

EBOOK



Achieving

FINANCIAL FREEDOM

through investment property



IGROW WEALTH
INVESTMENTS

ACHIEVING FINANCIAL FREEDOM THROUGH INVESTMENT PROPERTY

This article is not going to be a splurge about how you can make “millions in property” or how you can “become rich with other people’s money” but rather an honest look at why property investment makes sense mathematically as an investment vehicle to plan toward retirement or financial freedom.

Firstly, financial freedom and retirement are not necessarily the same thing. Financial freedom can be achieved before retirement in the form of passive income derived from multiple revenue sources. An example would be passive income generated from multiple investment properties whilst you are still working a full-time job. The more passive income you generate relative to the level of income you would require to retire from will determine when you can step away from work life and live off your passive income and retirement investments comfortably. The idea is to maintain the same standard of living.

This unfortunately, is not a reality for many South Africans mainly because they are not fully educated in retirement planning. What I mean by this is what is actually required to retire and essentially stop working. The norm in South Africa and most parts of the world is age 65. The reason for this is due to the traditional financial planning model where you save a portion of your income each month and build up a capital reserve to live off until the day you die.

The principal sounds simple, however, merely saving each month is not enough due to several factors. These factors include when you started saving, how much you are saving and lastly, what income are you planning to replace at retirement.

The guidelines for retirement planning is starting to save from the age of 23 where you save 15% of your salary to replace 75% of it in retirement. These assumptions can easily be skewed if you start saving from the age of 35 or if you only save nine percent of your salary. The percentage of income replaced really becomes unclear, and the most important factor, often neglected, is how long the capital is expected to last.



Yes, you can invest your money into a combination of investment products such as shares, retirement annuities, endowments and unit trusts. The idea is to achieve capital appreciation through compound interest and outperform inflation. We all know this, but we can only make assumptions as to what the expected investment returns will be based on economic and political factors. If you are approaching retirement and the markets are not performing, it will have an impact on how much income you can derive from the capital. This is more so whilst in retirement when you rely heavily on fund performance in order to prolong your capital.

We sadly do not have a crystal ball, so how long a person will live from the age of retirement becomes the biggest conundrum, where it is too late when income a pensioner realises, they are outliving their capital.

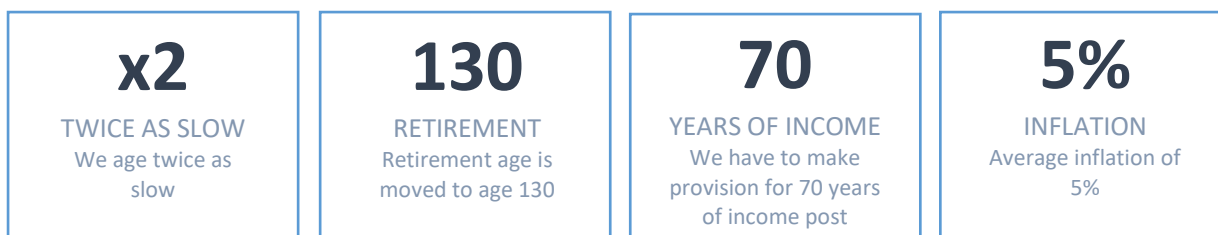
As a financial planner, I have seen too many instances where a pensioner wishes to increase their annual pension amount in their living annuity and if the annual drawdown is higher than the current fund performance, the capital depletes at a faster rate. Pensioners also have share portfolios but tend to move the capital into money market accounts due to the short-term volatility of share price fluctuations. By doing this, they are triggering a capital gains event, which is taxable due to the asset being disposed.



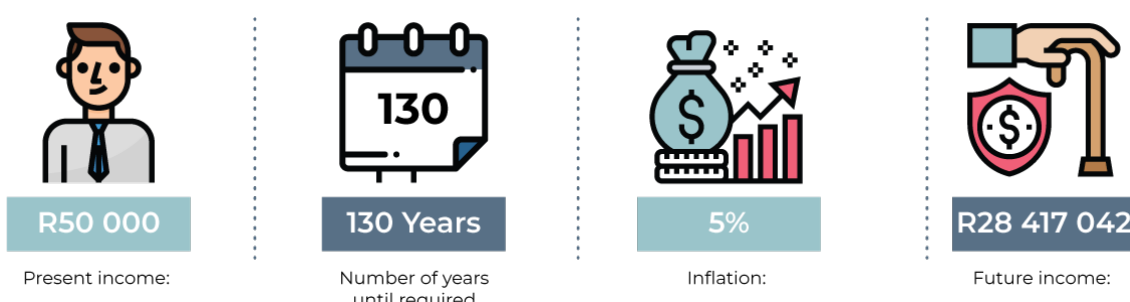
My biggest concern is the future. With advancement in medicine, people are expected to live longer. This simply means, that there is risk of capital depletion becoming higher as the provisions for retirement are still unchanged. An example is the Coronavirus Covid-19. Humans will adapt and their immune system will be able to battle this virus once it becomes contained and treatable. There will be vaccines produced by pharmaceutical companies all over the world. This has been the case with other viruses that have been discovered.



To illustrate my concern practically, I want to use the following example using the scientific assumption that a new born today can potentially live until the age of 200.



If we take R50 000 in present terms and a new born is planning to earn this each month when they retire in 130 years from now.



The new-born is expected to derive an income of R28 417 042 per month (R341 004 515 per annum) and this has to last for 70 years. So, the question is, how does one plan for that eventuality if they only start saving from the age of 23?

If average inflation increases at 5,5%, then the future income required will sky rocket to R52 697 469 per month in 130 years from now. These numbers appear comical, but if you look at what goods and services cost in the 1970's, you will see how inflation has impacted the buying power of money. This was only 50 years ago.

We can see at present there are several retirement products where actuaries have built in additional "boosts" or "bonuses" to provide extra allocation of capital at retirement. This is seen as a "loyalty" benefit for keeping the product running for the specified term. The main reason is to try improve current market performance where double-figure returns are a thing o the past.

So, why should you consider investment property as part of your portfolio?

Property is an asset. An asset appreciates over time, which means that, like gold, it will be worth more in the future.

This is fairly obvious, however, the biggest advantage of property, is the ability to leverage finance and obtain property without having to raise the capital to acquire the asset. In other words, the 'Opportunity cost'. The 'Opportunity cost' is the cost of making one decision over another and the consequences of that decision.

If you purchase an investment property, you have the benefit of acquiring finance with a bank and therefore use less of your own money to achieve the same thing. If you instead purchased the same investment property, and used cash with no bond finance, what was the opportunity cost of that decision?

Let's use a practical example. If you have R900 000 capital and purchase one investment property for R900 000 and do not utilize the banks, then you will own the property and derive the rental income. If the rental income was R7 500 per month, then we can say the gross yield is 10%.

This looks appealing; however, you are restricting yourself to one income stream. Had you approached the banks and applied for finance on two R900 000 investment properties and placed 50% deposits, then you could unlock R15 000 rental income per month and let the tenant pay off the outstanding bond. When the bond is settled, you own two assets generating an income, which positively impacts financial freedom and retirement planning. If the bond term was 20 years and the rental income escalated at 5%, then the future income will be R39 799 per month. The buying power will be in line with inflation.

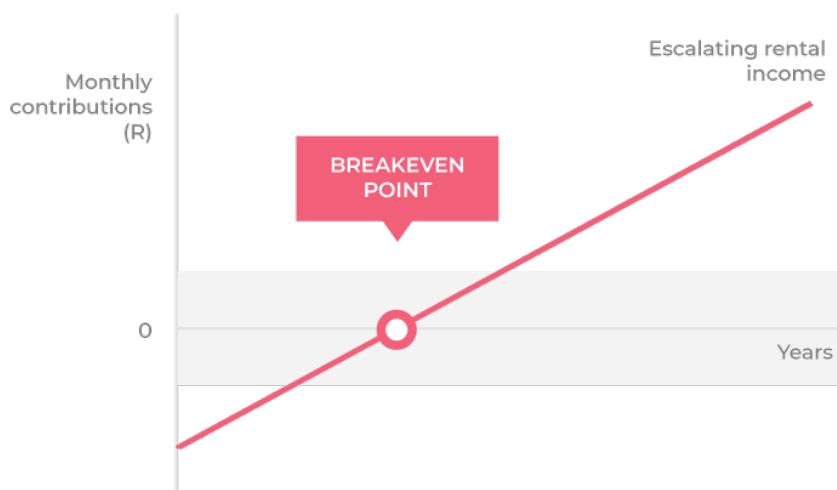
Had the R900 000 been invested in a unit trust for 20 year and achieved annual compound interest of 8% (net of costs and fees), then the future value would be R4 194 861. If we derive the same future income of R39 799 per month, then the annual draw down would be 11.4%. If the funds still achieved 8% annual compound interest, then we can see that the capital will be depleted.

Had you acquired two investment properties, to the value of R1,8 million, and the these appreciated at 8% per annum over the same 20 years, the future market value would be R8 389 722. This is 100% more than the unit trust and you used the same R900 000 capital.

We can therefore determine the actual opportunity cost by looking at both options mathematically.

A GRAPHICAL LOOK AT THE FINANCIAL COMMITMENT OF TRADITIONAL INVESTMENT PRODUCTS AND INVESTMENT PROPERTY.

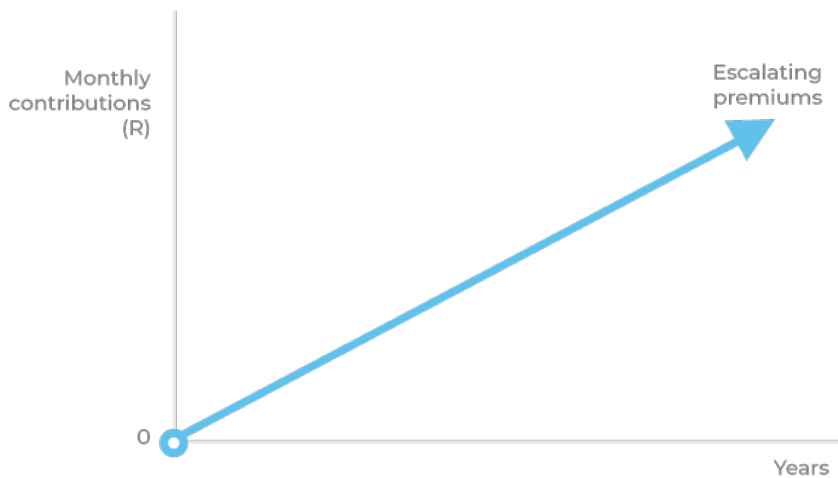
Property will incur monthly contributions until the property reaches its breakeven point. From that point onward, the property will be self-sufficient where the surplus cash flow can be reinvested.



With traditional financial products, such as a retirement annuity, this will incur monthly contributions that escalate each year until the year of retirement. The escalation rate is normally inline with inflation.

If the retirement annuity achieves an **8%** annual compound interest, then the real return or resultant rate would be **2,86%**. This is due to the investor escalating the contributions each year, which in itself is contributing toward investment performance. The real return is therefore 2,86% as you funding the investment throughout the term.

2.86%



With property investing, the objective is to acquire the right number of investment properties, which is based on your financial freedom or retirement goal, and then apply an investment strategy to transition the debt so that the outstanding bonds are settled by the goal age. If you are able to replace your salary with rental income across multiple properties, you are effectively retired, which can be before the age of 65. If you acquire the right number of properties over a short period of time, you can use amortization to settle the bonds at a quicker rate, which is not possible with traditional retirement planning.

Investing in property is a complex process and there are many factors to consider, which is why it is important to partner with a company that understands the market and can mitigate risks so that you can achieve your investment goals in a more effective manner taking all variables into consideration.

Whether you are a seasoned property investor or still starting your portfolio, it is important to have a team of professionals to support you and provide guidance when working toward a desired goal.

We have an exclusive Wealth Plan which we created to provide a holistic overview of an existing property portfolio as well as financial products so we could see the impact of each individually and collectively when tracking a specific goal. Rental income supplements pensions or capital drawdowns at retirement, so we can see how to best invest your money based on your current position and financial commitment.



Virtual consultation

If you would like to speak to one of your property investment strategists, please complete the contact us form to schedule a telecon, zoom or Skype call.

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