Plan as a matter of urgency.



Finding the right path to your financial success is as easy as speaking with us about what you'd like to achieve and how you might get there. Our Five Pillars to Financial Success programe has been the answer for so many clients and it might be the answer for you.

Options

What can Les and Fiona do to improve their prospects?

1. Term Deposits

In order to have access to their savings, Les and Fiona were thinking they might save $100 per week via term deposits and asked what this might enable them to save by age 55. The problem with this strategy is that interest rates on term deposits are only around 2% and the interest is taxable. While saving $100 a week might sound like a big ask the sad reality is that it only amounts to $78,000 over 15 years and with interest the account balance will only grow to $86,000 by the time they turn 55.

If they were to apply that to reduce their mortgage, they would be left with $92,000 owing and no funds available to cover their cost of living or travelling at age 55.

2. Additional Home Loan Repayments

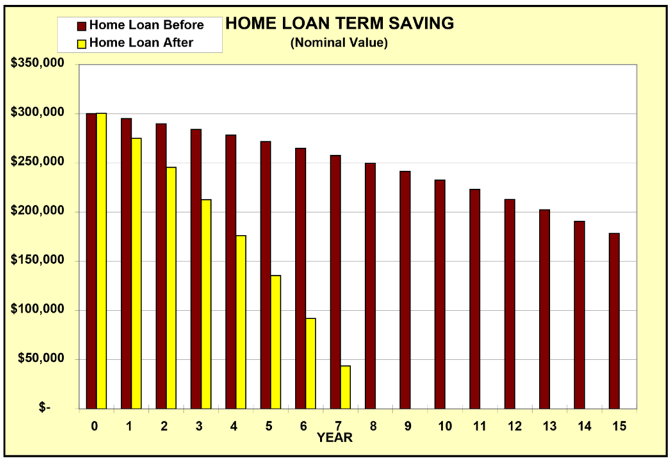
If their home loan had a redraw facility, Les and Fiona would be better served increasing their home loan repayments by $100 per week. A redraw facility would provide access to the funds if required while effectively increasing their earning rate to 6.25% after tax (i.e. their current home loan rate). This option would reduce their mortgage to $47,000 at age 55 which is a $45,000 improvement over the term deposit option.

This would provide Les and Fiona with access to $131,000 in redraw (normal loan balance $178,000 less actual balance $47,000) at age 55 which would cover less than two years cost of living allowing for mortgage repayments.

3. Mortgage Elimination and Wealth Creation Program

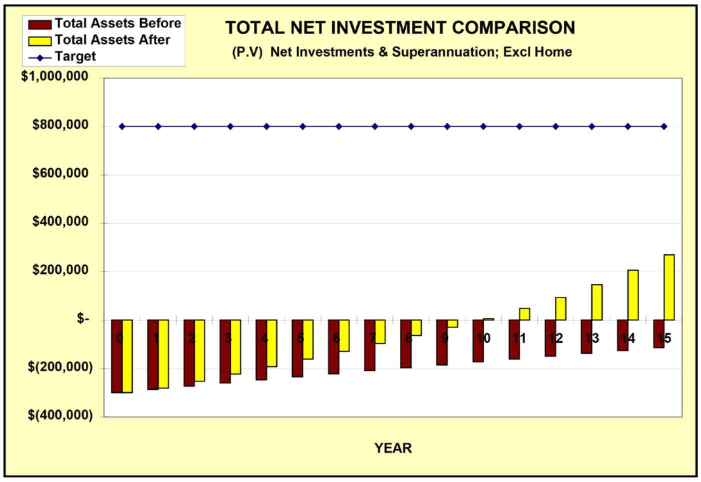
By accessing the equity in their home to establish an investment portfolio and managing their finances tax effectively, we were able to show Les and Fiona how they could pay out their home loan in 8 years (the yellow bars in Graph 1).

Graph 1: Home Loan – before and after Mortgage Elimination.



They could then and go on to build a nest egg outside superannuation of $300,000 in today's dollars by the time they reach age 55 (Graph 2). This assumes conservative gearing ratios and a return on investment of 10% p.a.

Graph 2: Non Superannuation Net Investments – before and after Mortgage Elimination.

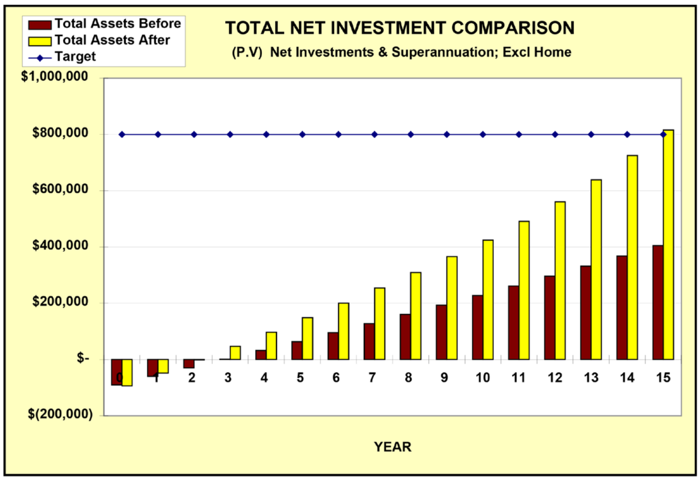


The brown bars show the home loan balance without investment plan. I.e. they will still have a home loan at age 55.
The yellow bars show they will have no home loan at age 55 and portfolio equity of $300.000 in today's value.

This would be sufficient to cover Les and Fiona's costs of living of $58,000 through to age 60 when they can access their superannuation.

Their total investments, including superannuation would be in the order of $1,270,000 at 55 which is equivalent to $816,000 in today's dollars as depicted in Graph 3.

Graph 3: Net Investments & Superannuation



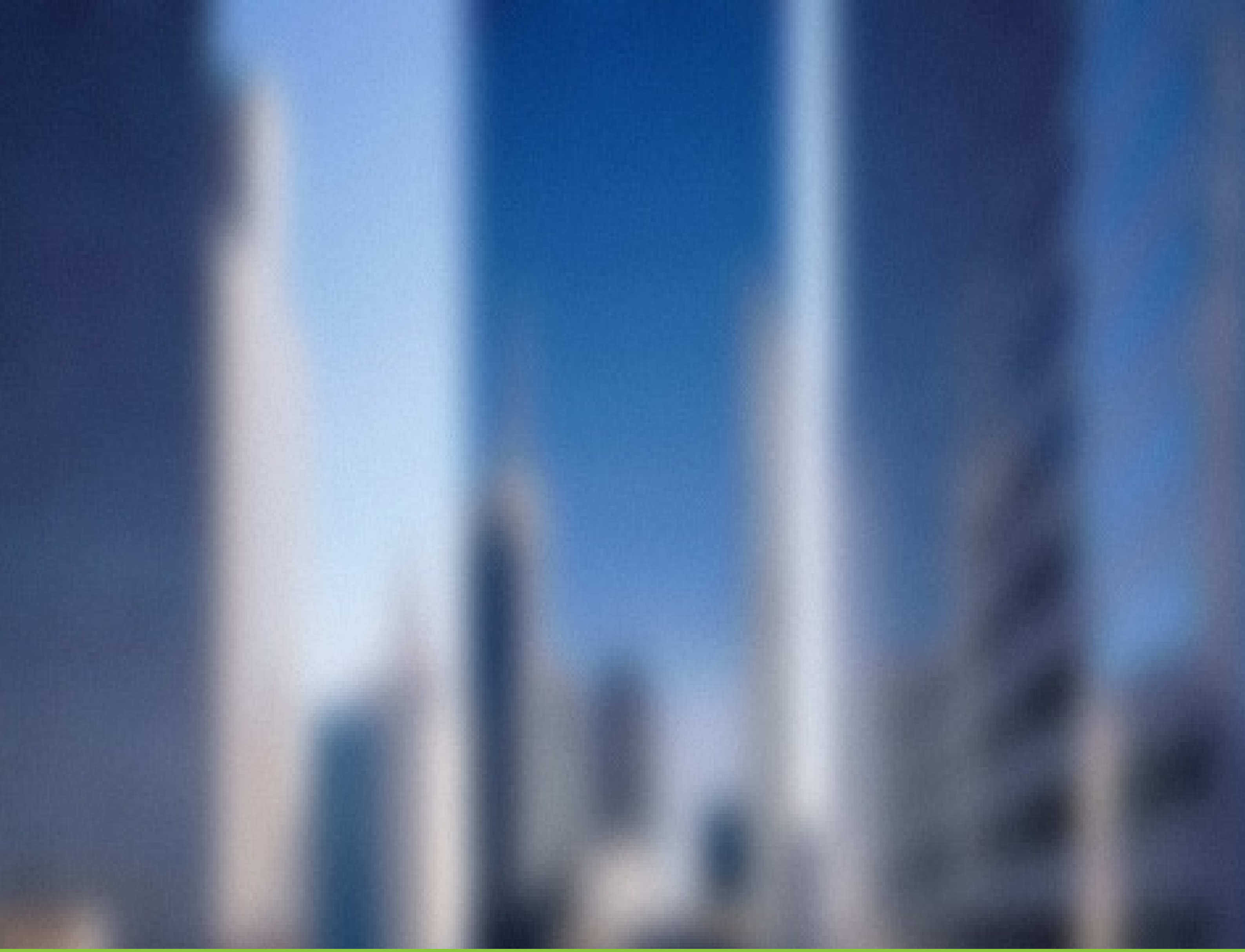
The brown bars project net investments excluding the savings and investment through to age 55. The yellow bars project net investments with the savings and investments through to age 55. All figures are in today's dollars.

So can Les and Fiona achieve their dream of retiring at 55 and living a comfortable retirement?

Yes they can.

But only if they commence a Mortgage Elimination and Wealth Creation Plan now to harness the miracle of compound growth and tax effective financing.

Their super should continue to grow to around $1,090,000 by the time they can access it at age 60 which, supplemented by the age pension at age 67, should be sufficient to provide them with a very comfortable lifestyle well into their 80's.



Get in touch

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