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INTRODUCTION

This eBook is designed to introduce you to the basics of wealth creation through residential property investment. I don't propose to “pad” this treatise with the various statutory factors like stamp duty, marginal tax rates, and superannuation rules, for these are forever changing. I want to address the underlying philosophy; the one that applies whatever the state of the market. I considered, at one stage, that I would call the book a "primer" in order to convey that it is “pitched” at the conceptual level, knowing that if you can grasp the principles you can build on them.

There are real estate "experts" everywhere, many with little experience and many without an analytical turn of mind. As an aside, I see these “experts’ holding seminars about property investment and property development and making the most extraordinary untruthful claims about their previous experience and prior involvement in various developments. How they get away with it mystifies me, but one clue to their veracity is whether, or not, they are reluctant to disclose the addresses of “their” developments. So, hopefully, this book will assist you to ask the right questions, not believe everything you are told, and learn to be your own expert—and to do that, you need experience. My belief, as an analytical person, ex stock-broker, accountant and economist, is that theory without experience is useless, but not the converse; Einstein agreed, he said, "Experience is knowledge, everything else is just information."

In this "I-want-it-now" generation, promoters of “instant riches" seminars have made large amounts of money charging thousands of dollars for seminars. I have observed that these seminars tend to attract the comparatively younger and inexperienced investors. They haven't learned yet that there are no instant riches. Warren Buffet, one of the world’s most successful stock market investors, said, “The market is a mechanism which transfers wealth from the impatient to the patient." He was talking about the stock market, but the same applies to real estate. Mark this well: more money has been made from real estate by sitting than by any other method.

The claims of the various gurus have a certain similarity about them and inexperienced people may find it hard to differentiate between the genuine and the fraudulent. How can you tell who is genuine? Well, start with their claims. The author recorded the following claims made over a period of some years by various seminar spruikers. When you hear any of these sorts of claims…

- Buy property at wholesale prices up to 20% below market,
- Start a seven-year super-wealth plan that guarantees massive wealth,
- Guarantee an income of $3,000+ per week within 10 years,
• Assure a 50% capital profit within seven years,
• Eliminate 100% of the risk,
• Make a quick $40,000 buying undervalued property,
• Use a little-known property secret that will guarantee your capital growth upfront,
• Purchase investments that dramatically outperform the market by 40%,
• Retire in eight years on $3,461 per week,
• Purchase property at a ridiculous 10% of its market price,
• Achieve a cash-on-cash return of 575%,
• Trade assets to create immediate “unheard-of” returns up to 3200% on a monthly basis,

then you are in the presence of a “snake-oil” salesman.

Rene Rivkin was asked, "So is there no such thing as making a quick dollar on the share-market?" He answered, "Oh, yes. There is a quick dollar to be made—but it's not investing, it's in gambling. Nothing happens overnight, unless it's lucky. Then it's just like winning the lottery."

Paul Clitheroe, of Money Magazine and Channel Nine’s Money show, said, "There is nothing I would like more than a genuine investment miracle that turned us all into millionaires, for little or no effort, but unfortunately such miracles don't exist."

With a healthy dose of skepticism and an enquiring mind, I invite you to learn about the principles of wealth creation and to put these principles into practice in the way that works for you.
PART ONE: YOUR PATH TO SUCCESS

1. The Psychology of Wealth Building

We all have dreams. Your dream is to build your personal wealth and retire comfortably. But, without a carefully planned long-range strategy, your dream will not become reality. The key issue is what wealth-building strategy you will adopt to get there; success is all about strategy.

In the real world getting what you want is a battle, but, your first adversary is in the mirror, because the war is with yourself.

We could ask, “What do exceptional achievers, like millionaires, Olympians, top businessmen, and Oscar winners have in common?” They are, by definition, motivated, passionate people, even obsessive to some degree. They have a strong drive to achieve that which is difficult in life. To those people life is a voyage where the wrong turns help them discover the path to their own pot of gold. Again, they will be optimistic by nature, which encourages them to keep getting up every time they are knocked down. In this respect they will be in the minority, not "normal," because unfortunately, normal people are unlikely to achieve abnormal results.

This doesn't mean champions are born abnormal; they learn to do what they need to do.

Personal change is at the heart of motivation because, almost certainly, you will need to become a different person to achieve outstanding goals. Regrettably, many are moving in certain directions, without being aware of their eventual destination—yet their arrival there is terribly predictable.

Much of the difficulty with motivation is caused by a conflict between goals. For example, to lose weight we need to become a person who is less fond of food or more prepared to walk, than say, take the bus.

The other problem is with the clarity of the goals: many people, in a broad sense, want to be rich, but they don't define how rich. They don't calculate a figure and work back to how much per year or per month they need to accumulate. Recent clinical research has shown that virtually no one has a clear understanding of what their goals are; it is all very inexact, yet, being clear about your goals has been found to be one of the most powerful factors in motivation.
Our desire to avoid risk is because we imagine coping poorly with failure, yet, again, current research indicates that, even if things don't go according to plan, we will probably cope better than expected. Those who would like additional information regarding this topic can go to:

http://ld.stanford.edu/compass/goal.html

Research from Stanford University divides people into three groups, determined by what psychologists term "time perspective."

- **Past Thinkers** are directed towards the past, are influenced by past mistakes and are wary of repeating them. They tend to be conservative and so, are reluctant to experience the unfamiliar, or, deal with change.

- **Present Thinkers** live for the moment, disregard the past and rarely consider the future consequences of their behaviour. They tend not to plan ahead and are unconcerned about rewards or punishments in the near future. They are unable to delay gratification and unable to plan for the future. Juvenile delinquents would fit into this category as would those with suicidal tendencies.

- **Future Thinkers** are good at setting and achieving goals, particularly long term ones. They are able to resist temptation, because they have an ability to see the negative consequences in the future.

So why do these classifications matter? Because your time perspective has been found to be predictive of how likely you are to yield to life's problems and how likely you are to achieve your goals.

I think a little "pat on the back" is appropriate here, because if you are reading this book then you are probably, by deductive reasoning, a future thinker. That's a good start; but the challenge will now be how much of your current lifestyle you are prepared to forgo (delayed gratification) for the future benefit (financial security).

In achieving your goals, it has been found that the most intractable motivational problem is that of procrastination—putting off decisions until tomorrow, notwithstanding that you know that you should make them today. This tendency to procrastinate strongly predicts less successful outcomes in most areas of life and it is associated with depression and poor self-esteem.
Joseph Ferrari of DePaul University in Chicago has been studying this problem and has established that procrastinating needs vigorous treatment. It has been found to be strongly linked to perfectionism and a fear of making mistakes and it leads to postponing a decision as a way to avoid the inherent risk in all decisions.

**Responding to Failure**

We all experience failure—winners even more than most—but what characterises the well-adjusted personality is their response to that failure. Winners understand that failures teach them valuable lessons about what they need to alter in order to reach their goals. Naturally, if you believe that any failure confirms your inadequacies you will seek to avoid risk. The downside of this behaviour is that you will miss out on a fundamental way to achieve personal growth by challenging yourself.

And, of course, this is the lesson from Scott Peck's wonderful book The Road Less Traveled. He teaches that life is about facing and solving problems and growing in self-confidence and self-respect by so doing.

In addition to time perspective, people can broadly be classified into one of two groups: optimists or pessimists. This classification has also been found to be one of the most important and highly predictive. Optimists are those who can persevere in the face of a setback and they are likely to be successful in life. The key difference between winners and losers has been found to have little to do with failure but has to do with the reaction to failures.

Interestingly, pessimists have been found to have a more rational view of reality than the "starry-eyed" optimists, but pessimists miss out because, while optimists persist in the face of adversity, the pessimists have long given up and gone home. It is precisely because optimists persevere that they eventually succeed while pessimists fail because their experience leads them to believe their efforts are a waste of time. Their low self-confidence comes from self distrust and low self esteem, whereas, the self-confident are the most tenacious in their attempts to advance themselves because they believe they are worth it.

So, how do you overcome these negative feelings? You expose yourself to a variety of situations; those that might cause temporary discomfort but, on the other hand, offer the opportunity to enhance your ability to cope. This will build your ability to adapt to new situations and thus your self-confidence and your self-respect.
Getting Out of Your Comfort Zone
The problem with this approach is that we need some fear to enhance performance. Remember that most skills and most of your positive experiences probably followed an initial uncomfortable baptism, which, with practice became familiar, even enjoyable.

Remember your first speech, learning to drive, your first date, your first day at school, homework and many other activities. Remember how you were forced to do many of these things against your will but how you learned to cope and eventually, with practice, became competent and consequently enhanced your self-esteem.

If you can bring yourself to challenge yourself, like you were once forced to do, your relationship with yourself will change: you will increase your opinion of yourself.

You can't avoid stress—even love causes stress, so stress and crises, great or small, are part of everyday life. It has been found that those who cope best do not focus on problems, but focus on solutions.

So, to sum up, what the study of motivation theory shows is that if –
1. you don't have significant goal confusion,
2. you are absolutely clear about your goal,
3. you track diligently and respond suitably to what your tracking is telling you, plus
4. you ensure your resources are adequate,
then the world is there for you to conquer - research clearly says, it's that simple.

So, why do some people always seem to fail? The startling answer could be, because they choose to!

Self-Sabotage
This common behaviour is called self-sabotage and is a new field of study in psychology. Surprisingly, we sometimes choose failure, albeit subconsciously, because it has some positive consequences whereas to risk success and fail would have negative consequences. This is described as a "trade off." We often make poor choices by focusing on short-term consequences at the expense of the long term. So, for example, the obese claim losing weight is their dearest wish, yet they may eat to cheer themselves up. Self-sabotage is occurring because their key desire is really to be
cheerful, not thin. But, the most startling reason for self-sabotage is that we manage to obscure, emotionally, what a success or failure would tell us about ourselves.

Discovering how attractive/unattractive or intelligent/unintelligent we really are might be deeply painful. So, this strategy provides a ready excuse if we do fail.

Success or failure has powerful messages for our view of self and therefore our self-esteem. We instinctively act to protect our self-esteem at all times, so sabotaging a challenge provides an "apparent" explanation for failure ("I was drunk") when the "real" explanation ("I'm not that smart") would be much more damaging to our self-esteem. In this way, self-sabotage is a trade-off that sacrifices your chances of success for psychological protection from the implications of failure.

So, the major new message is, if you want to succeed, the major obstacles you need to remove are not those erected by others, but, the impediments you have placed in your own way. It is only by mastering ourselves and our basic emotions—fear, greed, rage, panic, insecurity, envy—that we can gain control over your destiny.

All the great philosophers exhort us to conquer our inner world first. They teach that life is a "self-fulfilling prophecy" and this is because Belief dictates Behaviour which determines Outcome which confirms Belief.

I follow with a humorous poem called “Procrastination,” a subject well known to pessimists:

_I hesitate to make a list,
Of all the countless deals I've missed,
Bonanzas that were in my grip,
I’ve watched them through my fingers slip,
The windfalls which I should have bought,
Were lost because I over thought,
I thought of this, I thought of that,
I could have sworn I smelt a rat,
And while I thought things over twice,
Another grabbed it at the price.

It seems I always hesitate,
Then make my mind up much too late,
A very cautious man, I sigh,
And that is why I never buy.
A corner here, ten acres there,
Compounded values year by year,
I chose to think and as I thought,
They bought the deals I should have bought,
The golden chances I had then,
Are lost and will not come again.

Today I cannot be enticed,
For everything is overpriced,
The deals of yesteryear are dead,
The market soft - and so’s my head,
At times a teardrop drowns my eye,
For deals I had, but did not buy,
And now life’s saddest words I pen
"If only I'd invested then!!"

(Farm and Land Realtor Magazine, October 1917)
2. Why So Many Fail

If we could transport ourselves back at least ten years, knowing what we know today, can we agree that there have been numerous, if not millions of, opportunities to become wealthy?

The answer is obvious isn't it?

So, on the one hand, there have been lots of opportunities, while on the other, some 95% of people retire broke? What is the explanation for this apparent conundrum? Why do so many fail? What holds them back?

Well, it isn't a lack of opportunities.

The answer is in the mirror.

It can be said the greatest obstacle to your future success is YOU! As Henry Ford famously wrote:

“You Can If You Think You Can!”

If you think you are beaten, you are,
If you think you dare not, you don't.
If you like to win, but you think you can't,
It is almost certain you won't.
If you think you'll lose, you're lost,
For out in the world we find,
Success begins with a fellow's will.
It's all in the state of mind.
If you think you are outclassed, you are,
You've got to think high to rise,
You've got to be sure of yourself before
You can ever win a prize.
Life's battles don't always go
To the stronger or faster man.
But soon or later the man who wins,
Is the man who thinks he can.

Attitude is everything - the bottom line is that only you can choose how you live your life! To concentrate on the negative is the major limiting factor. Remember, all action is
preceded by thought so poor attitude leads to a lack of confidence, which means no belief and therefore no action and therefore no wealth.

To become wealthy you must educate yourself to see the positive aspects of any situation. Don't allow the negative perspective to undermine your well deserved dreams. Don't give in to your excuses, and to obstacles that your mind creates and which "appear" to require you to do nothing, or, at least, defer our decision until tomorrow.

In order to think like this you need strong motivation and a strong desire to succeed because that is the only way you will overcome the negative thoughts that we all encounter.

Not so sure that we all share these thoughts?

Our greatest Olympian, and arguably one of the greatest of all time, was Herb Elliott. Herb was never defeated over 1,500 metres, or a mile, and retired at 22!

In a book Herb edited he recounted his race to Olympic victory –
“We got to the half way mark & I can still remember the white line, the finishing line, go under my feet & thinking: two laps to go. This was the moment I guess that I, like most of the people, would have thought that, at that moment, I’d have a voice inside me saying - “Herb, this is your moment. This is the time that you’re going to establish your superiority. Show these guys a clean pair of heels, leave ‘em behind . . . show them what you’re made of . . . give yourself the opportunity after all the work you’ve put in the last four years’ etc etc.”

And the voice did come into his head. What do you think it said?

“Herb, you’re buggered! You’re buggered . . look, you didn’t expect to feel this tired at this particular point, so why go to the front now? Why not wait another lap? Stay where you are in fourth position & wait until the bell goes. You’ve still got plenty of time to win this thing.”

History records that Herb ignored that voice and went on to win Olympic gold.

Herb continued, “The popular image is that the champion goes into an event absolutely confident. And it’s true that there is part of you that feels that way. There is part of you that has to feel that way. But underneath it all the subterranean you is riddled with
uncertainty and doubt and vulnerability. It’s the people with the right mindset who jump the hurdles & go on to success.”

“It (the little voice) lives with us throughout the days and nights of our lives. It can be a ‘doubting’ voice – persuasive, convincing – turning us away from the things we know we must do. No one is immune. Champions hear that negativity too … but choose to ignore.”

Albert E. N. Gray said in 1940 at the National Association of Life Underwriters (NALU) annual convention in Philadelphia, Pennsylvania, “The common denominator of success--the secret of success of every man who has ever been successful--lies in the fact that he formed the habit of doing things that failures don't like to do.” While the minority of us achieve success, the majority don't because success is not natural and is not achieved by following our natural likes and dislikes, preferences and prejudices.

Malcolm Forbes, billionaire and owner of Forbes Magazine said, "Even failure is success if we learn from it."

John Eales, our retired Wallabies captain, added in Herb Elliott’s book “What is desperately important is to be aware of two things: that everyone else is going through exactly the same thing and that you’re not going to be successful if you stop.”

You either have a strategy to create the results you want or you will be stumbling along complaining that you never seem to get a break. And remember, that your life is the way it is because you have created the situations you are in. Every choice you make - including the thoughts you think - has consequences. When you choose the behaviour or thought, you choose the consequences. When you start choosing the right behaviour and thoughts - which will take a lot of discipline - you'll get the right consequences.

Don't be surprised to know that even the most destructive behaviour has a payoff, so be alert to the possibility that your behaviour is controlled by fear; it's easier not to challenge yourself, to do nothing.

I suspect that Jack Lemon (Grumpy Old Men) had it right when he said “the only thing I know is that the things you regret in this life are the risks you didn’t take.”

**Take the Plunge!**

Life rewards action. It's what you do that records the story of your life and you should only measure yourself by results, not intentions or words. Know that you will need to leave the comfortable and familiar behind if you are to move upward.
Create a strategy, take charge and hang on. If you know where you want to go and you have the faith in yourself you can win. Why faith? Well faith is the ability to believe, or to make decisions, with incomplete data, and if we are talking about property, the most important information you need in order to make a decision is the information you can't get—what will the value be tomorrow? So, to be successful requires strong self-confidence and that is the point where the widespread curse of negativity causes so much damage.

Only action leads to success. Do it! Don't sit around and think about what you want to do. Take action that leads you towards, not away from, your goals. Of course, the meek will say “I know I am sitting on the fence, but what if I get off on the wrong side?” I say, it doesn’t matter, at least you will know sooner that you are heading in the wrong direction!

So, how do you overcome these negative feelings? Again, expose yourself to a variety of situations; those that will most likely cause temporary discomfort but, on the other hand, offer the opportunity to enhance your ability to cope. This will build your ability to adapt to new situations and build respect for yourself.

The message still is, if you want to succeed, the major obstacles you need to remove are not those erected by others but the mental impediments you have placed in your own way.

Negativity and pessimism is widespread among the psychologically unwell and indicates a tendency to assume that the worst is inevitable; this supports chronic worry and a tendency to take things personally.

**What Makes You Happy?**

Everyone is pursuing happiness, but recent research has found that mental health is best established by aiming for mood stability rather than extreme happiness. In fact, the pursuit of intense happiness, will, in all probability render depression more likely because people who experience strong positive emotions are also likely to experience forceful negative feelings as well. So, the issue for depressed people is how to feel emotions less intensely.

Those prone to depression seem to interpret bad events as internal (caused by themselves), global (will happen in other spheres of life) and stable (will continue to
occur). On the other hand, those prone to happiness do not make these internal, global and stable interpretations for bad events, yet they do make them for good events.

Intense moods are seen to be the consequence of investing too much of one's sense of well-being in too few spheres of life.

Most psychologists now subscribe to the view that happiness results from the perception of being relatively well off rather than actually. Therefore, they have found that people can be unhappy in almost perfect circumstances yet happy in tough ones.

In particular, happiness depends on how small a gap there is between what a person hopes to achieve and what they are actually achieving and these aspirations are based largely on comparisons with other people and our own past experience.

Interestingly, it seems that happiness does build on hardship because the standard for comparisons does anchor in earlier experience, therefore people tend to be happier after hard times.

Change requires effective coping skills and they are not just helpful in the short term but are essential to preserve and enhance your long-term mental health. Half the art of successful coping is to not make things worse than they already are. These skills don't just help people deal with negative events; they also help them make the most of life, because confidence in your coping skills lessens your feelings of vulnerability.
PART TWO: PLAN FOR YOUR FUTURE

3. Time Waits for No One

Rough estimates by *The Age*, from available historic data, suggest that with today's average wage, for a male in full time employment, approximating $60,000 per annum, full-time workers can buy three to four times as many goods and services as their counterparts in 1941, and more than half as much again as in 1973.

But detailed bureau statistics show that the average wage is far from typical. In fact, 62% of full-time employees earn less than the average. Nevertheless, even on an income less than the average you can transform how you earn, save, and invest.

Notwithstanding your belief that you have left creating your "nest egg" to too late in life, it is not too late, even if you are in your forties, fifties, or sixties. These special strategies can make you more than you could imagine; more than if you had started much younger.

Take the First Step

The Chinese philosopher Lao Tzu said, “A journey of a thousand miles begins with one step.” The same can be said for building wealth—if you want to make millions, you’ve got to begin with that very first dollar; or, perhaps ten dollars.

You probably have ten dollars in your pocket right now. Could you set it aside today? Could you save ten dollars every day? If you can, you will save $3,560 per year. Can your partner save a similar amount?

Now you are saving $7,120 a year.

Are there any other ways you could apply the same principle? What about if you forgo your cigarettes or your monthly subscription to cable TV? How about taking your lunch to work, or getting your employer to match your contributions to the superannuation fund?

If you could each save just ten dollars per day, at the end of 25 years, at a 10% compound growth rate, you would have accumulated over $770,000!

The maths is easy and the sacrifice is minimal. You can do it!

The Retirement Crunch
In 1909 the government set the retirement age at 65. What appeared to be a generous policy was, in the best traditions of politics, not what it seemed, because at that time the male life expectancy was 60!

By 1947 male life expectancy had increased to 67, leaving the government liable for welfare support for an average of two years. Today the life expectancy in Australia is 79 for men and 84 for women increasing the liability for welfare to 14 years for men and 19 years for women.

In November 2004 the Productivity Commission issued a draft report on the economic implications of ageing. Consider:

- In 1904 less than 1 in 25 Australians was aged 65 or more.
- Today that figure is 1 in 8, and
- By 2045 it is projected to be 1 in 4.

In fact, projections indicate that over the next 25 years, in the world's developed countries, for the first time in recorded history the old will outnumber the young. Give some thought to the massive implications of that!

What does retirement hold for you? Financial guru Ross Greenwood reports that right now, most Australians are retiring with a lump sum that is just one-sixth of the required amount to sustain a "comfortable lifestyle." And the definition of "comfortable" allows a mobile phone and a digital camera, a family roast once a fortnight, seven glasses of wine a week, one expensive restaurant meal a week or alternatively a RSL club meal three times a week, a renovated bathroom or kitchen every 20 years, and a budget overseas holiday once every five years.

For a couple, that requires savings of around $470,000 cash or cash equivalent, which does not include the family home and car. Ross Greenwood said that the "me" generation—the luckiest of them all—born in the 1950s and '60s, has enjoyed free spirits, free loving and one of the most prosperous periods in the world's history.

Blissfully ignorant, the vast majority of the me generation is going broke, but they don't even know it.
The Ant and the Grasshopper
Do you remember the fable about the ant and the grasshopper? The ant prepared early for winter by storing away food. The grasshopper, seeing the sun shine every day, didn’t think advance preparation was necessary. You know what happened to the grasshopper when the snows fell. Don’t let the same fate befall you!

The decisions you make now will have a direct bearing on your future. Basic financial planning is simply the management of what you earn compared to what you own and spend.

You can basically classify people into two types:

• Those that spend and then save (the "normal" 95% of the population), and
• Those that save and then spend (the "abnormal" 5%).

The American businessman, philanthropist and self-help book author W. Clement Stone once said, “A part of all you earn is yours to keep, and if you cannot save money, the seeds of greatness are not in you.” He is correct. If you are not prepared to compromise your present lifestyle to build for your future, you have no chance. You need to save and you need to employ the principles of compound growth.

Have you thought about how much wealth you want to create?

Are you happy to create wealth in line with the average?

The 1996 Census indicated that less than 4% of retired Australians over 65 have an income greater than $700 per week (the 2006 Census increased that to $1,000). So, by deductive reasoning, after working until the age of 65, 96% of Australians retire with insufficient assets to enjoy a comfortable retirement. So this "average" yields few rewards because, at retirement, they now face the largest debt they will ever face—how to feed themselves for 20 years, without a wage!

We all want a comfortable retirement, which means starting now. For someone starting late the figures are challenging. One of the major banks calculated that if you want to retire at 65 years of age on 75% of your retirement salary you need to contribute:

<table>
<thead>
<tr>
<th>Age now</th>
<th>25</th>
<th>30</th>
<th>35</th>
<th>40</th>
<th>45</th>
<th>50</th>
<th>55</th>
<th>60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Female % of salary</td>
<td>20%</td>
<td>24%</td>
<td>30%</td>
<td>37%</td>
<td>49%</td>
<td>69%</td>
<td>108%</td>
<td>227%</td>
</tr>
<tr>
<td>Male % of salary</td>
<td>16%</td>
<td>20%</td>
<td>24%</td>
<td>31%</td>
<td>40%</td>
<td>57%</td>
<td>89%</td>
<td>187%</td>
</tr>
</tbody>
</table>
What is the secret?

Let's imagine that King Arthur asked Merlin the Magician for the one absolutely fundamental secret to the creation of wealth. To find that one secret Merlin distilled all the advice from all the expert sources in the land and when he was ready he appeared before King Arthur and passed on to him just one word. What do you think that word would be?

TIME

If there is one secret to achieving financial independence it is TIME. Give yourself time to create your future. Thanks to the miracle of compounded interest, the earlier you start, the easier is your task. Here’s why:

<table>
<thead>
<tr>
<th>Savings Goal</th>
<th>Period</th>
<th>Compounded rate</th>
<th>Investment per year</th>
<th>Total investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>$500,000</td>
<td>10 years</td>
<td>6%</td>
<td>$35,787</td>
<td>$357,870</td>
</tr>
<tr>
<td>$500,000</td>
<td>20 years</td>
<td>6%</td>
<td>$12,823</td>
<td>$256,460</td>
</tr>
<tr>
<td>$500,000</td>
<td>40 years</td>
<td>6%</td>
<td>$3,230</td>
<td>$129,200</td>
</tr>
</tbody>
</table>

To express this effect in another way—if an asset doubles in value each decade (10 years), then here is how it compounds over a 40 years working life:

<table>
<thead>
<tr>
<th>$1 invested at age 25</th>
<th>Is now worth</th>
<th>Increase in value each decade **</th>
</tr>
</thead>
<tbody>
<tr>
<td>At end of 1 decade (age 35)</td>
<td>$2</td>
<td>$1</td>
</tr>
<tr>
<td>At end of 2 decades (age 45)</td>
<td>$4</td>
<td>$2</td>
</tr>
<tr>
<td>At end of 3 decades (age 55)</td>
<td>$8</td>
<td>$4</td>
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<tr>
<td>At end of 4 decades (age 65)</td>
<td>$16</td>
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** See how the growth in each decade is twice that of the previous decade – it is accelerating! This is compounding in action and if you employ this principle wisely you cannot fail.

Regrettably, by the time most of us find out how powerful compounding is (Albert Einstein is reported to have said it was one of the wonders of the world), it may be too late!

Can you guess how much $250,000 would be worth in 10, 20, and 30 years if it was compounded at 5%, 10%, 15%, and 20%?
You will see that a 15% growth rate is only three times that of a 5% growth rate, yet, it performs 16 times better over 30 years—how amazing is that? So remember a few percentage points over a long period of time can make an astonishing difference. Again, this is the reason you must to select growth areas rather than those with less potential.

Why not harness these principles to your advantage?

To start at 25 years of age gives you four decade periods and the potential to multiply your investment by 16, but to start at 45 gives but two periods and a potential to multiply by only four—half the time equals one quarter of the potential!

If you are happy to achieve an annual retirement income of 75% of your final salary, and that income is, say, $50,000 ($1,000 per week), you will have to accumulate assets which will generate (yield) that amount each year. If you work on a net 5% return (yield) then you will need 20 times that amount, or $1 million, excluding the family home and cars.

If you now feel totally alone, take solace from the fact that your fellow Australians are achieving only 50% to 70% of these amounts.
4. Debt, Taxes, Leverage, and Superannuation

Most of us have enjoyed excellent gains from borrowing to buy our own house. And yet, repaying non-deductible debt (your home) is much more difficult than tax deductible debt (your investment property).

To buy a home and pay an interest rate of say 6% on 80% of the debt is a very expensive exercise, because, in order to pay the interest, from after-tax money, you need to earn more than that pre-tax. An investment property, on the other hand, with interest of 6%, will cost around 1% of the contract price (in cash flow terms) for the 31.5% MTR taxpayer, and that is assuming you borrow 105% of the contract price (to allow for costs). Interestingly, if you borrow at 8% the cash flow cost will rise to around 2.5% of the contract price. But remember, the cash outflow in year 1 should decline in future years, as rents grow. A maximum MTR (marginal tax rate) taxpayer will get that cost down to around nil cash outflow (at 6% interest).

In reality we all live with debt, whether it is in the form of credit card debt, lease debt or lay-by to buy our furniture.

The *Australian Financial Review* in its "Smart Money" section of June 2002 said "Debt can be the magic pathway to success - if you know how to use it." And, that's the key: not the debt, but the management of it.

The ATO (Australian Tax Office) makes it virtually impossible for the average investor to become wealthy from their income stream so acquisition of some debt is mandatory if you want to achieve financial independence.

The key is not so much the debt but where it is invested and the cardinal rule is only borrow to invest in appreciating assets and only those with an income. Of course, all assets are not equal. The financial losers borrow at 20%, or more, to invest in furniture and other items that make them feel wealthy, while the financial winners borrow at 6% to buy quality assets.

The famous American comedian Milton Berle said, "Poverty is not a disgrace, but it's terribly inconvenient." And, it is terribly inconvenient at the worst possible time, retirement time, when you are hoping for an easier life, finding your skills draining away, finding few employers wanting to employ you and without enough money, energy or
time to acquire new skills. Now that is stress! Kerry Packer got it right when he said, "If you think investing is risky, wait until you get the bill for not investing."

In America the answer seems to be to start a new business! Recent figures have revealed that the most entrepreneurial age group in America, in terms of starting new businesses is the over 55's. It is not hard to guess why?

Taxes

The seventeenth-century French statesman Jean-Baptiste Colbert said that the "art of taxation is in so plucking the goose as to get the most feathers with the least amount of hissing."

Money magazine (September 1999) wrote "our negative gearing laws and the way they relate to property, makeup about the silliest set of laws Paul Clitheroe has ever seen. But you can make them work for you." Paul’s article said “Most other major economies have tax breaks that help their citizens to buy one home and to live in it. We, on the other hand, have decided to make it really difficult for Australians to own their own home but very simple for a minority to own dozens of investment properties, paid for with someone else’s money and all funded by the taxpayer."

What Money magazine is talking about is the government's tax-sponsored encouragement to the average Australian to begin building wealth. If that can be achieved for around $100 per week (in cash flow terms) can anyone understand why so few achieve it?

Leverage The average person can't get wealthy from their wage, yet there are loads of people who have made $40,000 in a year via the increase in the value of their investment property. But, how many have saved $40,000 from their salary? Unfortunately, many believe that they do not have the capacity to be wealthy in retirement. They observe that some build wealth relatively easily yet they don't quite know how they do it.

If you sensibly apply the principles of compound growth you cannot fail. If you don't you cannot succeed. And you can magnify the effect of compound growth with leverage (gearing).
Let's consider a simple example of saving $100 per week. In 12 years time without interest, taxes or bank fees you would have over $62,400. But if you used that $100 per week to buy an investment property for $250,000 and it had grown by a modest 6% to $500,000, your equity (your share) would be worth $250,000, before tax and other charges.

And, guess what? It is possible to acquire a $250,000 investment property for around $50 per week (in cash outflow terms).

**Superannuation**

Until the recent changes, allowing over-60s to take their superannuation free of tax, the relative benefits of investing in superannuation, for the vast majority of taxpayers, has been illusory. This is because over 80% of taxpayers are on a marginal rate of 31.5%. In the past they would have, at best, paid as much tax on their super as they would have on their income, but now the game has changed.

Super has the great advantage of an attractive tax regime, especially compared with investments in personal names where investment income is subject to marginal tax rates.

For investors in the pension phase, the fund pays no taxation and receives a cash refund of imputation credits on franked dividends. In the accumulation phase, the income tax rate is 15 per cent. The fund also receives a tax credit for imputation credits to reduce this liability to lower levels.

The big winners from the new laws are those who can salary sacrifice or who can claim a tax deduction for their own contribution. Salary sacrificing, for higher income taxpayers, generates tax savings up to 31.5% immediately. These benefits provide a cushion for times when investment returns are negative.

**How Much Do You Need?**

My simple method for working out how much you'll need to finance your retirement is-

- Determine your required weekly gross (before tax) income in retirement and then add three noughts.

<table>
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<tr>
<th>Required gross retirement income per week</th>
<th>Capital required</th>
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<table>
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<td>$1,200</td>
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The proof to this formula is that if you invest the capital (as per the right hand column) at 5% then it will return you the income shown in the left hand column.

Is your estimate of your weekly needs in retirement realistic? Is $1 million enough to retire? With life expectancy and lifestyle expectations on the rise, it may not last as long as you think.

According to calculations from Russell Investments, if you begin at age 65 to draw down your $1 million accumulated balance for the next 25 years, within only six years you would qualify for a part pension. By age 85, your government pension would provide 25% of your income. By the time you reached 90 a Centrelink payment would be your sole source of income.
PART THREE: WHERE TO INVEST?

5. Buffettology and the Stock Market

Much has been written about the successes of Warren Buffett, perhaps the most successful investor (not speculator) in stock exchange history. His philosophy of "business perspective investing" with its accent on compound growth provides lessons for all.

In 1956, using his personal savings of $174,000, Buffett founded Buffett Partnership Ltd., an investment partnership in Omaha, Nebraska, USA. By 1962 he was a millionaire, and today his net worth is estimated to be $37 billion, making him the richest man in the world. He has achieved an annual compound growth rate in excess of 23% for more than 30 years.

"Folly" and "discipline" are the two keys to his investment philosophy: his discipline and others' follies. Other people's follies, brought on by fear and greed and the tendency of the inexperienced to get caught up in the herd mentality, will offer opportunities to the disciplined investor. When the market drops and the lemmings are going over the cliff, Warren is investing from a business perspective and buying.

He searches for stocks selling at a price below his calculation of their intrinsic value. This intrinsic value is the projected compound growth rate that he calculates the investment will generate and this figure is fundamental to his investment approach. This long-term view can only be applied to those businesses whose future earnings are reasonably predictable, and in order to be regarded as predictable they need to meet certain criteria; but, that is another story. In this way, one could say that this approach is "negative" in that it helps to cull out the majority of opportunities that one should not consider, rather than the opposite. In this way clever investors are often looking forward to a falling market to add to their portfolio at a price they regard as "value."

When I consider Buffett's philosophy I think about the late Don Scott, who was a legendary punter some 20 years ago. I read his book The Winning Way to Successful Punting, which explained his highly mathematical system for rating horses and calculating what their odds should be. Where he could back horses using his assessment of the odds, not the bookies', he would bet. Don Scott was very successful 20 or 30 years ago, but it is generally accepted that because he was so successful and
so many people followed his system that it lost its edge. And this applies to all assets; as the Yanks say, "when the bellhop is buying it's time to sell."

**Look for Value in Bargains**
Buying properties in unfashionable areas is a great way to achieve outstanding returns. Why? Because if the area becomes popular a re-rating occurs, which means yields drop and, therefore prices jump. Now, this will be an argument that promoters of positive cash flow properties will use. The difference, however, is that neither Don Scott nor Warren Buffett put all their eggs in one basket. Buying one or two properties will be betting your future on one throw of the dice and it will be years later before you find out whether your numbers have come up. If you get it wrong you will be losing the magic qualities of compounding, which works dramatically better the higher the rate of return and with the more time you allow it.

Looking back on my early days as a stock broker I notice that I concentrated on stocks that had valuable real estate. I was especially keen on the Sydney city retailers and had clients with around 10% of the capital of Anthony Horderns as well as significant holdings in McDowells. My promotion of the take-over of Anthony Horderns was probably my most successful big deal.

I calculated that the retailers share prices were less than the value, per share, of their tangible assets. I analysed their balance sheets and wrote off the intangibles (goodwill) and also discounted totally any value for plant. Then when their prices were below their tangible assets I would recommend them to clients.

Warren Buffet has a similar approach with businesses, but with even tougher criteria. To be selling at less than his calculation on intrinsic value is not enough. He wants the business to have elements of a consumer monopoly or features that insulate it from competition. In other words, he is analysing the business from a "worst case scenario" basis.

When I relate that approach to property it reinforces my view about concentrating on capital cities and major centres only. It's the old story; anyone can make money when the market is rising, but what about the opposite?

**A Penny Saved Is a Penny Earned**
It sounds trite, but it’s true. You can increase your available pool of money for investing not only by earning money from your job, but by saving money that you would ordinarily spend. Spending costs you twice: the money out of your pocket and also the lost "opportunity cost."
For example, if you could forgo investing $30,000 in a new car and you invested it to show a 20% return, at the end of 10 years you would have $185,782 years as opposed to a car worth next to nothing.

**Do the Pros Beat the Stock Market?**

Very few stock-market investors are as successful as Warren Buffett. It is easy to assume that professional investors would be better at picking stocks than you or I. That’s why people like mutual fund managers get paid huge salaries and bonuses.

This is what Time magazine wrote –

**Title: Why U.S. funds aren’t up to par.**

**Subject(s):** MUTUAL funds

**Source:** Time Australia, 27 January 1997 Issue 4, p52

**Author(s):** Kadlec, Daniel

*The pros are expected to beat the market. Most of the time, they don't. Most people wouldn't bet their retirement savings on a one in five chance—would you? They should check their latest mutual fund statement. They may be gambling more than you know.*

One of the fund industry’s not-so-funny little quirks is that most stock fund managers can’t beat important benchmarks like the Standard and Poor’s 500, even though they try with all their might. That index represents the average stock. In theory, half of all funds should beat it while half fall short. In reality, in the past 10 years only 20% of diversified, actively managed U.S. stock funds have done better.

Laggards include big names such as Income Fund of America, with assets of $16 billion, and Fidelity Puritan, with assets of $19 billion. In plain English, fund lovers, this means the vast majority of you, through fees levied against your funds, have been paying professionals for the privilege of losing your money. That’s only supposed to happen in baseball. According to Lipper Analytical Services, last year just 25% of stock funds matched the S&P 500. In 1995 the number was a pitiful 16%, and in 1994 it was 23%. If fund managers simply threw darts at a stock table, you’d expect more to match the benchmark.
This is no small matter. Over time, lagging stock funds take a huge bite out of what you might have earned. During the past 10 years, the average stock fund rose 260% vs. 314% for the S&P 500. If you had invested $10,000 in the average fund, it would have become $36,000; in the S&P 500, $41,400—15% more.

What are you doing about this problem? Throwing more money at it. The public pumped an estimated $223 billion into stock funds last year, nearly all of it into actively managed funds. It has been amply rewarded. "Measured against where all the money was 10 years ago—in banks—they've done great," says Robert Schmidt, president of Individual Investor Group, a financial magazine publisher. He's right—up to a point.

Even bottom-tier funds in the 1980s and '90s have been good enough to embarrass bank CDs, the likely repository for savings that aren't in stocks. Still, people left CDs for a reason. Having correctly made that tough decision years ago, they should not be grateful now for lackluster results. Even though their money on the whole has more than tripled in stock funds in 10 years, it could have quadrupled if only more managers were simply average.

There have been plenty of good funds, of course. In the same 10-year period, Twentieth Century GIFtrust rose a whopping 617%, turning $10,000 into $71,700. FPA Capital jumped 595%; PBHG Growth Fund popped 589%. And the really good news is that the 20 largest stock funds, which together account for nearly a third of all assets in domestic stock funds, have come much closer to matching the S&P 500 than most. If you own any of the winners, count your blessings. Just don't count on continued outperformance.

The sad fact is that fund investors have the deck stacked against them when it comes to beating the averages. Here's why:

Fees: The fund industry never met a fee it didn't like. There are management fees, 12b-1 fees, custodial fees, transfer fees, accounting fees, directors' fees and professional-services fees, to name the most common. This litany of levies, assessed each year, typically totals 1.4% of assets in a fund and reduces the return by roughly that amount. And that doesn't include the impact of one-time sales charges of up to 6%. Such "loads" aren't reflected in official performance data but are a cost that cuts into your results.

Turnover: In the typical stock fund, four out of five stocks held at the start of the year have been sold by the end of the year. The trading costs subtract an additional .6% from a fund's investment gains.
Cash: The typical fund keeps 7% to 10% of its assets in cash, a stash to pay off investors redeeming shares. That part of the portfolio is a drag on performance when the stock market is hot.

"The costs eat you up," says John Bogle, a low-fee fanatic and chairman of mutual fund company Vanguard Group, which champions "index funds" as the surest road to long-term investment success.

Over long periods, Bogle says, it's inevitable that managed funds will trail the benchmarks by roughly two percentage points a year, reflecting their costs. But index funds such as Vanguard's Index 500, which mimics the S&P 500 by owning essentially the same stocks, have low fee structures and allow individuals to easily approximate the market's average return year after year. Last year the Index 500 rose 22.86% compared to 22.95% for the S&P 500. Over 10 years, the Index 500 has risen an average annual 15.04%, just behind the S&P 500 index gain of 15.29%. Meanwhile, the average general stock fund has been lagging: 19.4% last year and 12.5%, on average, each of the past 10 years. Historically speaking, those returns are phenomenal. But they pale next to the average returns easily available through index funds.

Last year's results suggest the gap is widening, indicating that something more than fees is the problem. Ironically, no one seems to pin it on the influx of thirty something fund managers hired as part of the industry's explosive growth. "In a bull market like this, youth is an asset," argues Michael Lipper, president of Lipper Analytical. The young have no recollection of, and thus no fear of, a declining market. That translates into being fully invested and having got the most out of stocks during this exceptional rally.

So what does account for the widening gap? When stocks are flying as they are now, even discerning managers blindly plow money into the big stocks that make up major indexes. They want to hold little cash so it doesn't drag down performance. But the cash comes into their funds so fast that they can't find enough lesser-known stocks to spend it on.

So they park ever more money in big stocks, which are easy to buy and sell, while searching for true bargains. That behaviour tends to drive up the indexes and leaves fund managers reluctant to sell their big stocks, which are rising. The end result is that large stocks take off, and the lesser-known stocks in most funds—the ones being counted on to provide the most kick and produce superior results—instead hold the funds down.
I finish with one of my favourite quotes.

John Paul Getty inherited his fortune from his oil magnate father, reportedly the world's richest man. John Paul's formula for success was: "rise early, work hard, strike oil" (and wouldn't we all like that) but more importantly he said, 

“When the economy is bad and property values are falling and everyone wants to be a seller, buy well-located real estate and hold onto it. Don't sell, whatever the critics, the cynics and losers might say. That way, you will end up very wealthy."
6. Cash Flow Positive

American comedian Rodney Dangerfield joked about his marriage when he said, "We sleep in separate rooms, we have dinner apart, we take separate vacations—we're doing everything we can to keep our marriage together." Obviously, not many would call that a marriage, because the premise on which the claim is built is flawed.

In the same vein I think of the 100-to-1 long shots at the races. Your friends say, "Just think how much you will make when they win?" Unfortunately, the reason why they are at those odds is for just that reason; they won't win!

Some promoters have identified a class of investor characterised by a morbid fear of debt! These investors are being encouraged to buy positive cash flow properties. Naturally, to become a landlord and increase your income in the process, sounds hard to resist, because doesn't all property double every 10 years?

Well no, actually, it doesn't.

Be careful! We all make money when the market is rising but consider the situation when it isn't—and that is most of the time. Is recommending the purchase of positive cash flow properties (which are invariably "in the sticks") in the buyer's best long-term interests? I very much doubt it, because the chances of success are very low. The inexperienced will, naturally, be attracted to the idea of borrowing less. However, in my opinion, it is a high risk and flawed strategy.

With property you usually face the option of high potential growth and a low yield or, nil growth with a good yield. Remember, our system taxes capital gain at half the rate of income, so, naturally, it is better to receive the gain in that way. However, if you leave your money in the bank you enjoy no capital gain and lose up to 46.5% in tax, whereas if you borrow for investment you receive a government subsidy of up to 46.5% of the interest and the bulk of the gain is in the form of capital on which you pay no capital gains tax until disposal.

Just like the stock market, the property market seeks a higher yield to compensate for a lower perceived capital gain potential. Note that if the income yield is high the market is telling you that the growth potential is low and vice versa. Now, of course, the skill is in finding those "jewels" where the market has assessed the odds incorrectly.
You may think, it easy to get these decisions right most of the time. But, I would suggest to you that there is no escaping life's basic premise - you win some and you lose some. Hopes dashed and hopes realised are all part of "life's rich tapestry" as they say.

Have you ever wondered what success rates the "professionals" enjoy?

An article in the Australian Financial Review dated October 200 titled "Strategies and confessions of the market's professional investors" was interesting. The article profiled Ms Tarditi of BT Funds Management. She was originally called the "senior international economic strategist" and then became the "asset allocation strategist." She also headed up BT's quantitative analysis team. Her previous experience was as a senior economist with the Reserve Bank of Australia. She is a University medalist with a first class honours degree in Economics and a Master of Science degree from the London School of Economics.

Ms Tarditi was asked, "It must be hard to consistently get the calls right? Are you often wrong?" She answered, "Even the cleverest analyst would be happy to correctly anticipate opportunities 65% to 70% of the time. The key to great strategy is the ability to recognise the 30% to 35% of calls which are not working."

**What I Learned as a Stockbroker**

We all want to concentrate our efforts on investments, and perhaps, speculative endeavours, that are rewarding. The experts call it "focus" and certainly success requires a single-minded approach. Again, I have found that eliminating what doesn't work, or what requires unreasonable risk, cost, time and effort isolates what could work, and that is where I concentrate my time.

My substantial experience has led me to have no interest in short term day trading, derivatives, futures trading, charting or options trading. This doesn't mean that they do not have a place for managers of substantial portfolios, and that is not to say that you can't make money out of charting, trading shares, options or derivatives, but you won't do it speculating (not investing) short-term. Forget trying to make an overnight killing; that's just a lottery!

There will be are current and potential traders who will take umbrage at this advice but you mustn't feel that you are unwanted. In fact, the opposite is the case; undisciplined, gullible traders are vital to the market to provide the professionals with their profits.
Make no mistake, futures trading, option trading, derivatives and day trading represent complex and sophisticated markets and the very real dangers are disguised by the impressive returns accumulated by a miniscule few at the expense of the many.

Thinking of undertaking an option trading course (or share trading, futures, etc.)? They certainly sound straightforward don't they? Well to show you they may not be as straightforward as you expect let me recount some of the history of option trading.

Theory of Trading
I follow with an abridged version of a British BBC television program, which will, hopefully, give you a sense of how complex and mathematically intense option trading is. This doesn't mean that option trading isn't a valuable tool for those managing a significant portfolio. With skill, and many, many hours, every week, if not day, you could, possibly, possibly, double the yields on their portfolio. To get sucked into the belief that "one person made a killing and you believe it is because of them" overlooks the millions of people who lost millions of dollars on other stocks.

The BBC programme started with the statement that academics, as a rule, make terrible traders. The academics tried to construct a formula to predict the "nature of chance" so they began with probability" theory, at first. After 15 years they found that their forecasting was no better than weather forecasting.

Then in the 1950s a mathematician found a book written in 1900 by a Frenchman Louis Bachelier. This book was a revelation because it built a mathematical model of markets based on their random nature and the author claimed that he could find a way to remove risk - unfortunately he died before he found it.

The theory related to options and a way of valuing them. The risk is that if one buys stock and the price falls one loses. It suggested that the answer was to buy an option and only lose the premium. The problem, however was how they are priced (valued). Academics loved the challenge and attacked it - they developed mathematical models.

They surmised that if they could describe mathematically (this is the 1960s) the expectations of investors, their risk aversion and all the psychological factors they could remove the risk. Regrettably the 1960s yielded no answers.

The Black-Merton-Scholes Formula

This was to change when a mathematician called Myron Scholes theorized about uncertainty. The Scholes' family had a history of buying
"penny dreadful."

Scholes found them exciting because the odds were that they could only take the upside. He knew that these stocks would fluctuate all the time and this would mean that the value of an option would fluctuate. He tried some different factors --volatility, period of contract, interest rate and value of risk, and found that he could quantify all these factors except risk. With his colleague Fischer Black they tried hedging the risk. They created a theoretical portfolio and took the opposite risk to the stock so that they balanced the risk to defuse the uncertainty - it was called "dynamic hedging" - it was essentially riskless - it removed the risk.

Scholes and his colleague Black developed the mathematical formula to value any option. It said, "If you know the value of the share you know the option value."

This problem had baffled mathematicians for generations as did the practical application of this formula because it was dogged by the time it took to reassess the risk as the various factors changed. How could they develop a method of quick real-time reassessment?

This problem was solved by Professor Robert Merton from Harvard Business School who made intellectual history with his abstract theoretical views. He reformulated his own complex mathematical model and found the final piece of the jigsaw. His answer came from rocket science (yes, rocket science) and the problem of plotting a rocket trajectory so it could be continuously updated. He used a "continuous time" idea to eliminate "all risk." The Black-Scholes-Merton formula culminated a 50-year quest by the finest minds. The formula:

\[ C = S_0N(d_1) - Ke^{-rt}N(d_2). \]

How simple is that?

Before publication of the model and the formula option traders were using it physically on the trading floor. Traders knew the risk at all times (via hand held computers) and by "dynamic hedging" and made more trades at less risk. The more contracts the better; to reduce the risk one has to trade everywhere and all the time.

In 1997, as a result of this work Scholes and Merton were awarded the Nobel Prize. Additionally, Scholes and Merton created a hedge fund and massive funds from banks and institutions flowed in. Many of the people at the institutions had studied under both of them. The raised $3bn and operated the Long Term Capital Management (LTCM)
fund in Greenwich, Connecticut in great secrecy. They undertook "dynamic hedging" in the opposite direction with spectacular success and they proved that academics could succeed in the real world.

LTCM achieved 20% in year one and 43% in year two and 41% in year three. Then slowly a change in market dynamics become apparent. The "Asian crisis" struck.

This event was so improbable that it was not taken into account, and the models began to give strange results. In a crisis, cash is king, and you must be able to get out once you have realized you have made an error. But the models said, "things will return to normal," so they borrowed $100bn, which meant that if they lost 3% ($3bn) all their original capital would be gone. They could continue if nothing else unexpected happened. But it did.

In August 1998 Russia defaulted on its government bonds, which threw the models hopelessly out of kilter. The model was based on normal behaviour but the behaviour was not normal. The fund began to lose $100ml day after day after day until one day it lost $500ml. They were down $1 trillion, which was equal to one year's expenditure of the US government. So the government had to bail out the fund.

Scholes and Merton lost millions and 15 of the world's biggest banks spent $3.65 billion in an unprecedented bailout. That's when recriminations about the "gambling nature" of hedge funds started.

What was interesting was that the crisis seemed to arrive from nowhere, indicating just how little financial operatives knew about the extent and location of the risks lying dormant in the system.

Ten years on little seems to have changed as the sub-prime loans crisis wreaks havoc across the world.

Interestingly, the formula, referred to earlier, is still being used million of times a day by traders who know when to use it and when not to. Its use needs intuition and experience. Over the years it has been found that some people do it better than others - those people can make a judgment that something is out of kilter and so they "head for the harbour" and wait for things to return to normal.
This judgment has nothing to do with degrees or even IQ. But these people are the ones you want protecting your money.
PART FOUR: YOUR REAL ESTATE SUCCESS STRATEGY

7. Have I Got a Deal for You?

When we hear about a “great real estate deal,” emotions flood into our brain cancelling years of educational achievements. This is why the books, seminars, and workshops of Special Strategies Pty Ltd are designed to educate you, keep you out of trouble, and inform you of the vast opportunities and risks in the changing world of investment, especially property investment.

One thing is clear: there is money to be made from real estate, even in hard times, especially by those who can learn to see the opportunities. Land is the one resource that underlies everything—the places you work, live, shop, and play.

What is real estate development? It is buying land and putting it to its best and highest use, acquiring old buildings and renovating or converting them, or aggregating a site for a shopping centre, subdivision, or medium density housing project that brings together the basic principles of timing, use, and location.

As you will learn, real estate is many things to many people. It is a tax shelter and an inflation hedge. It will fluctuate, but it will always be in demand—and give you profits. To succeed at real estate investing, you don't need to determine if real estate will boom, just when.

By reading this book and putting my experience to work for you, you'll learn what kind of real estate best suits you and your pocket and where it may be found, and you'll learn how to recognise a good deal and avoid a bad one.

In the end it all comes down to you. You will learn how to be responsible for the success or failure of your investments and you will learn to understand your own motivations.

There are great opportunities in real estate from which many fortunes will be created because the investor understood what he or she was doing and why. The workshops will help you develop that knowledge and to develop a strategy that is financially and emotionally rewarding.

Have I got a deal for you? No! There are rules and cautions in the books, seminars, and workshops. The path to wealth is there and the potential is unlimited. You're going to deal for yourself and discover the excitement and self-respect that comes from handling
your own real estate. Don't expect instant riches, but do expect the challenge to make money in stimulating ways.

Maybe that's the most basic thing I've learned in this business: you can make real money. Winning in property is just a matter of knowing how, and my company will guide you to that goal.
8. Getting Started

Here are six basic rules to remember as you move ahead with your property development strategies:

1. Only invest where population growth is positive. Population growth creates the demand for jobs, shops, factories, etc., not the opposite!
2. Establish the market rent and if you can't achieve a market yield, or better, don't buy.
3. Only borrow from lenders who will disclose the valuation to you.
4. Don't forget your safety nets:
   • Take landlord protection insurance,
   • Protect your partner with life assurance,
   • Protect your "bread winner" with disability insurance.
5. Give full consideration to the taxation considerations of purchasing as tenants in common.
6. Understand how the right loan can accelerate the repayment of your debts.

Where Is the Real Estate Market Headed?
Objectivity is important! You must not invest in a neighborhood or community just because you think it is charming or you happen to know it. Successful investors need to be able to step back and take the long view. Do your research. For example:

• BIS Shrapnel has recently reported that "Australia's [housing] stock deficiency is estimated to have increased from 22,800 dwellings at June 2006 to 60,200 dwellings at June 2007, as underlying demand continued to accelerate during the year, while total dwelling completion showed a modest decline," the report says.

• "The majority of Australia's stock deficiency at June 2007 is located in New South Wales, Victoria, and Queensland with the three states accounting for 94 per cent of the national total."

• Brisbane—"Underlying demand should remain high in Queensland throughout the forecast period, with overseas migration to play an increasing role in keeping demand high."

• Senior Economist, Jason Anderson from BIS Shrapnel, said in an April, 2008 report, "Household income growth in Queensland has been significantly higher than NSW or Victoria over the past three years, which, together with an extended phase in rents and reduced vacancies, translates to a positive outlook for good positive growth for Queensland."
BIS Shrapnel forecasts, Brisbane is projected to show the best growth over the next three years and, by 2010 will be leading the long-term growth average of Australian capital cities. BIS Shrapnel research also shows that Brisbane, which, of course, represents a barometer for the whole SE Queensland region, is showing an imbalance between supply and demand and as a result, is set to affect prices. Jason Anderson believes the Brisbane capital will soon face a direct shortage of housing, especially for renters.

Real estate author Terry Ryder from the Hot-spotting website says, "Queensland remains the property market of choice for investors across the country—particularly those with a long-term view….Queensland is driven by the pistons of strong state economy and nation-leading population growth. The major markets of southeast Queensland are well into a recovery phase and locations beyond SE Queensland continue to show life, especially those impacted by the resources boom."

Other Peoples’ Money (OPM)

Borrowing money to buy real estate can be a very profitable exercise, because historically we know that we should make a margin on the borrowed money, that is, after costs.

Consider an example:

If you buy a property for $250,000 and provide a deposit of 10% ($25,000) you get all the gain if the property doubles in value to $500,000; the bank gets none. So your original equity of $25,000 is now $275,000. Your original investment has grown incredibly to 11 times the original deposit, or an increase of 1,000%.

The principle is clear; it makes good sense to borrow to buy real estate.

How Many Properties Do You Need?

Australians appear to have a remarkable capacity for self-delusion with their "she'll be right" attitude to the greatest debt they will ever face - how to feed themselves, at retirement, for twenty, or more years, without a wage.

Retirement will require either a disciplined approach to a wealth strategy or continued work (at least part time) until you drop. And, this latter scenario is the most likely when
one considers that current superannuation balances average approximately $90,000 - not enough for two years living!

The secret to creating financial independence is to have a saving (investment) strategy that employs the principles of compound growth. If you don't, you have no chance.

Yet, less than one percent of Australians own five properties or more. Most only ever buy one or two investment properties, which mean they will never achieve the financial independence they seek. Just like monopoly, the secret is to control as many properties as you can - you could call it a government sponsored strategy because the ATO subsidises the cost.

Our grandfathers would have sternly said "you don't buy anything unless you have the cash," but, what sort of strategy is that if prices double every 10 years? You know what will happen to the price of that house you have your eye on while you are saving $100,000? So, why not rent the $100,000 from the bank and start your program now.

To calculate how many properties you will need to retire you need to answer the key question - what pre-tax income do you need, in today's dollars, when you retire?

If you worked on the generally accepted figure of 75% of your final year's salary, and that figure was $800 per week then, you would need more than four properties renting at $200 per week, or more than three properties renting at $270 per week. I say "more than" because the outgoings will take around 25% of the rent and therefore you will need to allow for that when you are doing your calculations.

So, not only do you need to acquire the properties, which means borrowing, but you need to have the mortgages paid off by retirement day. If you start too late in life, it will be a challenge. The philosophy is that you buy more than your calculation indicates and sell the excess to remove the debt on the core portfolio.

The opposing theories are the "negative cash flow" approach or the "positive cash flow" approach. You may ask what major actions are going to influence the cash flow? The answers are:

• The yield on the property. Regional areas will offer much higher yields (rents/$) than are available in the major cities. For example waterfronts will offer, at best, gross returns of three percent whereas regionals can offer eight percent, even higher. But, remember, there is a reason why this is so.
• The level of equity; the more you contribute the less you need to borrow from the bank. This is not a realistic option though, because to retire comfortably you will need around five properties and who has 40% equity for five properties?

9. Buying an Investment Property

The demand for housing for rental is rising as homes become less affordable. This is good news if you own an investment property.

You only need to acquire a reasonable property in a reasonable location at a reasonable price, nothing more, because you are really making a decision to back the broader area that you are buying in, not the house.

The best house, in the best location, purchased below value is not much use to you in Silverton (an ex-mining ghost town). Proximity to transport facilities, schools, shopping centres, sports and entertainment facilities and areas of future jobs growth are naturally advantages, again, if you have chosen the right area. And, what is the key to choosing the right location? Household formation (which is, for our purposes, is population growth), pure and simple.

You’ve collected your rents (gross) and from that you pay your outgoings. For houses work on 25% of the gross as a rule of thumb for your outgoings (rates, insurance, management, maintenance, body corporate fees), which leaves the net return (your share). For units the outgoings are likely to be closer to 30% especially if there are lifts and on-site managers.

Around 30% of Australians are renters, which provides a huge pool of around 5.4 million people who are housed in, or looking, for rental accommodation.

Where can things go wrong? Well, try and-

• Choose the right location (i.e. areas of high population growth),
• Watch out for properties with high maintenance risks,
• Keep your rents at market,
• Minimise vacancies,
• Get your loan structured correctly,
• Don’t overlook any possible tax deduction.
• Don’t dismiss medium density properties; they generally offer better gross yields than houses and they can often be better located within the area you are considering.
Naturally, new houses (low density) are most likely to be found on the expanding perimeters of growing cities, whereas medium density dwellings are likely to result from redevelopment of older prized locations. Yes, because of Body Corporate fees the "nets" will probably be similar, but then depreciation can often be higher with medium density (units, villas, town houses).

- Revalue your properties regularly, so that you can use your additional equity to negotiate a larger loan, which you can reinvest in another rental property.

- If you find the right property, buy it.

- Don't be put off by the economic cycle.

What can be better than owning property?

Yet, only 0.5% of Australians own five properties or more.

On average, for every $100,000 of property there is a possible $14,000 annual return — $4,000 (4%) from rent and $10,000 (10%) from capital appreciation averaged over the long term. Take away interest costs plus outgoings of about $7,000 (6% interest + 1% outgoings) means you are making $7,000 for every $100,000 worth of investment you buy. In comparison, a $20,000 windfall would only save around $1,600 per year if it went to pay down the family mortgage.

What Asset Class?
The broadest accepted categories of asset classes are shares, cash, fixed interest and property. Property can be further classified into commercial, residential, retail and industrial etc. Shares could be industrial, retail, property, manufacturing etc.

The key is to pick the right asset class and the rest follows. Just like the stock market, don't try and beat the trend because your odds of success are very low. When the market is doubling you can buy anything (at fair value) and make money. When it becomes a buyer's market your chance of making money in the short term is very low.

John Wasiliev of the Australian Financial Review reported the words of Phil Dolan, then head of Macquarie Bank's Macquarie Investment Management. "Few investors are aware just how important asset allocation decisions are," he said. "It might come as a surprise to many investors that actual investments you pick within asset categories are much less relevant than a decision to be exposed or to increase or reduce an exposure to an asset sector."
So when we are talking about property what is the key to a long term upward trend? Household formation, similar to population growth, which creates demand and consequently the need for investment and jobs.

The Applied Population Research Unit of the University of Queensland calculated that population growth of 50,000 creates a demand for approximately:

- 18,000 new dwellings
- 600 new retail outlets
- 450 new hospital beds
- 125 new medical practitioners
- 25,000 additional cars,

Good reasons for only investing where population growth is positive.
10. Developing Your Property Portfolio

Becoming a property developer is easy, but becoming a successful property developer is a different story. It requires time, research, patience, and a willingness to take calculated risks.

The president of the Urban Development Institute of Australia (SA), Peter Jackson, says there is no real definition of "property developer," which ranges from people involved in subdividing land to those renovating for resale or knocking down and rebuilding. "Essentially it's somebody who is going to take a financial risk with respect to the purchase, construction, marketing and selling of real property. That ranges from an individual home right up to a major CBD building," said Mr. Jackson, who is also executive general manager at A.V. Jennings.

He said being a property developer was not a recipe for quick, easy money. It's a bit like the share market: educate yourself, talk to people, and look at what other people have done," Mr. Jackson said.

If you make the wrong move, you don't go back to square one; you go to square minus 10. Look for an area that is going through a growth phase, where the population is expanding and there is demand for rental homes and consider the proximity to schools, shops and public transport as this will increase the home's appeal.

Would-be developers should get familiar with their council and understand the council's development codes, as far as it relates to their development plans. Every council is different. The key is the prescribed Development Control Plan. Every council has one, but many are 500 pages long."

You would be wise to keep your financier informed at every stage of the development process. One of the common areas of difficulty is misjudging your cash flow needs up until you start to receive rental income. But the most common problem that leads to failure is delays.

Remember that "time is money." It's important to speak with your council's planning department, especially if there are any zoning concerns. Additionally, you need to
consider potential pitfalls such as significant trees, historic aboriginal sites, bush land, water courses and significant flora or fauna, all of which may interfere with your plans.

The advice of a good surveyor is critical as is a working knowledge of the advantages and disadvantages of the different types of title, whether Torrens, Strata or Community.

Sir Robert Jones, the highly successful New Zealand developer remarked many years ago that most property developers will go broke. He, quite properly, limited his personal liability and floated his property assets (about $200 million) into Robert Jones Investments Ltd.

Typically, developers will borrow 80% of the total project cost of a project and require a 20% profit from total sale proceeds. Therefore, their equity, before tax, should double. As every year passes red tape is lengthening the time it takes to go from "go" to "whoa." With increasing time comes increasing risk of change due to changed economic circumstances, which with all the delays and other risks leads me to believe a 20% margin is too low.

**The Disciplined Approach**
My attitude to any development is to minimise the areas of risk, allowing me to maximize the price to the vendor. I only buy:

- Subject to development consent, and
- Subject to a number of my fundamental conditions.

I negotiate the conditions first, and then I negotiate price. I usually convince the vendor to accept minimum option fees where options are used, and I will not pay nor release money on conditional contracts. Why would anyone release money on a condition that may not be achieved? In each case I believe I have obvious and sensible reasons for these attitudes and I rarely deviate from them - why should I, there are always other opportunities.

Additionally, in my mind I have two expectations:

- The project will take longer than I expect,
- The project will cost more than I expect.

When it comes to applying for a loan for your project you should provide something a little more sophisticated than the simple feasibility. A discounted cash flow and sensitivity analysis will assist.
To undertake a proper feasibility study for any project will take many hours of work so you need to develop some short hand methods to sort the “wheat from the chaff.”

Establish in your mind—

• For subdivisions, the number of blocks per hectare of raw land in your area and the value per block,
• For medium density, the number of units/townhouses, villas per hectare and the value per unit.

My shorthand method for the first stage assessment is—

• The raw value of sub-divisible land is around one third the retail price,
• The value of medium density land per unit should be the result of this calculation - Land cost/unit (L) + building cost/unit (B), where B is grossed up by 25% to allow for common areas, multiplied by 1.5 times should approximate the expected retail price (R).
\[(L + B) \times 1.5 = R, \text{ or to work backwards, } R/1.5 - B = L\]

Therefore, if the end retail price for a unit is $300,000 reduce that by one third to $200,000 then take off the building cost per unit (grossed up) and the resultant figure is the land content.

When the offering is around these ballpark figures then you may elect to go to the next stage of your assessment. At the next stage I will calculate the yield for the site. For example, when I was seeking sites on the Gold Coast I would take their residential flat code and calculate site cover and apply the Part B and then Part A calculations allowing about 35 square metres per lift, etc. Importantly, I would then send the calculations off to my architect who would check the calculations, or, in the case of a subdivision, my surveyor. The point is that you need to be able to do the same because, where possible, you need to learn to become an expert in your field.

**So You Want to Be a Developer?**

Perhaps, you are like a lot of Australians and you want to be your own boss. Unfortunately, over 80% of businesses fail within the first 5 years. The question is do you have what is required to beat the "odds".

Compare your responses with those of successful entrepreneurs.
1. What major sacrifices have you made to achieve success? If your answer is none, then you do not know whether you can withstand the pressures that flow from a lack of money and time.

2. Are you a competitive person? Successful entrepreneurs are internally driven to compete and outperform.

3. Are you prepared to take out a second mortgage on your home? The most important characteristic of a successful entrepreneur is a total commitment to succeed.

4. Do you set goals? The most successful entrepreneurs are goal oriented.

5. Have you willingly placed yourself in a position where you were personally responsible for the success of a project? Entrepreneurs take the initiative to see that things happen.

6. Are you intimidated by certain people or situations? Entrepreneurs are challenged by toxic people and difficult situations.

7. Do you have a need to know how you are performing? Entrepreneurs want feedback on how they are performing.


9. Do you prefer change or a steady routine? Entrepreneurs are flexible and have a tolerance for ambiguity, stress and uncertainty.

10. Would you consider parachuting out of an aeroplane? Many are calculated risk-takers but not gamblers.

11. Are you driven more by a need for achievement, status or power? An entrepreneur's most important need is to achieve.

12. How reliable are you? Studies have consistently shown that those who are the most reliable are the most successful.
13. How important is integrity to you? Integrity is #1. Studies have shown that with a lack of integrity your chances of success are minimal because your attitudes will eventually be revealed.
14. Do you focus on the future or the present? The most successful are both visionaries and in the present.

15. Have you learnt anything from failure? To entrepreneurs failure is a learning process.

16. Do you need to make decisions immediately? The most successful are quick decision makers.

17. Do you consider yourself creative? The most successful are intuitively creative.

18. Do you believe you have conceptual skills? Most are above average conceptually but IQ levels vary.

19. Do you inspire others? Many are told they are inspirational.

20. Are you told that you do things differently to others? Many are told they are unconventional in outlook.
11. The Value of Property

Wouldn't it be great to have a simple method of assessing the value, and relative value, of residential properties?

The car industry has a method of valuing cars: the Red Book used by dealers is invaluable because it records the resale prices. These resale figures reflect the sum total of millions of buying decisions about the relative merits of different cars. That is, their "real" value, not the manufacturer's asking price.

The difference between the sale price and the ongoing fall in value crystallises the depreciation, or loss in value, which, over the life of the car, is the major cost of ownership.

So, wouldn't it be great to find something that reflects the relative merits of individual properties, something that aggregates the millions of decisions and is, therefore, broadly based - something like the motor industry's Red Book?

Well, there is something and it is called –

RENT

If you can tell me the market rent for any dwelling I can tell you, reasonably accurately, its value. To do that I apply the "cap rate" (capitalisation rate) for that category of property, whether waterfront, city houses, city medium density and so on. As a rule of thumb, over many years, houses in Australian capital cities have averaged around a 5% gross yield, although in more recent years it has been less. Start with this rate because it is an easy way to learn the technique. So, a market rent of $300 per week indicates a value of $300,000 (5% return or 20 times yearly gross rent), a market rent of $250 per week indicates a value of $250,000.

This is a simple mental calculation and once done may require adjustment if the capitalisation rate ("cap rate") is not 5%. For example, over recent times, Brisbane houses have been returning around 4% gross (or, 25 times the yearly gross rent i.e. 100 divided by 4), so, to adjust your first calculation you need to add 25% to your original calculation. Rent of $400 per week indicates $400,000, at a 5% gross cap, or, if the cap rate is 4%, it indicates $500,000.
Yield (rent as a percentage of the value) is the universal measure of the value of an income-producing asset. Forget the hype, the value of an asset is the sum of its returns (income plus capital gain). Learn to compare all competing forms of investment on the basis of yield and understand that all asset classes bear a relationship to the long-term bond yield. Generally, property needs to return, around a 3% risk margin over the 10-year bond yield to become attractive. I see recent suggestions, now that we are in a bear market, that an appropriate risk premium for shares should now be around 6%.

And, this discussion leads to another factor. Just like the stock market, the yield (return), indicates the market's assessment of the capital growth potential. Rightly, or wrongly, the comparatively low yield on News Ltd shares tells investors that News Ltd is viewed as having greater capital growth potential than say the ANZ Bank with a higher yield.

Residential dwellings will be valued by qualified valuers on a comparable sale basis.

Remember this is an "opinion of value" and it is not uncommon to find a variation between different valuers.

I observe that competent valuers will often confirm their valuation with a quick "summary" valuation. That is, take today's vacant land value and add today's building price (depreciated around 1% per annum according to age) and add a factor for landscaping and improvements. This figure should approximate the valuation based on comparables.

Now, you will have plenty of people (especially sellers and their agents) tell you that this rent capitalisation process doesn't apply to owner occupied properties, only investment properties and that it doesn't apply in this situation or that. Don't believe them, it is a universal measure, it is a great "rule of thumb" and it will apply in almost every situation.

What Is "Negative Gearing?"
A primer definition would be: When the interest you pay is greater than the rent you receive. The word "negative" relates to the cash flow effect, whereas "gearing" means to borrow. Remarkably simple isn't it? Aficionados like to make it sound mysterious and a technique which only the select understand, yet every business in Australia has used it; they have used finance to buy an "income producing" asset, like a motor vehicle, a computer, or plant and equipment. If the asset is producing "assessable income" the cost of acquiring it (the finance) is tax deductible. If you understand the basic concept, you can now consider a more complex (and accurate) definition, which is, when the "after tax" cost of acquiring an asset is greater than the "after tax" net income. These "after tax" calculations, largely relate to taxation concessions for depreciation and
amortization and they can convert a negative gearing to a positive one, but usually only where the gross income and the gross interest is similar, in which case the greater the relevant marginal tax rate the more likely that is to happen.

You may ask "how can I simply and quickly make a guesstimate of the year one cash outflow of any residential property I am considering buying?"

Clearly, we are all seeking suitable investment propositions. You may have realised by now, that, my preoccupation with efficiency and time management has led me to believe that one of the key ways to isolate a suitable proposition is to find a short hand method of quickly discarding the majority of propositions that will not even come close to the mark. I observe that nearly everyone is happy to list their property for sale at a price above its market value – we all live in hope!

So, I have a three-stage assessment process. The last stage will be a full feasibility, supported by proof of every figure with supporting evidence.

It is a challenge to construct a simple guesstimate for you to use, but there are some reasonable assumptions that will assist. You will be surprised to find that nearly all the new house and land propositions you consider will have a—

- Land component around 44% of the contract price,
- A construction cost of the remaining 56%, of which 50% will be the "shell" and 6% the fixtures and fittings.

Medium density developments (units, town houses, villas) will be similar too, except where there are lifts, but, even then, although the body corporate levies will be higher, the depreciation will be too.

Additionally, with these calculations I assume—

- The purchase costs will be 3.5% of the contract price (non-deductible),
- The loan costs will be 2% of the contract price and can be written off over 5 years (equals 0.4% per year),
- No cash is provided by the buyer (that is, the total cost is borrowed),
- Depreciation of 2.5% of the "shell" (the same as 1.25% of the contract price) can be claimed each year for 40 years,
- Fixtures and fittings of 6% can be written off over 15 years at 0.4% of the contract price per year,
• Outgoings (rates, insurance, management, vacancy, etc) will be around 25% of the rent,
• Rents are 5% gross of the contract price,
• Assessable income of $30,001 to $80,000 will attract a marginal tax rate (MTR) of 31.5% (including the Medicare levy),
• Assessable income of $80,001 to $180,000 will attract a MTR of 41.5% (including the Medicare levy),
• Assessable income of $180,001 or more will attract a MTR of 46.5% (including the Medicare levy).

When all these factors are computed I calculate the break-even interest rate cost of acquiring a property (105% financed) will be APPROXIMATELY will be—

• For 31.5% marginal tax payers = an interest rate of 4.5%,
• For 41.5% marginal tax payers = an interest rate of 5.0%,
• For 46.5% marginal tax payers = an interest rate of 5.4%

So, how do you use this?

A 31.5% MTR investor would say my interest rate is 6.25% which represents 1.75% over the break-even of 4.5% and I pay 68.5% of that difference. Therefore, in cash flow terms in year one (assuming a $100,000 contract price) –

\[(68.5\% \times 1.75\%) \times 100,000 = $1,199 \text{ (or $20 per week/ $100,000 of price)}\]

Note, that you don't pay the entire margin by which your interest rate exceeds the break-even point. You only pay what the ATO doesn't. You pay—

• 68.5% if you are a 31.5% MTR
• 58.5% if you are a 41.5% MTR
• 53.5% if you are a 46.5% MTR

For a 41.5% MTR the calculation would be –

\[(41.5\% \times 1\%) \times $100,000 = $415 \text{ (or $8 per week/$100,000 of price)}\]

WEEKLY COST, after tax per $100,000 of price
Loan costs + borrowing costs 5.5%
Borrow 105.5%
MTR = marginal tax rate
Building cost = 50% of contract price +
Fixtures & fittings = 6% of contract price
Rent 5% gross

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Be very clear on these figures – they are step one calculations only for quick calculations in the field – they must be confirmed by a good program – I recommend Ian Somers PIA program.

12. Renovations

Years ago I remember being amused listening to John Laws; he was promoting a major pool builder who claimed to "guarantee it will add value to your home." And, of course they were right, it would add value. But what they forgot to add was the rider: "...but only half of what you spend."

This is the challenge with renovations; assessing where and how much to spend. My experience has taught me that street appeal, kitchens, and bathrooms are generally the areas of most importance. When I am undertaking a "back of the
envelope” assessment of a property I do two calculations. I check my assumption as to the comparative sales value with a summary valuation. I take today's land value and add to it what it would cost to build today, e.g. so many square metres x $/m². And then I depreciate the building component by 1% to 2% per annum for each year of its age.

To extrapolate the philosophy of the summary valuation should suggest a caveat to those considering renovations. And that is, that the older the property the less you are likely to add value by additions. For example, you are not going to make a 50-year-old house a new house, no matter what you do. I will never assess your additions to a 50-year-old house at current costs because it is still a 50-year-old house, and according to my thinking I will be depreciating the present building cost by probably 50%. The older the house the more difficult it is to get it right. Where that point comes is a matter of substantial study, judgment and experience.

Notwithstanding the above, there are many ways for owners and investors to add value to their property. And while an increase in rent is always acceptable, an increase in capital value is better if for no other reason than the tax laws, which tax the capital gain (conditions apply) at half the rate of income.

There are many strategies to employ. Renovation is spending money in the most beneficial places. How do you determine that? Well, my rule of thumb is, unless you are increasing the rental value of the property then you are unlikely to be increasing its capital value.

Here are a few strategies:

- Paint—pretty much “top of the pops,” more especially if you can use your own labour.
- Add a room—bedroom, rumpus room
- Convert the garage and/or add a room
- Add a deck
- Modernise the garden
- Renovate the kitchen
- Renovate the bathroom
- Polish the floors
- Add a carport
- Enclosing or opening a front verandah

Other possibilities which are unlikely to add a worthwhile margin over cost are—

- Upgrade fencing
One final suggestion: try and renovate with taste and style that meets the market's expectations, not your own. This is much harder to do than you think, and if you don't think so, have a look at Property Ladder on Foxtel.

Property Ladder is hosted by an English property developer, Sarah Beeny. Most of the developers (I would call them renovators) whose progress Sarah plots seem to be first-time renovators, often male and female teams. Observing the mental processes these renovators go through is fascinating, not only for the lack of advance planning that costs them time (which is money), but just how they fail to analyse the inevitable hurdles. Contrary to Sarah's consistent advice about being in the business to make a profit, none seem able to clearly identify the market they wish to satisfy, and therefore, they are not clear about the finishes (specification) that are appropriate.

Consistently, they buy what they personally prefer, with little reference to their market. I like to think that I have a logical approach to these situations. Here is how I analyse it: Let's say we are considering whether to upgrade to granite bench tops or perhaps to choose European appliances rather than local. How does one examine these questions?

First you establish what is the minimum acceptable specification for your target market. Your local real estate agent can be invaluable in this area. Find a good agent and listen to his advice about what your target market will accept and what it won't. You may ask him questions like, "Will the market accept laundries in the garage?" "Is a shower over the bath OK?" "Can I get away with an upright stove or does it need to be a wall oven?" "Will a laundry in the kitchen work?" By this method you will determine the minimum standard your target market requires. Then, the next step, as and when it arises, is the question of upgrading, or varying the minimum acceptable specification.

My philosophy is that the valuation of residential dwelling is, in simple terms, a capitalisation of its gross rent. Yes, that is the method used for the valuation of commercial, retail and industrial property but it also is my method for residential. For
example, houses in Brisbane (non waterfront) were selling in 2007 on just under a 4% gross yield, medium density dwellings around 5% gross. So, ask your agent, "If I upgrade to granite bench tops how much more rent will I achieve?" If he says $5 per week and properties are selling at, say, a gross yield of 4% (25 times the rent) then that $5 per week increases the value by $6,500 ($5 x 52 weeks x 25). Spend less than $6,500 on the granite tops and you have added value. If there is no more rent or a saving in time, why would you do it?

I renovated two blocks of red brick flats in Lidcombe and Auburn, Sydney. I painted internally, installed new basic kitchens with the laundry in the kitchen cupboards, carpeted throughout, left the bathrooms unchanged, installed verticals and undertook minimum landscaping and then auctioned them with L.J. Hooker. It was not a seller's market, probably an evenly balanced market, and we achieved a quick turnaround. I had a great result which was made even better by negotiating vendor finance and getting agreement to use the vendor's solicitor (all icing on the cake) but that's another story that I may get a chance to share with you.
CONCLUSION

Here is some advice from David Maister, Author of *Strategy and the Fat Smoker*. Maister is widely acknowledged as one of the world's leading authorities on the management of professional service firms. In 2002, he was identified as one of the top 40 business thinkers in the world (*BUSINESS MINDS*, Financial Times/Prentice Hall). For twenty-five years he has advised firms in a broad spectrum of professions, covering all strategic and managerial issues, building a global practice that finds him spending about 40% of his time in North America, 30% in Western Europe, and 30% in the rest of the world.


His books are currently available in English, Arabic, Dutch, Estonian, Finnish, French, Spanish, Indonesian, Japanese, Korean, Polish, Russian, Serbo-Croatian and Chinese. A native of Great Britain, Maister holds degrees from the University of Birmingham, the London School of Economics and a doctorate from the Harvard Business School.

He began his teaching career at the University of British Columbia, Canada, and then joined the Harvard Business School faculty, where he taught courses in managing service businesses from 1979 until 1985.

Maister lives in Boston, Massachusetts with his wife and coach, Kathy. He is an avid collector of popular music, and owns more than 15,000 CDs and a rapidly growing number of DVDs. In March of 2005, he finally took his own advice, gave up smoking, and lost 30 pounds.

**Words of Wisdom from David Maister**

"There is nothing so powerful in business as actually having principles that you hold on to passionately and require those around you to believe. One way or another, all my research conclusions, consulting advice and speeches in my professional career as a
global consultant, business author, and former Harvard Business School professor come down to passion, people and principles.”

**Force and Momentum**

"Find your passion" is common career advice. But less frequently pointed out is how difficult this can be. You really need to work hard to find out what you can be passionate about. Unless you are very lucky, you may find that, like me, it takes many years to discover what really turns you on over the long term. Successful people often appear to have had a rational career progression, with each step a seemingly sensible preparation for the next. The truth, however, is that most successful business careers have been based on experimentation and opportunism.

When he started selling records did Richard Branson know that some day he was going to found an airline or a telephone company? Did Bill Gates ever know what products Microsoft was going to offer in a few years' time?

To succeed, you must be prepared to keep searching until you find out what truly excites you, even though there will be temptations along the way for you to give up your search.

After all, what you are doing at any given moment is almost by definition the result of a previous guess of yours as to what you thought would be fulfilling. So, it's unlikely to be disastrous. It's probably "OK."

This is where the world divides into two groups of people. One group will stroll down the path labeled "It's OK, so why change?" while another group will run down the path marked "It's only OK, let's find something better!"

Even the most thrilling things become familiar after a while, passion and "engagement" will almost inevitably decline and there will be a lifelong need to seek out new challenges. However, given the power of momentum, only those determined to get somewhere will actually do what it takes.

If you truly want to succeed (and many people do not want it badly enough to make it happen) then you must never settle, never give up, never coast, never just accept what is, even if you are currently performing at a high level.
If what you have now isn't what you dreamed of, then you must keep looking. You must always search for the next thing you think you can feel passionate about, so that you will have a burning reason to show the discipline and drive that will distinguish you.
**Determination: the Only Sustainable Competitive Advantage**

There are no guarantees in life, and determination is only an essential ingredient, not a sufficient one.

People try and some of them fail. But a lot more never try, and they cannot win.

The key lesson is that lifelong drive and determination, the burning passion to get somewhere next, are the key ingredients in career success.

Did Richard Branson or Bill Gates succeed mostly because they had higher IQ's than anyone else? They are certainly very smart people. But what made them special and successful was clearly something else: discipline, ambition, passion, entrepreneurship, energy, enthusiasm, engagement, and a whole host of closely allied characteristics.

The point is worth stressing. In a free-market economy, what is rewarded is not inherent value, but scarcity (the relative supply and demand). If many other people have what you have, then you cannot earn a premium or distinguish yourself just because you have it. Intelligence, IQ, brains, and smarts are all important, but they are also more common than drive and determination. The latter will be more highly rewarded and also more determinative of future success.

And here’s the key: you can’t sustain lifelong drive and determination unless you are passionate about accomplishing something. Discipline for discipline’s sake won’t work.

These things also apply in most other walks of life. World-class athletes and artistic performers push themselves to the limit with repeated practice, training, and rehearsal. No matter how much natural talent they bring to the game, it is their determination to do what it takes to get there that makes people them distinctive. It is the most talented performers who practice the most. It’s the willingness to keep trying, always committing yourself to getting better, whenever you have just stumbled—which is hard.

What may be more critical, successful people keep stretching when they are already doing well, which is even harder! Whether we are in our 20s, 30s, 40s or beyond, the question that we must all address is: are we still trying to get somewhere? Do we have new worlds to conquer, and do we know what they are? It’s always worth examining this because, as Napoleon said: "Glory may be fleeting, but obscurity is forever."
**Bouncing Back**

We all have setbacks, whether they were our fault or not. The question then becomes: What are you going to do now? Withdraw, or renew your efforts? It’s tempting and completely understandable to conclude: "Ah, I’ve been trying but the struggle is too frustrating. Why bother? Look what happens every time I try to change things?"

It’s also tempting to beat yourself up. We have all lain awake at night thinking about mistakes we have made, things we could have done or said differently. Rather than dwell on any accomplishments they might have attained, people often tend to dwell on missed opportunities and failures.

All of this is, of course, quite useless—literally. Nothing productive can come from it. While we must not veer to the opposite extreme of always blaming external forces and other people for what happened to us, there is no point getting stuck in a "doom loop" of self-criticism.

You’re going to live with yourself for a long time. It’s your own good opinion of yourself that matters more than anyone else’s. Be kind to yourself. There are plenty of people out there prepared to judge you. Why do it for them?

The good news is that it’s amazing how many times you can mess up in life and still succeed. Winston Churchill once said, "Success is the ability to move from failure to failure without loss of enthusiasm."

Another example: George Washington barely won a battle in the early years of the Revolutionary War. His greatest triumph was to prevail by not losing (and inspiring others not to give up, despite terrible defeats and narrow escapes); just staying in the game led to victory.

The key skill in life is not "never make a mistake!" That’s impossible. Rather, it is rebounding from your mistakes. Although it doesn’t always feel like it, you have a choice in how you react to things that happen to you. You can let them get to you or you can brush them off.

"OK. I blew it—time to move on!"
ABOUT THE AUTHOR

After graduating from Sydney University as a Bachelor of Economics and gaining my accountancy qualifications I was employed in the research department of a large Sydney stock-broking firm, analysing company reports and writing research reports. From there I moved to advising private clients and administering the firm's arbitrage operations with London and its membership of the Sydney Greasy Wool Futures Exchange.

In time I advanced to dealing with institutions and companies, analysing and recommending various investments opportunities and switches. My dealings with various listed companies generally involved assessing underwriting propositions and raising capital for them, either as equity or as fixed interest securities.

These stages built an intimate knowledge of investing and speculating in shares, options, derivatives and involved charting. It also involved raising many millions of dollars for a number of mining and property groups and promoting three substantial market takeovers. Looking back I am interested to see that I was concentrating my efforts on listed companies that had an asset backing, in tangible assets that exceeded their market price, for example, Anthony Horderns, McDowells, Bebarfallds and Buckinghams, all city retailers.

As a result of this experience, I believe that I have a wide-ranging knowledge of the relative merits of all popular forms of investment.

The acquisition of a controlling interest in a small public company meant I moved away from stock broking and concentrated my efforts around property, buying, planning and developing sites through controlled corporate entities or in joint ventures with publicly listed companies.

As a principal and/or through associated corporate entities, I have been involved in property development, identifying, analysing, negotiating, acquiring, developing, constructing, managing and marketing residential subdivisions, industrial subdivisions, residential apartment buildings, shopping centres and commercial office buildings in:
• Ashley and Frederick Streets, Hornsby (three-storey walk-up home units)
• Albert Street, Hornsby (home unit site)
• Hunter Street, Hornsby (two home unit sites)
• Somerville Road, Hornsby Heights (residential subdivision)
• Finlay Avenue, Warrawee (residential subdivision)
• Warilla Avenue, Wahroonga (home unit site)
• Water Street, Warrawee (six acres, ex Mt Alverna)
• Livingstone Road, Lidcombe (block of flats renovated, strat'd and sold)
• Hevington Road, Auburn (block of flats renovated, strat'd and sold,
• Blacktown Road, Blacktown (residential subdivision, ex Blacktown Brick Pits)
• Great Western Highway, Wentworthville (shopping centre)
• Copeland Road East, Beecroft (residential subdivision)
• Malton Road, Beecroft (residential subdivision)
• Hoxton Park Road, Lurnea (industrial subdivision)
• Victoria Avenue, Baulkham Hills (industrial factory unit development)
• Church Street, Castle Hill (residential subdivision)
• Old Castle Hill Road, Castle Hill (commercial office building value about $3.4ml)
• Church Street, Parramatta (commercial office building value $25ml)
• Morala Avenue, Runaway Bay (28-townhouse development)
• O'Connor Street, Tugun (residential medium density site)

One such development, in partnership with Industrial Equity Ltd., a major listed company, included the planning, construction, and subsequent sale of a $25ml office building (Church Street, Parramatta) to the AMP Society.
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