Share in compound effect

NOEL WHITTAKER

Term deposits have fallen behind the investment pack since the 1980s.

STACKS UP: Shares offer flexibility, liquidity, tax benefits and capital growth.

FOR my money, shares are the best investment anybody can have. No other asset class offers such flexibility or liquidity, nor the tax benefits offered by franked dividends if you invest in Australian shares.

Peter Thornhill has been preaching the gospel of Australian industrial shares for more than 30 years, and I'm sure many of you have had the pleasure of listening to him at investment seminars.

A feature of his presentations is a graph which tracks both income and capital from a portfolio which matches the Australian Industrials Index. The graph highlights how different the outcome would be for two investors who used different strategies. One invests $100,000 in a term deposit in December 1979 – the other invests $100,000 in an index fund which matches the All Ordinaries Industrials Index.

Term deposits were doing well in the 1980s when interest rates were high, but have fallen way behind the pack in the current investment climate, where the best you can hope for is a fully taxable 3 per cent or $3000 a year.

To make matters worse, there has not been one dollar of capital growth, while the capital value has been slaughtered by inflation. Remember, in 1979 the average house price in Australia was about $80,000.

In contrast, the share portfolio is now worth $1.7 million, and is producing dividends of $75,000 a year.

One of the particular benefits of shares is the automatic compounding effect that happens when a company reinvests profits that are retained after paying dividends.

Think about it – XYZ Limited earns $5 a share, and pays $3 to its shareholders in dividends. The balance of $2 a share is effectively invested by the company to build its business.

This happens whether the shareholder chooses to spend the dividend or reinvest it.

Thornhill loves to buy in gloom. He bought Wesfarmers in 2008 for $13.50, after they had fallen from more than $40. The dividends he has received since purchase are $9.30 – 70 per cent of his purchase price. Those shares have also trebled in value.

In 2008 CBA was selling for $26, having fallen from more than $60. A person who bought then would have received total dividends of $18.24 – 70 per cent of the purchase price. The shares are now worth three times the amount paid, and the last 12 months' dividend was $4.01 – putting this parcel of shares on a current yield of 15.4 per cent of cost.

When talking to Peter I was initially surprised when he indicated that he would actually relish another global financial crisis. It seemed to make no sense until he explained that he didn't go hard enough the first time around.

He would love the opportunity to buy at bargain prices again.

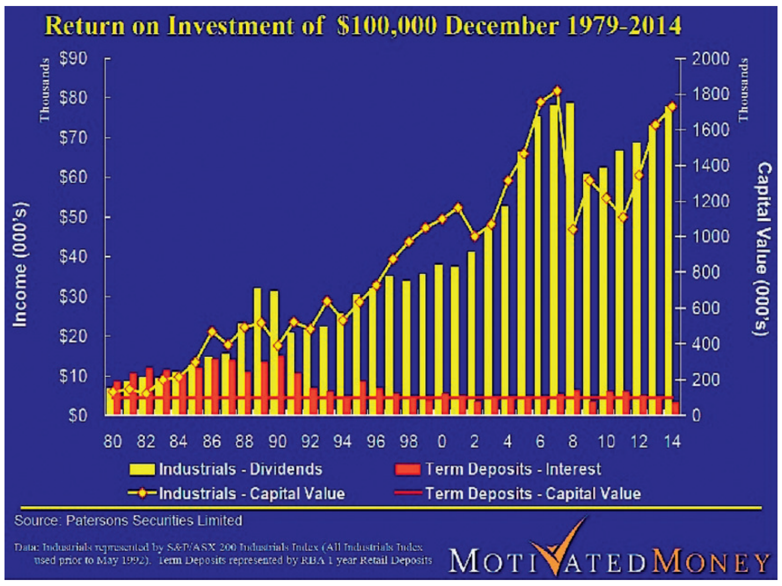
Noel Whittaker is the author of *Making Money Made Simple*, and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. Email: noelwhit@gmail.com.

Q We have a $200,000 mortgage on an investment property bought for $292,000 in 2011, which is now valued at $400,000. We plan to pay off the mortgage and transfer the apartment to our daughter. What are our tax obligations and do we pay CGT during transfer or when my daughter sells the apartment?

A You will be liable for CGT on the transfer to your daughter, and the appropriate date will be the date the agreement for sale is signed. If your daughter uses the apartment for her own residence, it will be exempt from CGT when she sells it unless she rents it for part of the period of ownership.

Q If I want to obtain a mortgage and gain a good credit record, is it possible when I have no credit history and don't have a credit card?

A Provided you have no adverse credit history, sufficient deposit, and proof of reliable earnings, there is no reason why you could not qualify for a mortgage.



Head or heart just start of many property decisions

By **MAX NEWNHAM**

LOAN LOWDOWN: As a general rule it is best to buy investment property using an interest-only loan rather than a principal-and-interest loan.

NOT everyone who buys an investment property makes money. It's all about making the right choices.

The first decision to be made is whether it is a lifestyle investment or a financial investment. A lifestyle property investment is bought more for lifestyle and emotional reasons than to just make money. An example is someone who would like to either have a tree or seachange when they retire.

When a property is bought to deliver the best return possible a choice must be made between commercial or residential. Commercial properties tend to have a higher rental return and the tenant pays all outgoings including rates, whereas a residential tenant only pays the rent.

The rental period for commercial property is often at least three years, while a residential rental period tends to be 12 months.

Where a residential property investment is often superior is in capital appreciation. Because land is a greater component of a residential property than a commercial property, and because the main driving factor for increasing property values is the increase in the value of land, residential properties often increase in value more than commercial properties.

If the decision is made to invest in residential the next choice is whether to buy an existing property or one from a developer off the plan. It has been my experience that the capital gain made by investors buying established properties is greater than buying a yet-to-be completed property.

There are often so many layers of cost included in yet-to-be-constructed properties, such as marketing and selling costs, that investors pay more than the true market value. One advantage of buying from a developer is that the investor will maximise their rental tax deductions. This is because in addition to claiming interest on a loan used to purchase it, and other costs such as agent's fees and rates, a deduction is also allowed for the write-off of the value of fixtures and fittings in the property and the cost of the building itself. Properties built after 1985, used to produce rental income, receive a tax deduction for 2.5 per cent of the construction cost of the building.

Once the property has been chosen a decision must be made on the type of loan to use. As a general rule it is best to buy an investment property using an interest-only loan rather than a principal-and-interest loan. This allows an investor to use any excess cash to either pay off private loans or make other investments.

The final choice is how long it will be retained. While a person is working and accumulating wealth a negatively geared residential property makes sense.

The problem is once they retire the low rental income produced by a residential property is a major disadvantage. As a person nears retirement the rental property should be sold and the proceeds used to provide a tax-effective retirement income.

Max Newnham is the founder of smsfsurvivalcentre.com.au