INVESTING IN PROPERTY

In Melbourne an interesting discussion on Investing in Property was held on 29 September by the Women's Investment Club. Peter Boehm, author of *The Great Australian Dream: A guide to buying your first home* joined a discussion facilitated by Pauline Taylor, Finance and Economics Consultant. Attendees included a good cross section of age ranges – Gen Ys, Gen Xs and Baby Boomers, so the full range of issues from buying a first home to purchasing an investment property were raised.

Women often prefer property as an investment – it is tangible and more easily understood than many other forms of investing. However, there are many matters to consider.

The overall **return on an investment property** is determined by adding the rental income (or yield) and capital growth together. The rental yield is calculated by dividing the annual gross rent by the value of the property, expressed as a percentage. Returns on property vary according to the economic cycle.

The Pros and Cons of investing in property were discussed.

Pros:

- *Capital appreciation* – it is important to remember that it is the land that appreciates, not the dwelling built on it. Property can be less volatile than shares and usually increases in value over the longer term, but it can fall in value during an economic downturn.
- *Rental income* - this varies by location and property type (e.g. house, unit, apartment etc). Before buying a property for investment you need to find out what rent it will generate – this information can usually be gained from the local agent.
- *Leverage* – you can take out a loan to purchase an investment property using the property as security at a higher loan to value ratio than you would on other asset classes, like shares. Interest on the loan is usually tax deductible. If the costs of owning the property exceed the rental income, in normal circumstances you can offset this loss against your personal taxable income. This is known as "negative gearing".
- *An asset base* – once you own a property and have equity in it, it can be used as security for other investments, such as purchasing an investment property. You can even use an investment property to buy your first home. E.g. your tenant helps pay the mortgage through rental payments and later on when you can afford it you can turn your rental property into your home; after a while you can sell the property and use any after tax capital

gains to put towards your new home; you can borrow against the equity in your investment property to help fund your new home.

- *Tax deductions* – as well as the cost of borrowing, repairs, maintenance, management fees can also be deducted from the rental income your investment property generates (see Leverage above). The ATO has a list of allowable rental property deductions.

Cons

- *High entry and exit costs* – in addition to the purchase price there are many additional costs– stamp duty, conveyance fees, legal charges, search fees, pest and building reports. As the owner, you will need to pay rates (Council and water), insurance, body corporate fees (e.g. for units or apartments), land tax, property management fees and other costs. If you decide to sell, there are agent's fees, advertising costs and legal fees. You may also need to pay capital gains tax.

- *Low liquidity* – you can't sell off a bathroom if you need a new car. Property values move in cycles and if you have to sell in a downturn you can lose money. It can take months to sell a property and you may be forced to sell at a lower price if you need to sell in a hurry.

- *Vacancies* – there may be times when you do not have a tenant but you still have to pay all the costs of ownership, including interest.

- *Bad tenants* – some tenants are reliable, but some may not look after your property, may even damage it and not pay their rent on time.

- *Rising interest rates* – property is a long term investment and interest rates can move significantly over time thereby increasing your cost of ownership if you have a variable rate loan.

- *Cash flow* – work out the difference between your income and expenses i.e. monthly rental income, less monthly expenses (interest, management fees etc) and if there is a shortfall you need to make sure that you can manage this. Peter's book has a chapter devoted to working out cash flow and overall returns on an investment property.

For more details on the pros and cons of property investment check out: www.moneysmart.gov.au/investing/property

Financing

You may prefer to use a mortgage broker rather than shopping around yourself. But remember brokers get commissions from financiers so may direct you to what suits them rather than you. Check out whether the broker is registered with the Mortgage and Finance Association of Australia and holds a current AFSL licence and Professional Indemnity Insurance.

Home loans are basically fixed rate or variable. Fixed rate loans are usually only taken out if you want certainty of your commitments. They can be a disadvantage if interest rates fall and exit fees make it difficult to refinance.

Whether you are buying a property as an investment, or as a home, you need to first calculate how much you can afford. This can be measured by adding together your borrowing power (you need to get a quote from your financier), the amount you have saved as a deposit and any government concessions you may be entitled to (e.g. first home savers grant.) You also need to work out the costs you will have to meet. Peter has placed a calculator on his website to help you work this out. http://www.peterboehmbook.com.au/files/budget.xls

Lenders Mortgage Insurance (which protects the lender and not the borrower) is usually charged if you borrow more than 80% of a property's value, meaning you have to come up with a 20% deposit. Ideally, you should aim for at least a 10% deposit.

Choosing the right investment loan.

Factors to consider:

1. Your investment timeline – think about which home loan product best suits your time horizon. For instance, don't take out a seven year fixed rate loan if you plan to sell in five years.
2. How much money you can contribute and how you will repay the debt – think about your cash flow.
3. Gearing – do you wish to be negatively geared and if so can you cover the short fall? Is the tax advantage worth it?
4. Ownership structure – e.g. if buying with someone else, whose name is on the title?
5. Interest rates – fixed or variable. Interest rates can be compared at www.iselect.com.au/Home-Loans or www.cannex.com.au or www.infochoice.com.au

Choosing the right investment property

Location is critical – investigate the land values in the region you are considering. You can generally get this from estate agents. Think about what a tenant would look for (usually 2 bedrooms, public transport, proximity of parks, shops, schools).

Capital growth potential – properties in high population growth areas have more prospects for capital gains. Remember the adage: Location, Location, Location.

Rental affordability – is the rent you propose to charge in line with the incomes of people in the region you are considering?

Vacancy rates – check out the vacancy rates with local estate agents in the area you are considering – anything less than 3% is generally safe, above this involves risk.

Property type – i.e. house unit, apartment – houses usually appreciate more in capital value.

Auction v private treaty

Property can be purchased either at auction or by private treaty. Estate agents like auctions – they provide an opportunity to promote their business. There are auction costs to consider: the auction fee (usually about $500), and the agent's commission of 1.5% to 3% of the sale price. The reserve price is set by the owner on the day of the auction. While it is illegal for agents to underquote, the price may rise substantially above the agent's estimate if there is strong bidding on the day. A sale at an auction is binding on both buyer and seller, whereas private treaty allows for a cooling off period.

Buying off the plan

Some investors are attracted to the benefits of buying property off the plan. The benefits include stamp duty relief (sometimes), a lower purchase price and more time to save. However, there are significant risks to consider:

- The completed building may not meet your expectations
- Contracts can be complex
- You are buying at current prices – dangerous at the start of a downturn
- There may be unreasonable delays.

First home buyers

If you are a first home buyer you may be entitled to receive the first home owner grant, the first home bonus, a regional bonus and a reduction of duty. More details are on the websites: www.firsthome.gov.au and www.sro.vic.gov.au

You may also want to consider opening a first home saver account where the Government contributes 17% on the first $5000 invested and taxes your earnings at a low 15%. More details are at www.ato.gov.au/individuals type in search box: first home saver account

Peter's book covers all the areas discussed and if you wish to purchase a copy visit www.peterboehmbook.com. It's only $25 and there's free postage if you buy it through the website.