

# The mortgage and family years



*We see creating and looking after your wealth as a lifelong commitment. That's why we offer regular financial advice and guidance throughout the different stages in your life. Together, we can build the financial wealth that lets you enjoy the truly important things in your life.*

## **Financial priorities: Pay off the mortgage and protect the family**

### **Life motto: My house is my castle/it's a family affair**

The mortgage years bring with them a large debt, but this is a price most of us are more than willing to pay for the security of owning our own home. Debt management becomes important, as we look at strategies like consolidating debt and enforcing a strict budget to pay off that mortgage sooner rather than later.

The mortgage and family years also span quite a large period of time, so our strategy may alter as we move through this stage.

### **Case study: David and Kelly Johnston**

**Ages:** David, 35 years old; Kelly, 34 years old

**Occupations:** David, marketing manager; Kelly, lawyer

**Children:** Emily, 2 years old; Jonathan, 4 years old

**Salary:** David, \$120,000; Kelly \$35,000 (part time)

**Debts:** Home loan \$190,000 (variable interest, currently at 7%)

Credit card \$10,000 (fixed interest, 15.95%)

**Financial goals:** Accumulate wealth and pay off the mortgage

*'We want to pay off our mortgage and we want to start saving for other things like our children's secondary education, a new car, holidays and retirement. We're not sure if we should put extra money into the home loan or start an investment fund.'*

### **Recommendations/strategies from financial planner**

**Debt:** Firstly, David and Kelly could look at consolidating their debts. They can do this by approaching their bank or mortgage provider and borrowing an additional \$10,000 on their home loan. This money can then be used to pay off their credit card. Then, all their debts will be contained in the housing loan, which has a much lower rate of interest. The extra

### **What is wealth advice?**

Wealth advice is support and guidance on the best way to manage all your finances. Whether it's adjusting your debts to minimise repayments, saving for a home or a holiday, investing money, planning for your retirement, maximising pension entitlements or ensuring your family are protected if something happens to you, the right advice from the right people will help you achieve your goals faster and more effectively.

cash flow can be used to pay off the debt faster, invest for the future or improve David and Kelly's standard of living. By consolidating these two debts, they would save \$895 each year.

### Home loan

David and Kelly want to pay off their loan sooner, and there are a few strategies they can use to achieve this goal. One simple strategy is to make their repayments on a fortnightly basis, rather than a monthly basis. Currently, David and Kelly have monthly payments of \$1,413 (in arrears) and their loan term is 25 years. However, if they paid \$706.50 per fortnight the loan term would be reduced to 20.5 years.

By increasing these fortnightly payments even more (from 50% of the monthly payment up to 100%) David and Kelly could reduce the loan term dramatically.

So, if David and Kelly pay \$990 per fortnight (70% of their original monthly payments), they would reduce the loan term by 13.8 years, from 25 years to 11.2 years and their loan would be paid off before David turns 46. It would also reduce the total repayment from

\$423,842 (\$223,842 in interest) to \$289,060 (\$89,060 interest), a saving of \$134,782.

### Offset mortgages

Another type of mortgage that David and Kelly could consider is an offset mortgage. In this arrangement, both David's and Kelly's salaries would be paid directly into their mortgage (interest is calculated daily) and they would pay for most things with their credit card. Then, at the end of the month, they'd redraw from their mortgage account to pay the full credit card amount, on the due date. Because their mortgage interest is calculated daily, they're using their credit card's 'interest-free days' to their advantage, keeping as much money as possible in their home loan, for as long as possible. This is a good strategy if David and Kelly find budgeting on their credit card easy to do (some people find they lose track of how much they spend).

### Home loan vs investing the money

For many people, they will come out ahead if they pay off the mortgage first and then start their investment strategy. This is particularly the case for taxpayers like David, on marginal tax rates of 40% or 45%.

For our comparison, let's assume a direct investment in a diversified Australian shares managed fund will have a pre-tax return of approximately 8.3% (4.2% income, 4.1% growth). David is on the 40% marginal tax rate and has a mortgage with an interest rate of 7%.

So, an 8.3% return is better than a 7% saving... right? Wrong. Given that David's interest payments come from post-tax dollars and his investment return is in pre-tax dollars, we are not comparing apples with apples. To compare the two we must state the interest rate on his mortgage as a pre-tax saving.

Given that David pays 41.5% income tax (including Medicare levy), to pay \$10 off his loan he will use \$17.09 of pre-tax income. The equivalent rate of saving from paying off his loan will be  $7\% / 0.585 = 11.97\%$  pre tax.

For David to be better off investing money rather than paying off the home loan, the pre-tax rate of return on the investment would need to be in excess of 11.97%.

### Salary packaging

Salary packaging is one way for David and Kelly to buy that new car. If it's possible through David's work, they could salary package a car using David's pre-tax dollars.

Through a novated lease, lease repayments and fringe benefits tax (FBT) would be taken out of David's fortnightly pay and then, at the end of the lease, David and Kelly could buy the car (residual value attracts 10% GST).

The FBT liability is based on the cost of the car and the FBT taxable value, which is usually calculated using the number of kilometres travelled per year. For example, the FBT liability on a \$30,000 car that travels 20,000km/year would be \$5,760.

### Term reduction (in years) by making fortnightly payments in arrears (original loan term 25 years)

Fortnightly payment as % of monthly payment	Interest rate					
	5%	6%	7%	8%	9%	10%
50	3.5	4.0	4.5	5.0	5.6	6.2
55	6.8	7.4	8.1	8.8	9.6	10.3
60	9.1	9.8	10.6	11.3	12.1	12.8
65	10.9	11.6	12.4	13.1	13.8	14.4
70	12.3	13.0	<b>13.8</b>	14.4	15.1	15.7
75	13.4	14.2	14.9	15.5	16.1	16.7
80	14.4	15.1	15.8	16.4	16.9	17.5
85	15.2	15.9	16.5	17.1	17.6	18.1
90	15.9	16.5	17.1	17.7	18.2	18.6
95	16.5	17.1	17.7	18.2	18.7	19.1
100	17.0	17.6	18.1	18.6	19.1	19.5

## Comparison: Salary packaging vs no packaging

	Packaging	No packaging
Cost of car to package	\$16,196	
Superannuation guarantee	\$8,570	\$9,909
Cash salary	\$95,234	\$110,091
Total cost to employer	\$120,000	\$120,000
Taxable income	\$95,234	\$110,091
Tax on taxable income	\$25,522	\$31,688
Net pay	\$69,712	\$78,403
Car payments	n/a	\$10,000 (after tax)
Net cash	\$69,712	\$68,403
Saving	\$1,308	

## Risk insurance

Risk insurance is an important element in David and Kelly's financial plan, particularly given they have children and Kelly currently works part time. Life insurance, income protection and trauma insurance can ensure that the family is protected financially.

David and Kelly have identified that if David were to die, Kelly would want to pay off the home loan and draw a total income of \$50,000 per year.

### David and Kelly's assets

#### Assets

Superannuation (David)	\$50,000
Life insurance through super (David)	\$100,000
Subtotal (investments/assets)*	\$150,000

#### Debts

Mortgage	\$200,000
Funeral expenses	\$15,000

\* Kelly also has superannuation of \$35,000 but she would probably not be able to access these funds if David died (David's super, however, would be paid out to Kelly).

David and Kelly's current situation would leave Kelly short. In fact, she would not even be able to cover the home loan, let alone draw an income to supplement her part-time work.

Life insurance would provide an additional lump sum. This could be used to:

- pay off the home loan;
- pay the funeral expenses; and
- purchase an investment to provide an income.

Kelly wants to retain the principal, and live off the income (in conjunction with her \$25,000 salary). To reach her goal of \$50,000 per year, the investment would need to generate \$15,000. If we assume an investment return of around 7%, Kelly would need to be left with \$215,000 after all debts have been paid.

#### Assets

Superannuation (David)	\$50,000
Life insurance through super (David)	\$100,000
Subtotal (investments/assets)*	\$150,000

#### Debts

Less debts (mortgage)	\$200,000
Less funeral expenses	\$15,000

#### Subtotal

Add life insurance	\$280,000
Total Kelly receives after paying off debts	\$215,000

#### Kelly's income

Salary	\$35,000
Income from \$215,000 investment invested at 7%	\$15,050

<b>Total income before tax</b>	<b>\$50,050</b>
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Life insurance of \$280,000 will ensure Kelly can pay off the debts and receive the income she needs.

## Other risk insurance

Income protection, specifically for David who's the main income earner, is also important. It will ensure David and Kelly can keep up with their mortgage payments if David cannot work due to an accident or illness.

Income protection is designed to replace up to 75% of a person's salary. As a non-smoker (35-year-old, male marketing manager) David's premium would generally range from around \$800-\$1,000 (fully tax deductible) for the first year.\* His premiums would increase slightly each year as he grew older. This cover has a 30-day waiting period and would pay him \$60,000 per annum (indexed) whilst the accident or illness prevented him from working. Cover is payable up until his 65th birthday.

Trauma insurance is another type of risk insurance that David and Kelly could consider. Trauma insurance would pay a lump sum payment if the person insured suffered a covered medical event. The lump sum payment is designed to meet medical costs (which in many cases are not covered by medical benefits insurance) and costs associated with any lifestyle changes. In many cases, people who suffer these events are capable of returning to work in a relatively short period of time, making them ineligible for other forms of insurance payouts.

\* Market quote for an agreed value comprehensive policy on stepped premiums at standard rates.

## Superannuation

Super can be an effective way to save money, because of its tax advantages. However, in the early part of the 'mortgage and family years' David and Kelly want to focus on paying off that mortgage. If they adopt one of the mortgage strategies above, then they'd be in a position to look at wealth accumulation (both inside and outside of super) much

## Salary sacrifice example – \$21,000 p.a. (pre-tax dollars)

	Year 1	Year 5	Year 10
Balance	\$0	\$81,780	\$226,230
Contribution <sup>1</sup>	\$17,850	\$17,850	\$17,850
Balance <sup>2</sup>	\$18,410	\$105,940	\$254,640

### Assumptions:

- 1 Annual salary sacrifice contribution net of contributions tax.
- 2 Balance at end of year assumes:
  - Earning rate of 6.8% p.a. net of investment and fund fees. 15% tax on investment income.
  - Contributions made monthly.
  - No advice fees allowed for.
  - Rounding to lower \$10.

## Non-super investment of \$14,385 p.a. (\$21,000 p.a. taxed at 31.5%)

	Year 1	Year 5	Year 10
Balance	\$0	\$64,900	\$175,700
Contribution <sup>1</sup>	\$14,385	\$14,385	\$14,385
Balance <sup>2</sup>	\$14,790	\$83,750	\$197,030

### Assumptions:

- 1 Annual saving is invested in Kelly's name, when her marginal tax rate is 30% (plus Medicare levy).
- 2 Balance at end of year assumes:
  - Income 3%, growth of 4% p.a. net of investment fees, with allowance for 31.5% tax on investment income.
  - All income reinvested.
  - Savings invested monthly.
  - Rounding to lower \$10.
  - No advice fees allowed for.

sooner – say 10 years' time. They may also find that at this stage Kelly has returned to full-time work, and is on a higher salary.

An option is salary sacrificing to super – David and/or Kelly could adopt this strategy. This has many tax advantages over an ordinary investment, such as a managed fund. One of the main advantages is that you're using pre-tax dollars instead of post-tax dollars.

Notice in this example, over a 10-year period David and Kelly would be over \$57,000 better off by salary sacrificing and using pre-tax dollars to save for their retirement.

### Estate planning

Estate planning is also important during this stage of your life. You want to ensure that your assets pass to the right people and in the most tax-effective fashion.

*At Genesys, we want you to get the most out of life so you can take advantage of any opportunity and be prepared for any challenge – that's what wealth advice is all about.*

### Looking for advice?

No matter what stage of life you're in, a wealth adviser can analyse your unique situation and help you make the most out of your finances. For more information on saving for your retirement, risk insurance, estate planning, etc., or to make an initial no-cost, no-obligation consultation, please contact:

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