Home Study Program Module 15
Negative & Positive Gearing

Wealth Creation Dynamics

Learn how to **drastically** advance **your** financial future.

by Philip Sigglekow
Author of best seller 101 ways to get rich quicker.

Welcome

Module 15
Negative & Positive Gearing

Welcome to module 15 of the Wealth Creation Home Dynamics Study Course - Negative & Positive Gearing

This module is number 15 of 24.

Each module is presented in the same layout and contains exercises that you can do in your own time.

The benefits of participating in this Home Study Course are:-

- You progress at your own pace.
- You can study in the privacy of your own home.
- You can ask questions regarding the course at questions@apin.com.au

We hope you enjoy the Wealth Creation Home Study Course.

Best regards,
The team at APIN

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Friend or Foe

Often proclaimed as a property investor's best friend, negative gearing is a concept that few people really understand. Sadly this ignorance is causing many investors a lot of financial heartache.

Let's review the basics of negative gearing, the way it works and how unwary investors are being willingly coaxed to buy a so called asset that's purposefully designed to lose money.

In his special article entitled 'Positive Cash Flow Returns Through Property Investing', expert property commentator Steve McKnight rightly pointed out that there are two ways to make money in real estate. Either through capital appreciation, when your property value goes up, or via positive cash-flow returns, when you have more income than expenses.

In the world of property investing, the most common way that investors seek to profit is through capital appreciation, which is why location is regarded as critical to real estate success.

The preferred weapon in the fight to achieve capital gains returns in Australia, New Zealand and Canada is something called negative gearing.

Negative gearing seems simple enough – buy the right property in the right location and then have the tenant and the taxman partially fund your repayments while you sit back and profit from the appreciating property value.

But can using property to make money be that simple? In a rapidly rising market, as was seen in most of Australia between 1996 and 2002, yes – it can appear to be that easy. Just hop on the escalator and ride the easy way to the top.

Yet there are quite a few investment pitfalls that aren't discussed in the glossy 'off the plan' brochures, at the free seminars, or on the carefully tailored TV reality shows.

So let's take a full "warts and all" look at negative gearing to see when to use it … and when to avoid it like the plague.

What is Negative Gearing?

There's lots of hype when it comes to negative gearing. Lots and lots and lots in fact. And this all stems from the fact that quite a number of property sharks make a killing from selling negatively geared properties to unsuspecting investors.

Sadly, a lot of investors are sold on the potential outcome of owning property (hopefully making truckloads of money) without understanding the immediate consequences of their investment.

Negative gearing is a strategy that provides immediate tax benefits while also offering the promise of long-term gains in the form of capital appreciation.

Tax Benefits

The Australian Taxation Office (ATO) allows property investors to offset an income loss (where property costs are higher than property income), incurred on a real estate investment, against any other income. To explain how this works we need to work through the numbers based on a typical property.

EXAMPLE:
John is a taxpayer earning $80,000 per annum (plus superannuation) in a contract job for a major IT company. He is thinking about purchasing a property for $230,000 (inclusive of $7,850 in closing costs). To maximise his available tax deduction he has been able to secure 90% finance on a 25-year principal and interest loan with a current variable interest-only rate of 6.7% per annum. He makes weekly loan repayments in advance. The developer has offered a 5 year rental guarantee at $250 per week. The rates and body corporate fees total $2,000 per annum and there is also an 8% rental management commission to be paid. We are going to ignore depreciation benefits for the time being. At the end of the first year, the profitability of John's property investment would be:

Rental income	$13,000
Rental Management	($1,040)
Loan Interest	($13,869)
Rates etc.	($2,000)
Total	($3,909)

John is then able to claim the loss of $3,909 against his salary income and can reduce his overall tax bill as follows:

	John With No Property	John with One Property
Salary	$80,000	$80,000
Property Tax Loss		($3,909)
Taxable Income	$80,000	$76,091
Tax + Medicare	($26,180)	($24,284)
Nett Income	$53,820	$51,807

Even though John has made a Loss of $3,909, the after-tax effect on his bottom line income is only $2,013 ($53,820- $51,807).

Are you wondering that knowing this investment was going to lose money, why on earth would John want to buy it?

Good question! Trying to explain a good answer raises several key issues at the heart of negative gearing that must be addressed before you'll make one dollar in profit.

The short answer is that John is speculating that his potential capital gain will be consistently more than his certain income loss.

Which isn't out of the realms of possibility given that all he seemingly needs to make is capital appreciation of just 0.88% ($2,013 / $230,000) per annum to at least break even.

Indeed, if John had purchased this property back in 1996 then it's extremely likely that he would be sitting on a small gold mine right now.

But trying to examine John's intention for investing actually opens up many other issues that must also be considered to paint the full picture of his investment - now and in the future let's now examine some of those issues.

Can you make money and save tax at the same time?

At any given point in time you can't make money AND save tax because the act of making money gives rise to the need to actually pay tax.

This is where we need to discuss the difference between a realised and an unrealised profit/loss. In negative gearing the loss is real in that John will physically have to come up with the after tax shortfall of his expenses over his income. This can be summarised by:

Property loss	($3,909)
Tax benefit @ 48.5%	$1,896
After tax loss	($2,013)

The consequence of this is that John will physically lose the buying power of $2,031 out of his pocket until expenses fall and I or income rises, from owning this property.

On the other hand any of his capital gains remain unrealised, and as such there is no tax to pay, until he decides to sell.

John can even refinance any capital appreciation he obtains and effectively pay no tax provided he doesn't sell!

But the problem with an unrealised gain is that you can't generally use it to fund your lifestyle. For example, you can't go into the supermarket and pay for your groceries using your capital gains debit card.

Accessing your unrealised profits can also be expensive (with redraw fees) and time consuming (with forms to fill in and sometimes lengthy delays).

Contrast the situation of realised loss and unrealised gains (as discussed above) with cash-flow positive property that has only realised income gains.

Because your property income is higher than your property expenses then you'll have to actually pay tax on your profit.

For example, imagine John purchased a property that had the following annual outcome:

Property income	$12,000
Property expenses	($10,000)
Subtotal	$2,000
Tax payable @ 48.5%	($970)
After tax profit	$1,030

Unlike the previous negatively geared example, if John purchased this type of property then he'd instantly add to his bottom line, That is, he'd have more money from investing in property from day one (before any capital gains) not less.

And under both models he would profit from any capital gains although it has been traditionally claimed that it is difficult to get both capital gains and positive cash-flow from the same property.
The bottom line here is that it's not possible to use negative gearing to consistently invest in property in a way that sees you pocket more cash AND also claim a tax deduction at the same time.

How many properties can you afford to own?

Statistics show that only 1 in 200 property investors own more than 5 properties. But if owning property was such a great idea then wouldn't it make sense to own multiple properties... say 10, 20, 30 or even more?

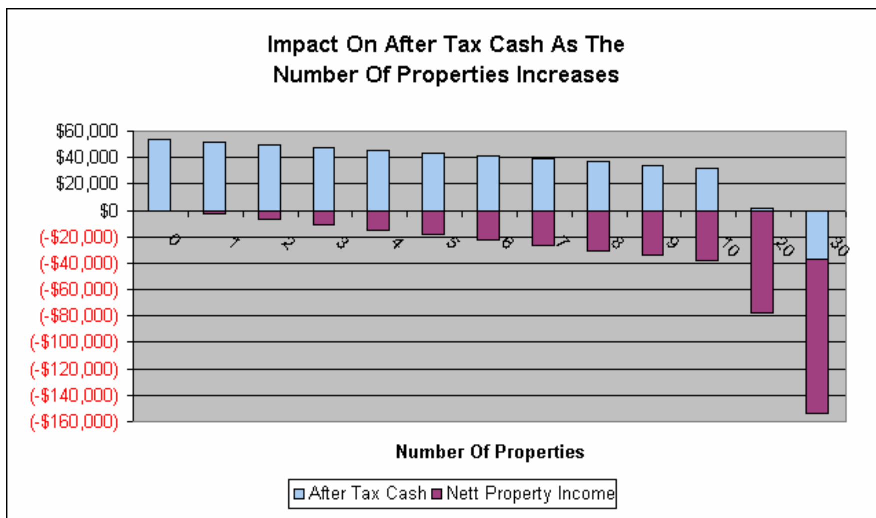
The reason why only 8% of all investors are able to own 3 or more properties is because of an affordability issue.

Let's go back to our earlier example and imagine that John was able to buy 5 of the same negatively geared type properties. How would his after-tax financial circumstance look then?

Rental income	$65,000
Rental Management	($5,240)
Loan Interest	($69,345)
Rates etc.	($10,000)
Total	**($19,585)**

	John With One Property	John with Five Properties
Salary	$80,000	$80,000
Property Tax Loss	($3,909)	($19,545)
Taxable Income	$76,091	$60,455
Tax + Medicare	($24,285)	($16,682)
Nett Income	$51,806	$43,773

What we can see now is that as John owns more properties his after-tax cash position is dramatically shrinking. Sooner or later John will reach the point when he can no longer afford to buy more property. His real after-tax wealth is reducing in ever decreasing circles, which is illustrated in the graph below.



The graph above shows that as John owns more property his after tax available cash decreases, whilst his losses from owning property increases. This illustrates the decrease in his purchasing power as only a maximum of 48.5% of the property loss can he claimed as a tax deduction. The remainder must be paid out of John's after tax salary.

The Lack of sustainability is a phenomenon of negative cash-flow that is rarely discussed.

The outcome of this investment is that you need to keep working in order to continue to earn enough of a salary to fund the cash drain of the loss making investment.

Five years on...

Let's take our example of John a few steps further and fast forward five years. His property has appreciated by 40% and is now worth $322,000.

His rent has increased by 10% and he now earns $275 per week, but his rental guarantee has now lapsed and he needs to allow for $1,000 per annum in maintenance. Rates have risen to $2,200. Let's imagine interest rates have remained steady at 6.7%. During the same time John's salary has risen to $90,000.

His annual property income statement would now look like:

Rental income	$14,300
Rental Management	($1,144)
Loan Interest	($13,869)
Rates, etc.	($2,200)
Maintenance	($1,000)
Total	**($3,913)**

Based on these figures John's property has been able to hold its own in terms of profitability in that his rental increase has offset his additional expenses. Really though, allowing for inflation, he is slightly worse off as a dollar five years on buys less than a dollar at the time John bought his property.

	John With No Property	John with One Property
Salary	$90,000	$90,000
Property Tax Loss	-	($3,913)
Taxable Income	$90,000	$86,087
Tax + Medicare	($31,030)	($29,132)
Nett Income	$58,970	$56,955

Whereas five years ago John was $2,013 out of pocket, now he's $2,015 a minuscule deterioration.

But he has earned unrealised capital gains of $92,000.

In summary, on paper he's doing well, but in reality his purchasing power has taken a hit. Negative gearing has achieved an outcome of theoretical wealth creation but an actual real loss in purchasing power.

Using the equity

Now John has made a paper gain of $92,000 on one property. If he decided to realise that gain, what options does he have?

1. Sell

Assuming John sold his property for $322,000 on the last day of the tax year then his profit would he:

John with one property

Sales price	$322,000
Agents commission (4%)	($12,880)
Legal's etc.	($2,000)
	$307,120
Acquisition Cost	$230,000
Gross Capital gain	$ 77,120
50% Exemption (Note 1)	($38,560)
Taxable portion	$ 38,560
Income Tax at 48.5%	($18,701.60)

After Tax Profit	$19,858.40
Add Tax Free Portion	$38,560
Total After Tax Gain	**$58,418.40**

However, in order to calculate his true return we need to deduct the negative cash-flow for five years and then divide it by his original deposit (10% of $230,000)

True After Tax Gain Total Gain	$58,418.40
Five Years (After Tax) Negative Cash flow	($10,065)
Nett Gain	$48,353.40
Less Original Deposit	$23,000
Nett Gain	$25,353.40

After Tax Project cash on cash return: 165~5i% ($15,200 / $23,000)

After Tax Annual cash on cash return: 1 3.22% ($3,040 / $23,000)

If John sold his property under this circumstance then he would have made a small return and he would have had to take a lifestyle cut in order to fund the annual negative cash-flow from expenses being higher than income.

2. Hold and Refinance

If John didn't want to pay tax then he needn't sell. He could approach his original financier and seek to refinance his loan to 90% of the new value. That is, he could access a further $82,000 (90% of ($322,000).

Should John use this money for investing in other property investments then he would qualify for a tax deduction on the additional interest. But if he did this then his annual negative cash flow would increase because he has borrowed more money.

It would now appear as:

Rental income	$14,300
Rental Management	($1,144)
Loan Interest (90% of $322k)	($19,417)
Rates etc.	($2,200)
Maintenance	($1,000)
Total	**($9,461)**

What John would find is that refinancing would allow him to acquire another property with no money down, but the additional interest cost would further reduce his after-tax available cash.

The worst thing that John could do is redraw the equity and then fund his lifestyle with the proceeds. If he does this then he will lose the interest deductibility of the redrawn amount - which will have a nasty impact on his overall wealth creation.

Lets look at what would happen if John redrew all of his equity and funded a round the world extravaganza.

Rental Income Statement if John refinances and spends money on lifestyle

Rental income	$14,300
Rental Management	($1,144)
Loan Interest (see note)	($13,869)
Rates etc.	($2,200)
Maintenance	($1,000)
Total	**($3,913)**

John with one property

Salary	$90,000	
Property tax loss	($3,913)	
Taxable income	$86,087	
Income Tax * Medicare	($29,132)	
Subtotal	*$56,955*	
Non deductible interest($5,548)		
Nett Cash Flow		$51,407

Note: The total interest would be ($222,000 90% of 6.7%, $19,417, however on the portion relating to the property investment ($13,869) would be deductible. The remainder ($5,548) is not deductible as it relates to private rather than investment expenditure. The wash up of all this is that if John sold then he would pocket a handsome gain - the product of steady capital appreciation while he owned the property.

But if he refinanced and then invested the proceeds then his borrowings would increase, as would his interest costs, which would have the effect of further decreasing his nett after-tax available cash

Even worse, if John refinanced the property and then took his equity and spent it he would be left with an interest bill that was not deductible. He might just as well have applied for a personal loan. Investors should never drawdown on equity to fund a Lifestyle. It would be better for John to sell and pay for his trip as at least he would have borrowed the money but would have used realised profits.

Fairytale assumptions

It's just assumed that you'll make money from buying a negatively geared property, provided you can hold on for the long-term and wait for the escalator of property prices to steadily rise, in times of rapidly rising prices this is great, but in times of stagnant or even falling prices then negative gearing is a poor strategy.

It's true that you won't lose unless you sell. If you can hold on for the long-term and ride out any bumps then you should do well because property prices generally trend upwards (meaning that the average property will increase in price over time.)

The real losers are investors who buy in the boom and have to sell in the gloom because they can't afford to ride out the storm.

If John had of purchased five properties and interest rates rose from 6.7% to 10% then the result would have been disastrous. His after-tax remaining cash-flow would be:

Rental Income Statement: John with 5 properties and interest rates rise to 10%

Rental income	$65,000
Rental Management	($5,240)
Loan Interest	($103,500)
Rates etc.	($10,000)
Total	**($53,740)**

John with 5 properties

Salary	$90,000
Property tax loss	($53,740)
Taxable income	$36,260
Tax + Medicare	($7,802)
Nett income	**$28,458**

Ouch! John's available cash has just about been crunched. It's no wonder so many property developers went to the wall when interest rates spiked at 17% in the early 1990's.

Assuming that interest rates will remain low or that property prices will rise forever is nothing more than a fairytale assumption that is really the best case scenario.

Exercise

If you owned a 'Negatively Geared' property, would you have more or less nett income at the end of the financial year and why?

Is it best to sell your 'negative geared' property after a couple of years or hold on it until the loan has been paid off and why?

The Truth

Truth #1: Negative gearing is a strategy guaranteed to lose money

A negatively geared property is designed to enable you to access an immediate tax deduction arising from the shortfall of rental income failing to cover your property expenses.

In other words, negative gearing is a strategy guaranteed to make a loss.

In order for you to afford this loss, you'll have to fund it out of your existing cash flow by working longer hours, or by taking a lifestyle cut. For most people this means going without some of the luxuries they previously enjoyed.

No one wants to lose money, but it is testimony to the power of effective marketing that smart investors are fleeced out of thousands of dollars by being conned into a concept that only exists to lose money in the short term.

The only way an investor can make money from negative gearing is if any potential future capital appreciation is higher than the certain cash flow loss incurred today.

Negative gearing is a valuable profit-making tool in a rising market. But it is not a strategy for all investing seasons.

Truth #2: The dangers of depreciation

Buying a property based on depreciation benefits is dangerous and deceptive.

Depreciation is an accounting term used to describe the wear and tear of an asset that occurs over time. In practical terms, depreciation on a property refers to the carpet wearing down, the walls becoming chipped or stained and the furniture dating.

In most new properties you are allowed to claim a tax deduction for the depreciation of the fixtures and fittings and in certain circumstances you may also claim a building write-off of either 2.5 per cent or 4 per cent of the property (not land) value too.

Slick marketing companies sell the notion of the taxman paying off your property using depreciation and building write-off deductions, but this sales pitch is quite deceptive because you don't avoid paying tax with depreciation, you just defer it.

Commonsense suggests that depreciating an appreciating asset like property will give you a tax deduction today, but you'll have to repay it in the form of capital gains tax at a later date when you sell.

'Bracket-creep' issues can catch out many taxpayers too, If you earn $50,000 when you buy the property you will only be able to claim a deduction for depreciation at 43.5 cents in the dollar, but if your income rises to $60,000 when you sell then you'll need to repay the depreciation at 48.5 cents in the dollar.

If you don't ever plan to sell the property then at a minimum you should recognise that your depreciation tax deduction represents the wear and tear on your asset that will need to be eventually refurbished in order to continue attracting quality tenants.

Finally, beware any financial model that allows for depreciation benefits but does not include a maintenance budget. You cannot have depreciation without an expectation of repair costs - even new properties still need tap washers replaced,

Truth #3: The deception of attracting premium tenants

A common strategy used to sell negatively geared property is to focus on purchasing a blue-chip property that will attract a premium tenant, since a premium tenant is more likely to be a quality long-term and high paying occupant.

Yet my experience reveals premium tenants are often the most volatile segment of the rental market. When times are prosperous, then premium tenants look for glamorous living in the newest kind of accommodation available with all the modern conveniences.

But when the economy contracts, premium tenants with high paying salaries are at a high risk of being downsized. If this happens, then they will seek cheaper accommodation leaving investors owning expensive properties competing for new tenants in a shrinking market.

In times of serious recession it's not unusual to expect vacancies of three months or more on premium properties, which can make owning negatively geared properties an absolute investing cash-flow disaster.

A better strategy would be to attract a quality tenant who is willing to pay between 10 and 20 per cent above the market rate for a well-maintained property and decent landlord service.

There will always be demand for a house that the average family can afford to live in. It would be wise for you to focus your attention on purchasing a property that is less prone to market fluctuations, and then seeking to charge above market rates for a quality property to attract long-term tenants that want to treat your property like a home.

Truth #4: Unfair comparisons

Figures used to substantiate expectations of appreciating property values are in many instances downright deceptive. One common example is the rise in the value of median property prices being applied to premium real estate market.

In reality property prices can rise and fall in the same market at the same time. To eliminate this variance, statisticians adopt a mathematical snapshot of the market based on the value of median properties sold during the period.

Movements in the median property price are certainly not representative of movements in the highly priced end of the market. Attempts to correlate movements in the median property values to highly priced real estate is statistically incorrect at best and potential fraud at worst.

Making an assumption that real estate values double every seven to ten years, across all types of property (houses, units, etc.), in all States, is misrepresentative.

It's very easy to build a financial model and then hide distant reality in broad assumptions or leave out important information all together. For example, making no allowance for vacancies after the rental guarantee period has finished or showing after tax nett profit with no allowance for capital gains tax payable when that asset is sold.

One quick way to test the conviction of a sales agent promising capital appreciation is to get him to personally guarantee it in writing, Given the degree of their certainty about rises in property value and considering the massive investment you'll need to outlay to own a blue chip property, a written guarantee simply confirming the underlying assumption isn't too much to ask.

Be very wary of the assumptions used in any financial model.

Truth #5: Who's really paying for the secret commissions?

If you liked the idea of purchasing property similar to the one that John purchased then you're probably asking, Where can I find such a property?'

Enter the free property seminar circuit, which is often little more than an elaborate attempt to sell you an overpriced property that meets the finely-tweaked financial models devised by clever marketing agents who are paid a commission to sell real estate on behalf of developers.

It's not unusual for commissions to be five per cent of the sales price, which on the property used in the earlier example amounts to $11,500.

This fee is not paid from the developers margin. It's a cost added on top and paid for directly by you the purchaser. It can become unnecessarily expensive buying prime property off the plan when there are kickbacks to financiers, fit-out providers and sales agents all funded by you as the purchaser.

Negative gearing is often sold as a strategy that will make you rich in the future, but when you buy a boutique property you'll be making developers and sales agents rich ~ Be very wary about letting other people profit at your expense.

Remember to always ask who gets paid when I buy?

Truth #6: The trap of trying to save tax!

One of the many sales reasons given for investing in a negatively geared property is that qualified accountants recommend it.

Indeed, if you approached most accountants and asked for strategies that legally minimised tax then negative gearing would be one of the first options discussed.

But investing in negatively geared property to save tax is a double-edged sword. For every dollar you lose, you'll only ever recoup a maximum of 48.5 per cent back as a tax saving.

While you're waiting for illusive capital appreciation you'll be working longer hours and trying to cut back spending in order to fund the continual cash outflow when your property expenses are always higher than your rental income.

If you are paying your accountant for advice then spend your money searching for strategies that will earn cash profits, not ways that are guaranteed to make a loss

You might pay more in tax but you'll also be earning much more cash profits too.

Truth #7: How many of these properties can you afford to own?

As you own more negatively geared property, your after-tax available cash reduces. This is because you only ever recover a maximum of 48.5% in a tax deduction, the remaining 51.5 cents in the dollar comes from your back pocket.

It makes sense that as you own more loss making property, your real buying power shrinks in ever decreasing circles.

The Final Word

Negative Gearing is a proven wealth building strategy during times of rapid price increases provided you can comfortably afford the negative cash-flow and are happy to continue working.

But as the saying goes… 'horses for courses'.

Negative gearing is a strategy designed to lose money and in order to fund that loss you will need to continue working. This makes the strategy at odds with the broader target of financial independence. If your goal is to stop working as soon as possible or to free up more time to do the things you love, then negative gearing is not a wealth building strategy you should implement.

Remember that there's a lot of hype about negative gearing because a huge industry of developers and sales agents make a living by selling property. It's more important than ever that you complete your proper due diligence over a potential property purchase to ensure you can afford the ongoing cash outflow from your property.

Summary

Be very careful about blindly purchasing any kind of property.

Be extra cautious when buying something when the outcome is likely to be negative cash-flow. Be extremely careful when buying property that a sales agent or a developer says has tax advantages… this is a red flag that the property is guaranteed to lose money.

Making a profit from speculating that property prices might rise while you incur a certain income loss is risky.

Remember that if all you did was make money, then you'd have to make money. If your investments are not making money, then something's going badly wrong,

Exercise

Why can depreciation be considered 'dangerous'?

Where does the shortfall come from when you own a 'negative geared' property?

Making Money in Property

There are three possible outcomes from property investing:

1. You make money
2. You lose money
3. You break even

And in the world of property investing you can only make money in two ways - either capital appreciation and/or positive income returns.

Capital appreciation is straightforward enough. Over time your property increases in value so that it becomes worth more later than what you initially paid for it (this is also known as an increase in equity).

The only trick with capital appreciation is to remember that the amount you pay for a property is the contract price *plus* closing costs, and the amount you receive when you sell is the sales price *less* agents commission, your loan payout and other selling costs.

You can only turn your capital appreciation into positive cash-flow by redeeming your equity through refinancing or by selling your property.

The second way you can make money in property is by securing a **positive *income return.***

Positive income returns occur when your investment income is higher than your investment expenses.

This concept is different from 'negative gearing' which focuses on capital appreciation at the expense of a positive income return. In fact, negative gearing is all about creating an income loss so you can claim a tax deduction.

What is it you want from your investment?

Assuming that you're investing in property to make money, does it really matter whether you focus on capital appreciation or positive cash-flow returns?

This question has been the centre of a lot of debate recently and the property gurus seem divided. Some swear that capital appreciation is the way to go whereas others strongly advocate positive cash-flow income returns.

The truth is that there's probably no absolute right answer, in other words, the best anyone can say is "it depends".

Depends on what? Well, the reason why you want to make a profit in the first place.

You need to clarify your investing purpose so that you can decide what type of property you should buy to obtain an outcome that is consistent with your investing objective.

For example, if you want to buy a property that's likely to appreciate in value, then you'd be wise to focus primarily on location. However if you want a positive income return, then a property's location isn't as important as the likely income and expenses.

Financial independence and passive income

Financial independence is an investing outcome that is becoming increasingly more popular as disgruntled employees look for a better quality of life.

Financial independence means the freedom or release from the need to have to work.

It can occur in varying degrees from partial independence (when you get to take a few hours off work a week) to complete financial freedom (where you no longer need to work at all).

The way to attain financial independence is through acquiring passive income.

Passive income is something that flows to you and is largely independent of the number of hours worked in a job.

It needs to be pointed out that there is really no such thing as completely passive income because every dollar of passive income must flow from some kind of work or effort in the first place.

For example, while rental income might seem to be passive income, the task of finding and investing in property, together with managing the tenant, filling in tax returns etc. is anything but passive!

A good example of passive income is royalty payments paid to musicians. They write a song once and are potentially paid a royalty each time the song is played. The initial act of writing and recording the song wasn't passive, but the ongoing payments when it is included on music CDs (sometimes many years later) is. Just think of the Beatles!

The word 'passive' really means avoiding being paid by the hour.

Instead you seek to do some work today and leverage off it tomorrow. This leverage is in the form of receiving multiple payments without the need to work again.

For example, if you invest in a positive cash-flow property then you hope that the work involved in finding and acquiring the property will create a positive income stream that will last until you sell the property. One days work now for a lifetime of return later.

It's like an extended form of delayed gratification.

Time and Money

A myth about financial independence is that it's all about money. It's not. It's all about time.

As we age we begin to realise that we're getting older, we begin to see that time is quickly running out. Sooner or later we even realise that time is actually more valuable than money. For example, if you knew the exact moment that you were going to pass away, what price would you put on your last hour alive?

Time is finite, money isn't.

Yet money in the form of regular and constant passive income can buy us freedom to spend time (that we would otherwise allocate to working in a job) doing the things that we really love. That is, money can buy us control of our time that we would normally otherwise sell to an employer in exchange for money to fund our lifestyle.

Now for some people the freedom from having to work means little because they love their job to begin with. That's fine, but it would be even better if you were the one calling the shots and not your boss!

But the reality is that most of us have other things that we'd rather be doing, such as giving time to the kids, exploring spiritual matters, making the world a better place or maybe even playing more golf.

And all this would be possible, if only we didn't have to work in the first place! After all, electricity isn't free and neither are the groceries.

If you want to work less but don't want to take a cut in your lifestyle then you're going to need to focus on finding some sort of passive income to replace the salary you'll forgo when you cut back your hours.

Look at it this way, if you were paid $50,000 per annum in a standard 9 to 5 job, how much passive income would you need per week in order to take every Friday off without suffering a drop in lifestyle? [Go grab a calculator!]

Your answer $

The outcome to this discussion is that unless you plan to work until compulsory retirement age, you're going to need to start building some passive income that will substitute your wages as you gradually work less and less in your normal day job.

Calculate below to determine how much you are paid per day and week based on your annual salary and assuming you take four weeks annual leave per year.

Your annual salary $

Net $
Tax $

Passive income and property investing

Let's just do a quick review of the discussion so far.

There are two ways to make money in property investing; your property can increase in value and/or you can earn positive cash-flow if your investment income is higher than your property and finance expenses.

Both are valuable and can occur independently to the other. That is, you can have capital appreciation and no positive income returns (this is negative gearing), or you can have a positive income return and no or negative capital appreciation, or you can have no capital appreciation and no positive income too (or both).

Is capital appreciation better than a positive income return? Perhaps, perhaps not.

But if you're looking to retire from you job without necessarily taking a lifestyle or pay cut, then you're going to need to source some kind of passive income to replace the wages you lose from cutting back at work.

Now you can do this by converting your capital appreciation into a series of payments. But once you've spent the gain then it's gone forever, your financial independence becomes dependent on further capital appreciation which is by no means certain.

Positive income returns on the other hand regenerate, which means they may continue on indefinitely. Sure, tenants will come and go and there may be times when your property will be vacant, but generally speaking your passive income stream is not limited or capped.

Conclusion

If the reason why you want to make money in real estate is to try and attain some degree of financial independence to gain the freedom from having to work, then it makes sense that you should focus on positive income returns rather than capital appreciation.

This is because you can't use your 'capital appreciation debit card' to fund your weekly grocery bill, but you can pay for it out of a property income surplus.

The ideal situation would be to have both capital appreciation and positive income, but opportunities offering this can be quite rare.

It's fair to say that different property investments offer the potential for different types of returns. Some are specifically designed for capital appreciation and focus on location irrespective of cash-flow returns (such as inner city apartments).

At the other end of the spectrum are investments that offer high cash-flow returns but no/low prospect for capital gains (such as regional or country properties).

You can only determine what property you should buy after you've clarified what outcome you're working towards.

If that's working less then you wouldn't buy a negatively geared property that was designed to lose money which meant you had to work harder to pay for the loss.

Instead you'd focus on properties that delivered ongoing positive cash-flow returns, since that's what you'd need to replace your salary and fund the lifestyle you deserve.

Exercise

What are the two main ways to make money in property?

Why is ‘positive cash-flow’ becoming more popular with investors?

final reflections

What key points have you learnt from this module?

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When considering your investment options, ask yourself these 13 critical questions:

1. What's the end purpose to my investing?
2. Will buying this property bring me closer to, or push me further away from that goal?
3. Am I saving tax or making money?
4. What is the annual cash in or outflow?
5. Can I afford to make a sustained loss?
6. What is my exit strategy if things get tough?
7. What has to happen in order for my property to make money?
8. How many of these properties could I afford to own?
9. Have I checked and double-checked all the figures and sought independent information to ensure the data I have is realistic?
10. What happens if I lose my job or my income drops?
11. Can I sell the property easily if I need to?
12. Is the investment protected in the case of Death, Divorce or Disaster?
13. Is my portfolio well balanced or over weighted?

You are ready for the next module.