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Why your sinking fund costs you money

The Main Points

1. Like all forms of funding in strata, sinking funds have advantages and disadvantages – the trouble is, few people stop to think of the disadvantages
2. A very important disadvantage is that sinking funds are very expensive, usually more expensive than strata borrowing or having a special levy
3. In the example that Jimmy and I worked out, a sinking fund would cost owners between 18% and 20% per year!
4. The responsible way to approach funding capital works is to consider the advantages (and disadvantages) of each form of funding as they apply to your particular situation
5. The responsible solution is likely to be a mix of all three methods – special levy, borrowing and sinking fund
6. Best practice would be to seek to build a sinking fund for 20% of your expected capital works budget and to review your situation annually to check that it's right for you

The Details

Sinking Funds – not as good as we used to think

Most people think a sinking fund must be a good thing – it's cash on deposit that accumulates for the day when you'll need to do some major works.

Unfortunately, not many people understand the disadvantages of a sinking fund, in particular, that it will cost you money.

Three ways a sinking fund costs you money

There are three ways a sinking fund costs you money – let's start with the easiest, interest and tax.

Low returns that are taxed

The earnings of a sinking fund are limited, usually to bank term deposit rates. And the interest it earns is taxable, so, whatever rate you are getting for your deposits, take 30% away because that goes to the tax man. But doesn't everyone pay tax so that just evens out in the wash? No, many don't. If you are a retiree or on any kind of fixed income, or if your super fund owns your strata investment, or for a host of other reasons, it's likely that your tax rate is less than 30% or you pay no tax at all, so that sinking fund is starting to cost you compared with what you could do yourself.

Inflation

Next is the cost of the project. While you wait to accumulate funds in a sinking fund, the money in the sinking fund is subject to inflation. And this is not just the Consumer Price Index! The costs of strata capital works are more likely to rise in line with the Labour and Materials Index. Also, whilst you are waiting, the scope of the work may increase, thus adding to you costs. And you may be paying higher maintenance costs in the interim. (Project inflation won't apply if the works are going to be done in the future, but if they need to be done now then a sinking fund is a very poor option).

There are better things you can do with the money

But the most significant cost of a sinking fund is 'opportunity cost'. Everyone strata owner should be thinking about what is the next best thing they could do with the money. If you have credit card debt at the end of a month, then you would be better off with that sinking fund money in your own hands so you can pay off the credit card. If you have a mortgage, you would be better off taking the money from the sinking fund and putting it against your mortgage.

It's relatively easy to measure the 'cost of the lost opportunity' of not reducing your credit card debt: that's about 20%pa for most people. And the cost to you in leaving money lying dormant in a strata sinking fund when you could have a lower mortgage will be about 5 or 6%pa. If you have any credit card debt at the end of the month, then the last place you want your money is in a strata sinking fund.

However, for some people that cost will be a bit harder to calculate – what's the cost of not having a holiday? Or not being able to help your kids? Or not being able to replace your old car?

Summary

In summary, a strata sinking fund costs you money in three broad areas. First is that the returns are limited and are reduced by tax. Another is that the cost of the project will get bigger all the time you wait. Most importantly, most owners will have much better places to invest their money – perhaps in reducing credit card debt, perhaps in a mortgage or perhaps in something that is very important but hard to calculate as a percentage.

What does this mean in real terms?

When Jimmy Thompson and I sat down to work out a few examples, we calculated that a sinking fund would cost a strata owner between 18% and 20% per year!

This should be shocking to most people, as we've been seduced by the notion that a sinking fund must be a good thing. Of course, your property and your situation may be different and that's why it's very important to consider the actual costs that apply your particular property and your particular financial circumstances.

At Lannock, we've analysed hundreds of buildings. On average, sinking funds cost owners between 10% and 15% per year.

What about a special levy? The most important part of the cost of a special levy is 'opportunity cost', that is, "what's the next best thing you could do with your money". Our analysis has revealed that the average special levy costs an owner between 11% and 13% per year.

And the cost of borrowing? Currently about 10% to 11%pa.

Making Responsible Funding Decisions

This information has important ramifications for the decisions of owners, executive committees and governments, as well as being important for strata managers.

If the sinking fund in your building, like the examples Jimmy and I looked at, will cost owners 18% or 20% per year, what does that mean for people who have the responsibility to manage the finances of a strata corporation? How do you responsibly manage the financial needs of a strata scheme when one of ways of funding capital works is so expensive for so many owners?

Here are the things to consider:

1. What are the relative merits, that is, the advantages and disadvantages of each way of funding capital works?
2. How do these apply to your particular property and your particular personal situation?
3. How do they apply to the owners in your property as a whole?
4. Given that each form of funding has advantages and disadvantages, what's the responsible thing to do in your situation?

It's clear from our analysis that there can never be a one size fits all approach to funding the capital works in your property. A block of 10 in one area will have different needs to a block of 10 in another area or a block of 100. And residential will be different to commercial. And one owner's needs will be different to the owner next door.

As a way to consider this, the following principles are likely to apply:

The best form of funding is likely to be a mix of special levy, sinking fund and borrowing.

If your goal is to have a low cost of funds, then it's likely that borrowing will be a significant element in that mix, most likely more than 50%.

If there had to be a single solution for all of strata, Lannock would recommend you seek to have a sinking fund at 20% of your future capital budget requirements and each year assess the situation in the light of the facts at the time. That way you've established a culture of properly considering the future, you have some funds in hand to start a project or deal with an emergency, and you have a plan to reconsider the matter on a regular basis to ensure that it's still relevant.

Lannock has analysis tools that can help you do this (including the tool that Jimmy and I worked through) – just call or email.

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