The Elephant in the room

It never ceases to amaze me that so much media content for investors is devoted to talking about wealth minutia while managing to avoid the elephant in the room.

At the risk of being controversial, in my view the elephant in the room has been and always will be ***cash flow***. Wealth minutia includes the myriad of tax, super and investment "tricks" that most advising organisations use to hook the unwary.

To press the point home, in my early days as an adviser I came across the following two quotes which still form part of my core approach to managing wealth for clients today.

1. "A tax benefit never made a bad investment good."
2. "There is nothing an adviser can do to keep clients from the poor house, if they're spending like drunken sailors."

A tax benefit never made a bad investment good

Taking the first quote in hand, you no doubt think that this is an obvious statement. However, how many thousands of investors have lost untold millions pursuing a tax advantage without having understood the underlying investments and their associated risks.

With regard to the second quote, while it might appear to be even more contentious, let me provide you with some straight forward logic in support of its assertion by posing the following question:

What will pay a loan off earlier?

1. Finding a loan with a slightly lower interest rate? or
2. Making large additional payments off the principal over time?

Clearly the answer is the extra payments.

The interest rate can only impact on the loan principal itself and only then in a marginal way particularly if you're hunting for a loan that is, say half a percent less expensive than the one you have.

Now let's look at the other side of the ledger.

What builds wealth faster…

1. Finding an investment or tax strategy which might deliver a sightly better return on your capital than the return you're currently getting? or
2. Making large additional investments to your asset base from savings

Or, put another way for those retirees trying to preserve their capital as long a possible.

What "chomps" through wealth faster…

1. Finding the same or similar investment or tax strategy with marginal return benefits? or
2. Limiting your expenditure on large capital items like cars and holidays?

Now, despite the recent global financial crisis, the answer is obvious but unless this type of simple truth is "top of mind" its one piece of logic that continually gets lost in the media "noise".

The importance of cash flow as a wealth driver

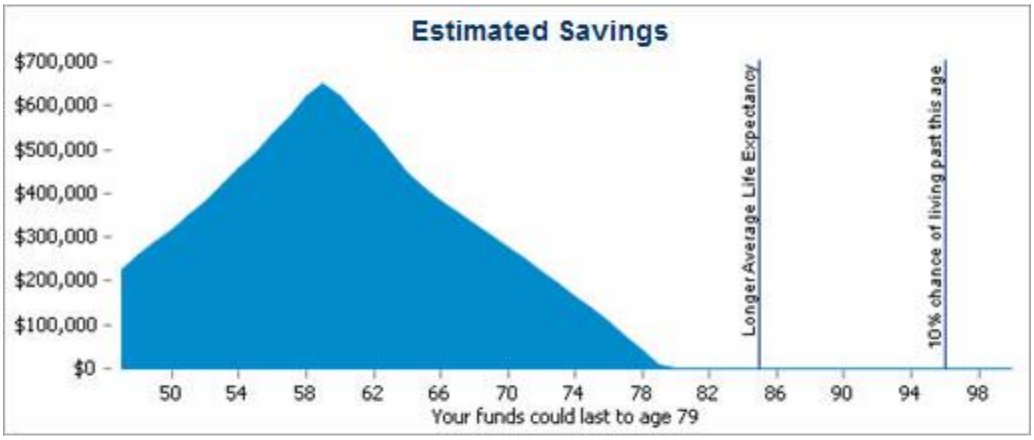
Let me try to convey the relative importance cash flow plays as a wealth driver by using a recent client example (details changed to keep things confidential).

Step 1: Consider how long your savings are estimated to last

Fred and Gladys are both aged 45 and would like to retire at age 60. They both work and earn a combined annual income of about $150,000. After tax, living costs and loan repayments they save approximately $3,750 a year. They currently have $230,000 in net financial assets (net of investment loans and ignoring the family home).

The following graph projects where they were heading.

Initial outlook - savings estimated to last until age 79

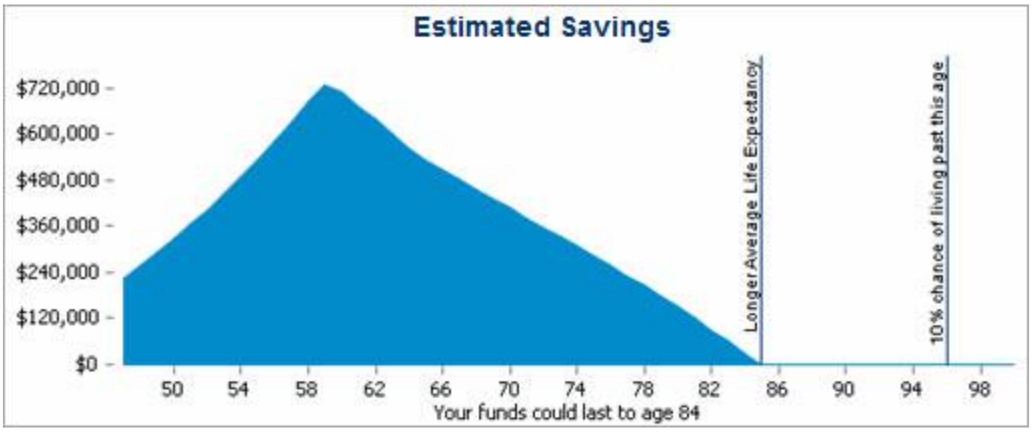


As you can see their combined family wealth is going to run out well before reaching the life expectancy of the person who is expected to live the longest (in this case Gladys).

Step 2: Consider the impact of potentially higher investment returns

In order to deal with this challenge, I firstly increased the investment return in the projections from 1% above inflation today and in retirement to 3% and 2% respectively. This had the effect of adding a further 6 years to their post retirement funding. Keep in mind achieving this additional return, year on year for the next 30 years would be no mean investment feat (and cannot be guaranteed).

Revised outlook - savings estimated to last until age 84

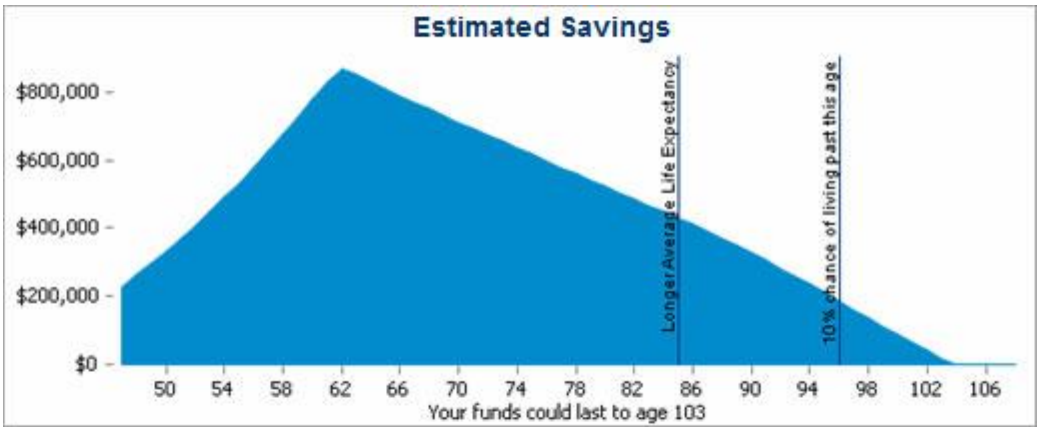


Step 3: Consider the impact of improved cash flow management

Now let's consider the impact of reduced spending and working for a few years longer.

After resetting the investment returns back to 1% above inflation I then reduced their living costs by just $100 per week now and $200 per week in retirement. I also extended their retirement age to 63 to increase the amount of accumulation “time”. The results appear below.

Revised outlook - savings estimated to last until 103 years of age



The result

Reducing expenditures and working a bit longer had a much larger impact on the financial situation.

As you can see, the projected outcome in terms of post retirement funding is around 4 times more potent than changing the investment return.

If you would like to discuss your financial situation and how it might be improved, I invite you to phone me on 0412 366 570.

Yours sincerely,

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