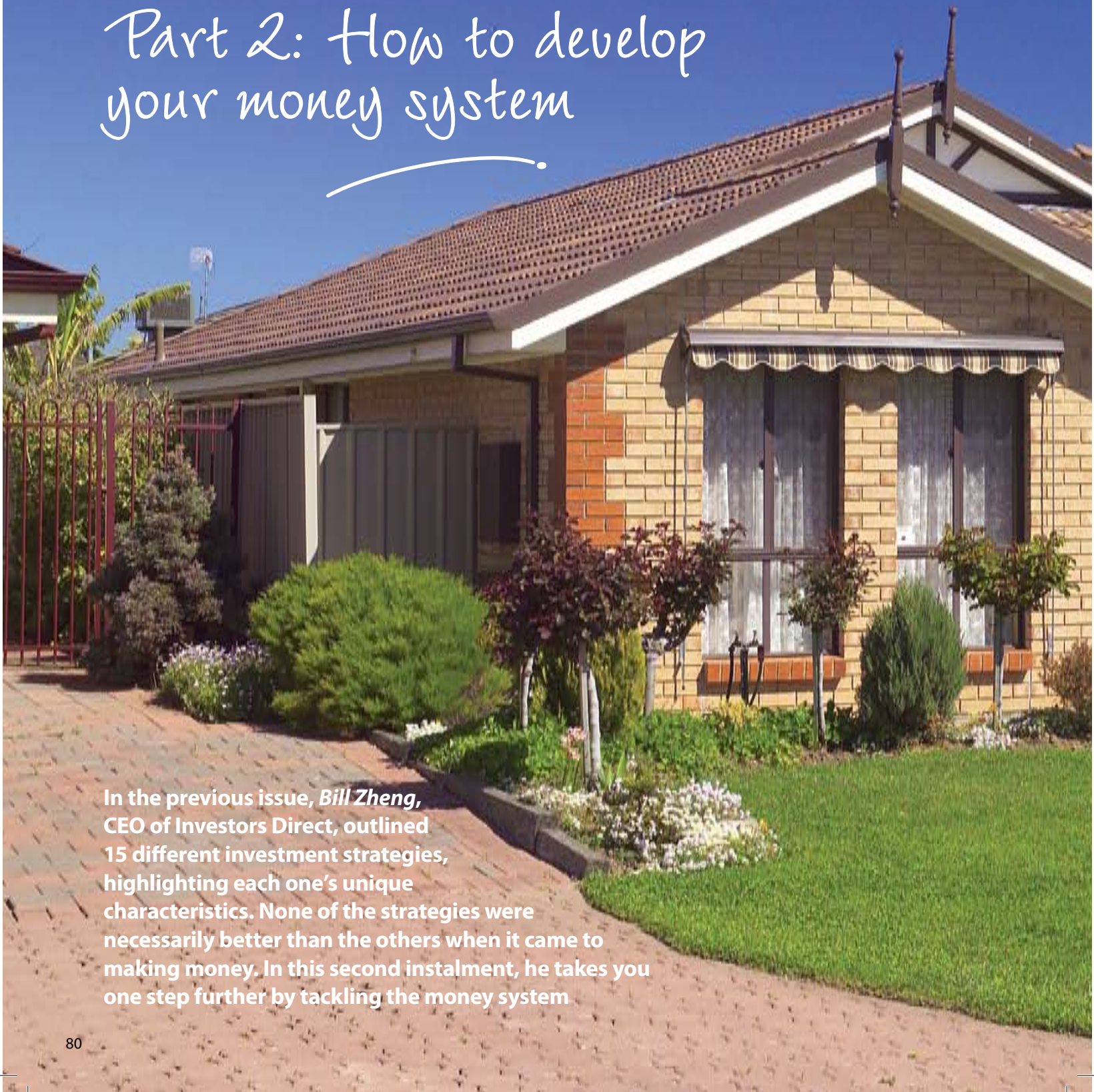


Your no-nonsense guide to property investment

Part 2: How to develop your money system



In the previous issue, *Bill Zheng*, CEO of Investors Direct, outlined 15 different investment strategies, highlighting each one's unique characteristics. None of the strategies were necessarily better than the others when it came to making money. In this second instalment, he takes you one step further by tackling the money system



To be a successful property investor, there are three different types of systems you need to master:

1. Property systems
2. Money systems – your capital plan, cash flow plan and finance plan
3. People systems – your team and self management

It is the second system, your own money system, which determines whether you will achieve your property investing goals. Let's face it, property investors are in the business of making money. Property is the vehicle or asset class you as an investor have chosen to focus your efforts on.

Having a thorough understanding of money and how it works, and understanding your own money system are crucial for achieving financial independence through property investing or, for that matter, any type of business venture.

Why is having a system important? A good system allows you to stay away from unnecessary distractions while you are investing. Most people know how to make some money every now and then, but very few can stick to a system long enough to reap the real benefits.

Contrary to the widespread diversification theory, most wealthy individuals become wealthy by doing one thing really well first before getting into diversification, especially when they have very little to diversify with at the beginning.

Before we jump into the discussion of money systems, it is worth mentioning that even the best system is useless if



you don't have the discipline to follow it through. So being accountable for your own actions goes hand in hand with a well-defined system.

Do you treat your property investment as a business?

We believe that investors should treat their property investment as a business, right from the time they purchase their first property, ie they should start with a business owner's mindset.

Why is this critical?

At Investors Direct, we have spent the last few years observing those people who have achieved financial independence for themselves.

We wanted to figure out how they did it. We wanted to know what it was about those individuals that led them to achieve their goal of financial independence. Most importantly, we wanted to discover what our clients could do to be more like them.

According to our research, 87% of people who are financially independent are business owners and 13% are employees with strong financial discipline or people with exceptional talents with loyalty income.

We found:

- the majority of business owners never made it to financial independence;
- the majority of self-employed people never made it to financial independence;

- the majority of employees never made it to financial independence;
- the majority of investors never made it to financial independence.

But of those people who, inspiringly, have made it, and gained financial independence:

- the majority were business owners;
- the rest were employees who treat their investment like a business.

So, obviously, business owners have some necessary attribute, some characteristic, that drives them to reach financial independence.

What we discovered is that achieving financial independence has got very little to do with what you do for a living, ie it has got very little to do with whether you're a business owner or an employee.

But it has everything to do with your mindset.

In other words, you can be a business owner but still think and act like an

employee. (I call it business owners with an employee's mindset.) On the other hand, you can be an employee but think and act like a true business owner (I call it employees with a business owner's mindset.)

Let me demonstrate this using the following table. There are three mindset categories: business owner, self-employed and employee (remember, this is not what you do for living, just a mindset).

They are defined by how much financial accountability you take and how you build systems.

All people who achieve financial independence have the business owner mindset, regardless of what they do. Why? Because only the business owner mindset combines building of profitable systems and taking 100% financial accountability. It is possible for an employee to think like a business owner when it comes to investments.

Table 1: Mindset operating styles

Mindset category	Financial accountability	System building
Business owner mindset	High – do or die	High – create profitable systems for others to work in
Self-employed mindset	Medium – keeping busy	Medium – at best, they are the system
Employee mindset	Low – my boss's problem	Low – working in a system created by others, at best improving it

We have plenty of clients who are employees who love their job and are not inclined to leave it, yet they achieve financial independence.

This happens because they treat their investments as a business with full financial accountability and build their own systems.

When we talk about building systems, we're referring to systems that you develop to achieve some financial success, and then replicate again and again to achieve even more.

Money systems

Before we can talk about financial accountability and building a money system, we need to learn how to identify the "flow of money" around us. You need to know what you have before you can manage it.

The concept of money flow is not what you will learn from traditional business schools. What we are trying to illustrate is a very complex subject with the simplest possible interpretation, especially for non-accountants.

Let's examine Diagram A.

Imagine that the money around us is like water, and you have a few containers to hold it in. There are four key components to understand in this diagram:

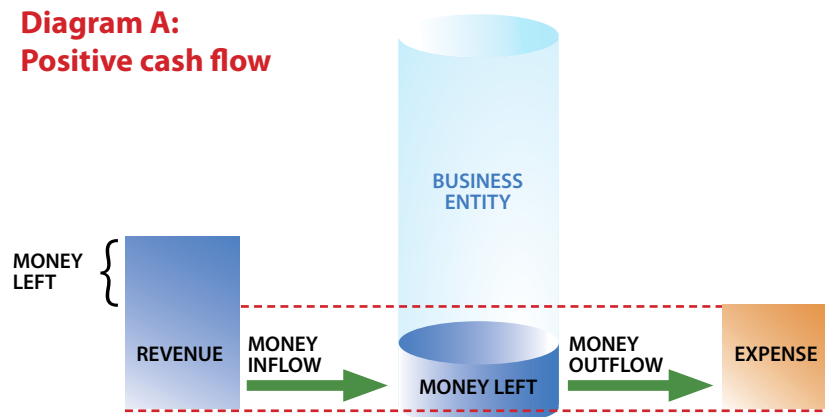
1. Water coming into a container is called 'money inflow', ie 'revenue'
2. Water leaving a container is called 'money outflow', ie 'expense'
3. Each container is called a business entity. The concept of a container is to separate your money-making activities so that you can see the boundaries and manage the money better. A business entity here can be a PAYG person, a normal business, a property investing business, etc (more explanation on this later)
4. If the money inflow is greater than the money outflow, then there is surplus water in this container, ie you have positive cash flow and are making money

It's not hard to see that if you can maintain positive cash flow, ie if you continue to have surplus water in all your containers, you will be making a profit.

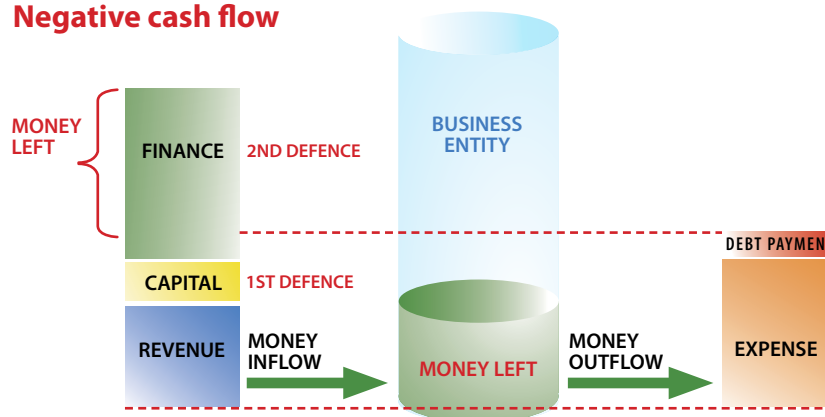
In reality, maintaining positive cash flow is not always possible in business. This leads us to our next question.

How do you manage the risk of having 'negative cash flow' while you

**Diagram A:
Positive cash flow**



**Diagram B:
Negative cash flow**



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are still in the process of building your business or asset?

Risk management

In Diagram B, there are two basic ways to carry yourself through a negative cash flow situation:

- **Inject capital.** We call capital our first layer of defence. This can be money put aside for rainy days, start-up capital, working capital, or investment capital, etc
- **Obtain finance.** We call finance our second layer of defence. It can be money borrowed against the business

entity, eg a business loan, a personal loan or a mortgage. While the money you borrow can keep the business going further, its debt repayment will also reduce your cash flow.

What capital and finance really do is buy you more time so that your asset can grow and your cash flow can become positive again.

Look at the container in Diagram B. There is still some 'money left' for this business entity, albeit from finance – the second layer of defence. As long as there is some water left in the container, the business can live to fight another day.



Once we have a basic understanding of the flow of money for a business entity (container), we can check how many containers we have. Table 2 lists three different containers: you (PAYG), a normal business and a property business. You may have one or more of them at the same time. Use each column to test yourself to see if you can follow the flow for each container.

As a general rule of thumb, you would try to avoid having negative cash flow if possible, but you definitely cannot have no 'money left' because that means you have exhausted your money option to keep the business entity viable.

You may wonder why we should identify the different kinds of container.

You are probably thinking: "Can't we just have them all in one container? It's all my money, anyway."

The reason is that it is a lot easier to manage something smaller. The 'divide and conquer' method can help you manage your financial affairs much better. Once you can see which container is leaking, you can fix it accordingly.

How does this relate to residential property investors?

Many property investors have either a job or run a business. It is very important that you treat each as a self-contained business entity, or container.

While you may not always be able to have positive cash flow from your investment property, you must still make sure there is always 'money left' in that container, which means you must keep enough cash as a buffer or make sure you can borrow more money against your property down the track.

A common mistake many property investors make is to use the water from one container to fill another, and ignore the fact that some of the containers are leaking beyond repair.

For example, you may be running a loss-making business for too long, but your property is going up in value. It is not uncommon to see an investor keep pulling money out of their property to keep the business afloat while they ignore the critical issues (leakage) of their business.

The same can happen to personal expenditure. Many investors can live beyond their means while their properties are doing well and, in so doing, they neglect to see that their personal container is full of holes.

The moment something happens to their properties, they will find themselves not being able to handle the living expenses.

It is very clear that once you can see your money in different containers, you should get rid of the one that is leaking, because it will get to the point where it won't have any 'money left'.

For property investors, how do you ensure that your 'property business' container always has some money left, ie is a viable business?

Money systems for a property investor

If you refer back to the above diagrams, whether you will have any money left for a business entity depends on how you manage your cash flow, capital and finance.

Hence a money system comprises three key elements:

- Capital plan
- Cash flow plan
- Finance plan

Without getting into too much technical detail here, the following sections will give you an idea of what these plans are about. Every person has their own individual situation. To develop a tailor-made solution that will evolve with you over time, you should regularly check in with your finance consultant.

Capital plan

It is a known fact that most businesses fail not due to lack of profit, but due to inadequate capital. As a capital plan is part of your risk management plan, it is important that you put some serious

Table 2: Features of types of business entity

Business entity	You (PAYG)	Normal business	Property business
Money inflow	Revenue: Salary Capital: Savings, winnings Finance: Personal loans, etc	Revenue: Business income Capital: Working & seed capital Finance: Against business value	Revenue: Rent, tax, benefit Capital: Deposit Finance: Current value and future capital gain
Money outflow	Expenses: Family living, etc Debt repayment	Expenses: Business expenses, taxes, etc Debt repayment	Expenses: Legal and accounting, education, taxes Debt repayment
Cash flow	Can be either positive or negative	Can be either positive or negative	Can be either positive or negative
Money left	Must be positive	Must be positive	Must be positive

planning into this before starting your property investing business.

Your capital plan will come from answering the following key questions:

- How much money should you put into your property business now and in the future?
- What other equity do you have available outside of your property business?
- How much contingency buffer do you need for your risk appetite?
- What is your total leverage capacity based on your capital contribution?

Cash flow plan

Your cash flow plan is closely related to your capital plan. For example, you might want to put in a lot more capital to reduce your borrowing when you buy a property. This will greatly enhance your cash flow position due to less debt repayment.

Conversely, a better cash flow position can reduce your reliance on additional capital and finance.

Your cash flow plan will come from answering the following questions:

- What is your current annual cash flow from existing properties?
- What adjustment do you need if the existing cash flow is positive or negative?
- What is your new annual cash flow after adjustment?
- What is going to be the cash flow impact of purchasing additional investment properties?
- What could be the worst-case scenario and how long can you last before you have to sell the property or sell down your shares?
- What is the potential to turn future capital gains into cash flow from further refinancing?
- What is the realistic amount of property you can purchase safely right now?

Finance plan

The capital plan and cash flow plan have helped you to come to a simple conclusion: how much property you can purchase safely at this point of time.

Your finance plan exists to ensure that you can obtain the finance you need to reach that target. This plan is the final filter of the strategies defined by your capital plan and cash flow plan.

Some of the most important points to keep in mind for your finance plan are:



What capital and finance really do is buy you more time so that your asset can grow and your cash flow can become positive again

- **Flexibility** – ability to access more money by adding, increasing or changing your loan with ease
- **Risk management** – protect yourself from interest rate movement and lender's aggression during bad times
- **Suitability** – there are a few stages of finance an investor would go through over time, and there is suitable finance for each stage
- **Cost** – there are always costs involved in running any business and we may not be able to go for the cheapest option to achieve our overall objective; it is always a balance between cost and benefit
- **Lender's policy** – this can have a great impact on your finance options, and their policy is heavily influenced by the availability of funds, historical performance and current conditions in the market

Your finance plan will let you answer the key questions:

- What is the total amount I can borrow right now?
- How many properties does that equate to and at what price?

Remember, your finance plan may reduce the original target you set using the capital plan and cash flow plan. However, your finance plan is an essential enhancement of your capital plan and cash flow plan.

Summary

It was Sun Tzu (*The Art of War*, c 500BC) who said “it is that in war the victorious strategist only seeks battle after the victory has been won, whereas he who is destined to defeat first fights and afterwards looks for victory”.

Sun Tzu's book has been used by many notable people over the centuries for planning and fulfilling their winning ventures. A well-defined money system is the victory you can win before the battle even starts, and will make contesting the battle a mere formality.

Next month, we will focus on strategies to define the final component of your property investment strategy, your personal system. ■

Vincent Power, Regina Looi, Lee Dittmer, Lynda Heise and Tim Riley also contributed to this article. Investors Direct is a property finance company that provides financial solutions exclusively for property investors and understands that your mortgage is an asset, not a liability.

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