The 5 Pillars of Financial Independence

WHAT YOU CAN DO NOW TO SECURE YOUR FINANCIAL FUTURE

PARADIGM
STRATEGIC PLANNING

What do we mean by “financial independence”?

The simplest definition is “the ability to support your life without having to work”. Which means, for most of us, financial independence isn’t a “now” thing. Unless you’ve got a trust fund, financial independence is something you need to work towards for the future. And that’s a good thing because it’s a goal that’s within the reach of us all, it’s energising to have goals, and it’s also energising to know that there are steps we can take now that will set us up nicely for the future.

What are the five key pillars of that financially independent future? Let’s get straight into them now!

1 Less debt, more savings

The word "thrifty" is rarely thought of in a positive sense but that's not fair. If we continually spend more than we earn, our debts will eventually catch up and other words such as "default" or "bankrupt" might become more familiar.

Being thrifty doesn't mean doing without – quite the opposite. Here are six simple tips to build up your savings: the first pillar of achieving financial independence.

1. CREATE A BUDGET AND STICK TO IT

Before you can get your spending under control you need to know exactly how your income compares to your expenses. There are many free online budgeting tools available, such as the MoneySmart Budget Planner found at ***www.moneysmart.gov.au***.

There are also a multitude of smartphone apps that can help you to record everything you spend. This can be an interesting exercise. At the end of every month, you can easily compare your total purchases and outlays to your budget. You might be amazed to see where your cash is actually going.

2. BE DEBT SMART

Make a list of your debts and organise them in order of annual interest rate. Those with the highest rates (most likely your credit cards) should be paid off first, especially as the debt is not tax-deductible. It rarely makes sense to invest money to receive 5% per annum while you are paying credit card interest of 20% (or more). Your goal should be to pay off your card(s) in full every month.

3. TIME FOR A MORTGAGE CHECK-UP?

Like all things, mortgage products change – particularly with interest rates at record lows. If you are more than five years into your mortgage, it could be time for a review. Check with your lender to ensure you're getting their best rate. You might be astonished at the deals lenders are prepared to do to keep your business. Also, you could be paying for extra features that you don't need.

4. SWITCH AND SAVE

When was the last time you compared costs on your home/health/car insurance, phone plans, gas and electricity? By shopping around and negotiating a better deal you could save significant dollars on your monthly spend.

There are helpful websites to make comparison shopping much easier but be aware that they only list providers who have paid to be promoted on their sites. It might be worth it to take the extra time and do the comparisons yourself.

5. BE ORGANISED!

Most people are amazed at how many gifts they buy each year, often at the last minute. By establishing a gift list and allocating a set budget for each recipient well ahead of time, you can progressively buy gifts on sale during the year. This will certainly help your cash flow and circumvent overspending by avoiding that last-minute rush (not to mention the added stress!).

As you watch your bank balance increase, enjoy the feeling of being in control and knowing you can have whatever you want with just a little discipline.

2 Making use of the power of compounding interest

Forget about location, location, location being the key to a good investment outcome. For now, let's think of the most important ingredient as being regular, regular, regular!

A regular savings plan can turn small amounts of money into a sum that can take you closer to your dream of financial independence much faster. All that's needed is time and discipline.

For example, let's see what happens to an investment starting with just $100 and adding $100 each week from your regular income. The table below shows what the investment value would reach after five years and up to twenty-five years. In this example, we have assumed the investment pays a return of 5% per annum (paid quarterly).

	5 years	10 years	15 years	20 years	25 years
5% return	$29,598	$67,454	$116,037	$178,386	$258,402

Table 1: Regular savings plan of $100 per week compounding monthly

The results show that a regular savings habit can potentially turn small sacrifices into large outcomes.

TO BUDGET OR NOT TO BUDGET

Think about what you might have to do in order to save $100 per week to add to your investment. Maybe instead of eating out every week, make it a special monthly event. Taking lunch to work is a big saver. Or you could cut back on your coffee purchases if you're a regular at the local café. Review essentials such as your mobile phone plan and utilities to get better deals and direct that extra cash straight to your investment.

It might sound picky, but in return for this self-restraint you can see what can be achieved:

- the $29,000 in 5 years might go towards a deposit on your first home or an overseas holiday;
- the $67,000 in 10 years might contribute to your children's secondary or tertiary education; or
- the extra $258,000 in 25 years might help you to retire more comfortably or earlier than you thought you could.

Any of these outcomes would make your small sacrifices feel extremely worth-while in the long run.

And remember to write down your financial goals as early as you can because it's much easier to make those sacrifices if you know what they are helping you to achieve.

Reducing expenses is not the only way to find a spare $100 each week. Another good time to start a savings plan is when you receive an increase in your disposable income from a new job or a pay rise. Before you spend it, send it to savings instead.

2 Making use of the power of compounding interest CONTINUED

THE TRICK IS TO START SOON

Everyone's ability to save is different. If you can't save $100 every week, the above figures are still worthy of your attention. For example, if you can save $50 per week simply halve the results in Table 1. Conversely, if your savings capacity is higher, multiply the figures.

The results also demonstrate the effect of time and compounding returns on the value of your investment. The sooner you start, the less you need to save in order to achieve the same outcomes.

THE DIFFERENCE 10 YEARS CAN MAKE!

Christine plans to retire in 20 years from now so she starts saving an extra $100 per week for this goal. Based on our simple calculations she might expect to have an investment of around $178,000 to add to any other superannuation or retirement benefits she has at that time.

Christine's twin Ben also plans to put down the tools in 20 years, but he is confident he can save more money than his sister. So Ben ignores any type of retirement planning for the next 10 years. He then saves twice as much as Christine – $200 per week – for the last 10 years of his working life.

Assuming a 5% return on the investment, the difference is staggering. By starting 10 years earlier, Christine will have saved just over $178,000 compared to Ben's outcome of $134,743.

Even though the total amount he has put into his savings is exactly the same as his sister ($104,000 over the period of the investment), Christine has benefited from the compounding investment returns on her money over a longer period of time, earning an extra $44,000 in interest – or better known as "free money"!

Another way to look at it is that Ben would need to save around $265 per week for the last 10 years of his working life (a total of $137,800) to end up with the same final outcome as Christine.

AND FINALLY...

The examples we have used here are aimed at highlighting the benefits of time and discipline when it comes to investing in a regular savings plan.

To keep things simple, we have not taken into account other factors that will impact on the outcomes you can achieve, such as taxation, fees and differing investment returns. These factors are nonetheless important and will need to be considered when you are deciding on the type of investment you choose for your regular savings plan.

Higher-interest bank accounts, managed share funds and superannuation are just a few ways to implement a regular savings plan like the one we have examined here (although you won't find any at call bank accounts that pay close to 5%pa at present!). The type of investment that is best for you will depend on your own specific circumstances, including your goals, timeframes and attitude to risk (volatility).

3 Managing risk via appropriate levels of insurance

Most people either cringe or yawn when the word insurance is mentioned but regardless of whether you find it scary or boring, managing risk now is a crucial pillar of future financial independence. Let's cover all of the bases to help ensure that when it comes to insurance, you're hitting a home run.

FIRST BASE – INCOME PROTECTION

Considering that over 530,000 people in Australia suffered a work-related injury or illness in 2013/14, what would your future look like if suddenly you were unable to work?

For most of us, the ability to earn an income is our most valuable asset. Depending on your age, your future income may well be worth far more than a house and its contents, a couple of cars, a boat or caravan all combined. Yet few people properly insure their income, and if illness or injury prevents them from working, financial hardship often results. With around half of us likely to spend more than three months off work due to ill health during our working lives, Income Protection insurance should be the first item on the personal insurance list.

Income Protection or Salary Continuance insurance can pay you a regular amount, usually up to 75% of your normal income if you are unable to work due to illness or injury. Benefits are taxable, and commence after a waiting period. Payments continue to be made until you return to work or until the benefit period expires. The waiting period and the benefit period are selected at the time of application.

SECOND BASE – LIFE & PERMANENT DISABILITY

Life Insurance pays a lump sum benefit if the policyholder dies. But what happens if they don't die and can never return to work in their chosen occupation? Total and Permanent Disability (TPD) insurance can help ease the financial burden caused by loss of income by providing a lump sum payment.

Most people underestimate the level of life insurance they need. The insured sum should be enough to clear net debt, cover future expenses such as school fees, and provide an adequate replacement for the income that the deceased would have earned through to their normal retirement age. For a breadwinner with young children, an appropriate amount may be well in excess of $1 million. This cover is also important for primary care givers to ensure the children are properly cared for.

THIRD BASE – TRAUMA COVER

Financial security for you is a goal worth working for. But a sudden, life-threatening illness or major accident could undermine your hard work, draining your financial resources and badly affecting the quality of your life.

Trauma Insurance fills a gap between Income Protection, Life and TPD Insurance.

South African heart surgeon, Dr Marius Barnard, pioneered the idea of this "living insurance" after witnessing his patients' recoveries being hampered by their concerns over the financial burden caused by major illness.

Trauma Insurance pays a lump sum benefit on the occurrence of a specified condition such as cancer, heart attack or stroke, which can strike at any age.

Managing risk via appropriate levels of insurance CONTINUED

It often provides a benefit when neither Income Protection nor TPD Insurance claims can be made.

Unlike Income Protection, where the benefit is paid if you are unable to work regardless of the nature of the illness, trauma payments are based upon the specific illness, not the degree of disability.

It is designed to cover out-of-pocket medical expenses and other costs associated with major illness, and to allow recovery to take place without financial worry.

In Dr Barnard's words: "this means that you can obtain a benefit, not because you will die, but because you will live".

HOME BASE – GENERAL INSURANCE

Most people insure their house and contents, motor vehicles and other possessions. The key here is to make sure that all possessions are covered for full replacement value. Insurance companies provide guides on their websites to determine an appropriate level of cover. Don't forget valuables like jewellery, antiques or artwork, which often have to be separately noted in the cover.

A SUPER WAY TO INSURE

Most superannuation funds (and all industry funds) offer Life and Permanent Disability Insurance.

There are a number of advantages in holding life insurance inside your super fund.

Super funds can sometimes negotiate wholesale insurance rates, so premiums for their life insurance are often lower than can otherwise be obtained as an individual. In addition, premiums are paid from your superannuation balance. Whilst this reduces your ultimate retirement benefit, the relative effect is usually small, and by relieving the strain on the household budget, you may be able to increase your overall savings. The main advantage of insurance held in super is that the premiums are tax-deductible to the fund, which ultimately reduces your cost of insurance.

When you join a superannuation fund you may be offered a minimum level of insurance. This is rarely enough to provide adequate cover and it's up to you to request an appropriate level. Depending on your age, medical history and the level of cover you require, you may also need to undergo a medical examination.

When leaving a superannuation fund you should find out what happens to your insurance cover. You may be offered a "continuation option", which is an ongoing policy provided by the insurance company. If you don't take this up within the period that the offer covers, you may find yourself without insurance. If this happens, and if there has been a change in your health, it may be difficult and cost much more to obtain replacement cover in the future.

4 Ensuring you've planned well for life after work

The premise of financial independence is that one day you'll be able to support your living costs without the need to work. To be able to have this choice, it's imperative that you plan ahead, even if you think retirement is for everyone else.

As a rule of thumb, it is suggested people should aim for a retirement income of between 50% and 70% of pre-retirement salary/wages. Based on this premise, it is estimated you will need to save around 15% of your income for 40 years. The problem here is that your employer is only compelled to provide superannuation contributions for you at the current rate of 9.5% of your income per annum.

How might this be done? You can start contributing to super earlier in your working life, raise the combined rate of your super contributions to 15% by making personal contributions (keeping under the annual limits, of course), and take heed of the following tips throughout your working life.

YOUNG, SINGLE AND INDEPENDENT

- You might be thinking that retirement is only for the oldies, but if you start small and early you lay the foundations for future choices.
- Maximise your government co-contributions—they can potentially add thousands to your super.
- If appropriate, take out disability insurance through your super fund. It is often the cheapest and most tax-effective way of providing insurance cover.
- Choose an investment strategy that suits your long-term risk profile.

A FAMILY AND A MORTGAGE

- Your focus is probably on repaying the home loan, but don't forget about your super entirely.
- A mortgage and young children mean insurance is a top priority. Taking out life and disability insurance can be a sound decision at this stage.
- Check eligibility for a tax offset on spouse superannuation contributions and government co-contributions.
- Review your investment strategy and risk profile.

THE "IN BETWEEN" YEARS

A higher income and a smaller mortgage open up the opportunity to boost your super but take care not to exceed contribution and balance limits.

Find out if salary sacrifice or tax-deductible personal contributions could further lift your super balance.

Review your insurance cover and investment risk profile.

RETIREMENT IS LOOMING (MAYBE)

Over 55s enjoy some handy incentives to contribute to superannuation but keep an eye on your total balance.

4 Ensuring you've planned well for life after work CONTINUED

Consider combining salary sacrifice with a transition to retirement pension if beneficial.

- Review your insurance cover, investment strategy and risk profile.
- Start comprehensive retirement planning or a new career focus.

DOWN TOOLS OR START AFRESH

- For retirees over 60, withdrawals and pension payments are tax free.
- Review your investment risk. Keep enough growth in your portfolio to ensure your money lasts as long as you do.
- Review your insurance cover.
- Stay active and enjoy life - or launch into your next career. There are no rules!

Remember, it's never too late, or early, to start.

5 Ensuring all your affairs are in order

It is generally believed that death is final. However, a grieving family knows only too well that the death of a loved one can trigger events that may drag on for years afterwards, especially when it comes to sorting out the estate of the deceased person. If the unthinkable happens, below are some actions you can take that will help reduce the burden on those you leave behind and provide them with the gift of financial independence while they grieve.

1. PREPARE A WILL

A properly prepared will is one of the crucial elements of your estate planning. Your will should not only state how your assets are to be divided, it should also nominate an executor who will be responsible for carrying out your wishes. When preparing a will it is important you make adequate provision for your dependents, and clearly document the reasons for your decisions to help minimise the risk of your will being contested.

2. WHAT ABOUT A 'LIVING WILL'?

Otherwise known as an Advance Health Directive, a living will is another important tool. It enables you to give detailed instructions in relation to your health care, including decisions on any treatment you wish to receive or refuse if you are incapable of communicating those instructions.

3. ESTABLISH A POWER OF ATTORNEY

Whilst a will deals with your estate upon your death, Powers of Attorney are designed to deal with your affairs while you are still alive. A Power of Attorney enables you to appoint an individual to deal with your affairs if you become incapable of making your own decisions. They can be as wide-ranging or as limited as you require or desire.

4. APPOINT A GUARDIAN FOR CHILDREN

If you have young children, consideration could be given to appointing a guardian to care for them. In doing so, you can provide that guardian with guidance about your child's upbringing, and make provisions for your children's financial future using the most tax-effective means available.

5. MAKE BINDING DEATH NOMINATIONS

It is also important to consider that binding death benefits nominations are made on superannuation and retirement income stream products as they ensure these funds bypass an estate, and in so doing, be excluded from any potential claims against an estate. And make sure you keep them current.

6. COVER THOSE ASSETS NOT INCLUDED IN YOUR ESTATE

One of the most common mistakes made in estate planning is leaving no instructions for those assets not covered by your estate, such as assets held in trusts and companies. Separate provision needs to be stipulated to ensure that control of these assets passes on to those you intended.

Ensuring all your affairs are in order CONTINUED

7. AVOID THESE COMMON MISTAKES

Some estate planning mistakes to avoid:

- Writing an informal will and not having it witnessed – or having beneficiaries as witnesses;
- Not reviewing or updating your will on a regular basis;
- Not telling anyone where your will and other important documents are located.

Financial independence: DIY or get some help?

When people think about financial advisers, they usually think of people who help them invest their money, then monitor those investments to help them grow their wealth.

But financial advisers do so much more than that. Most businesses in the financial planning and financial advice industry (our business included) provide a service that is wholistic and much more focused on the 5 Pillars of Financial Independence outlined here than just investment management.

If you're feeling a bit daunted by the what's been outlined in this e-book and you're interested to find out how we can remove much of legwork and stress involved with executing the 5 pillars, our website gives some insight into the type of people we typically work with, and how our process works:

paradigmsp.com.au

We'd love to help you first plan for future financial independence, and then work with you to get you there.

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