The tale of a poor rich man

A valuable lesson in fiscal restraint for long-term returns.

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Summary: Even high-income earners can have poor financial outcomes, if they overspend without planning for the future.

Key take-out: Working to a family budget, cutting back on discretionary spending, having good insurance cover, and directing more into superannuation, are all important steps in building personal wealth.

Some years ago, I was visited in my office by one of the shinning lights of an 'East Coast bar' – and I'm talking wigs and gowns here, not 'schooners'.

This person (identity protected) posed the question: "I'm 50. I average around $1 million a year in income. Our house is rented. Our cars are leased. Our children go to one of Australia's most expensive private schools. We travel overseas each year – and we are long-term renters of our holiday home. My partner does not work. I presently have around $100,000 in super… how can I ever retire?"

My answer: "It's simple. However, you will need to dramatically change your lifestyle – right now – or you can't." He left, in the same cab he arrived in.

It occurred to me that the cab driver, earning $50,000 per annum, probably had more financial assets than the man who had been in front of me.

My advice to this prospective client, in terms of what he needed to do to fix his financial health (if he was prepared to 'man up'), would have been as follows:

Understand your income and expenses

By simply drawing up a family balance sheet and profit and loss summary, you will become aware of where you are now and where the money is going.

In this case, based on the pre-interview questionnaire, I knew that the rent on the family home was consuming around $150,000 pa after tax. The holiday home was taking $30,000, school fees $50,000, car leases (a pre-tax expense) cost $50,000, overseas holidays $60,000, and what could be called extravagant living consumed the rest.

Protect your main asset – your ability to earn

Recognise that you may have another 15 years or so in the workforce, so there is time to turn it around. The income generated means you can still work towards a comfortable retirement.

Following this advice may ensure that there are sufficient resources to turn the family's finances around.

The first, imperative step, is to take on life, total and permanent disability (TPD) and income protection insurances. Yes, they are expensive, particularly as we get older, but strokes, heart attacks and cancer happen all the time.

The cost of life insurance can be reduced by using a 'fee for service' financial adviser – who will usually rebate or discount the commission paid on these insurances, thereby reducing their cost by around 12 per cent to as much as 30 per cent. Income protection insurance may also be tax deductable, thus reducing the net cost even further.

Don't forget to make a simple, but very clear will, which outlines how you want your estate distributed. It can save enormous hurt and uncertainty in times of grief.

Be prepared to adjust your lifestyle

A "look at me" lifestyle based on conspicuous consumption might not seem out of place on a $1 million income (which is still huge compared to what most Australians earn), but not if it is based entirely on a finite cash flow and limited savings. A five-year plan of cost cutting could well get you out of the mire – and back into sustainable comfort.

I would suggest having an adult conversation with all the family involved – bring everyone onto the same page, and approach it as a group challenge. Get everybody onboard. If there is potential, encouragement to seek a part-time job may help a partner to feel that they are contributing and making a difference.

Release the weekender. Even rented, a second home is a money pit. You can book a motel room for a break if need be, and save $20,000 - $30,000 straight away. Put the first $25,000 saved into a superannuation account in your partner's name – it makes little difference to who 'owns' the money, as super is a family asset, even if it's not accounted for in that way.

It does, however make a good psychological point that "you" are benefiting from our new fiscal fortitude, not "me". With the current contribution and transfer caps on super, it also often makes sense to split your super. Repeat this process every year.

Cancel the overseas holidays. The family can still afford to go to Port Douglas (or a similar destination) for a week or two, but an even better approach is to do some volunteer work and camp out. There are lots of environmental projects looking for this kind of support and it creates bonding while reducing outgoings – as well as providing social kudos. The savings? Potentially another $35,000. Put the first $25,000 saved into your superannuation as a concessional (tax deductible) contribution – and do this annually.

It may also be worthwhile discussing with the children how they feel about their school. This may be the hardest part of any financial restructure. If the children are totally opposed to a move, it is probably best to leave them in place. Remember, however, you chose the school, not the children.

You may be surprised with how they feel! If they moved to a state school, the family could save approximately $45,000 pa – alternatively, a local church school could save around $30,000 pa. These are big pools of money for the savings pot. An option might be to save these funds via an insurance bond to help the kids buy their home in 10 years or so.

Leased cars are addictive. It is easy to blow an after-tax $50,000 pa on two BMWs – they look great, drive well and everybody thinks they are cool. However, they are, after all, just German Commodores and a five-year-old BMW can be bought for $20,000, and a two-year-old Mazda 3 for $17,000 – as a result, your annual outgoings are likely to be around $15,000. Repeat every five years until you are out of the financial mire.

Now, examine your lifestyle. What are you blowing your money on? Is it restaurants, wine, the latest technology, brunches, new clothes? Challenge yourselves, ask the question, what is mandatory and what is an option? Set a budget and stick to it!

Buy a new home in an emerging area – in Melbourne this can be achieved for $600,000, and in Sydney for around $800,000. As an alternative to paying $150,000 pa in rent in a 'premium' suburb, the new place could be owned by the family in six years or less – with the potential to upgrade, repeat the process after five more years, building equity to eventually owning a home in your desired location in retirement.

Plan your superannuation

A starting balance of $100,000 at age 50 would provide a retirement income of just $5,000 pa. A non-home-owner couple with assets under $583,500 would also be entitled to the Centrelink Age Pension from age 67. After access to gross income of $1 million each year, however, trying to get by on around $37,000 (Age Pension plus super income) life would be very tough indeed.

Having made the cost cuts outlined above, therefore, I would advocate contributing the maximum $25,000 pa for each partner (as concessional contributions) over the next 15 years. That's a raw net figure of around $640,000 – but over time this time compound interest will help boost this dramatically. In addition, as the benefits of the cost cutting become clear, an extra $100,000 pa (the current maximum non-concessional contribution) could also be contributed to each partner's super.

Based on this approach, with the benefits of compound interest and a disciplined spending regime, the projected value of the family's super could conservatively be in the vicinity of $2 million at retirement – providing a tax-free income of approximately $100,000 per year, plus home ownership and two motor vehicles.

In addition, they would have had the benefit of income protection and life and TPD insurance to make sure they get there, even if illness, disability or death were to strike.

But he drove away, this poor rich man – without taking timely advice which could have could have been remedial.

I see him in public occasionally and my reflection is simply the hope that he may have subsequently received similar advice and acted on it.

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