

October 2007 Newsletter

In this issue:

1. Next big growth suburb—do you want it?
2. Our best interest rates

The next big growth suburb – do you want it?

You may have heard people say that investing is all about risk and return. Generally, if you want a higher return on your investments, you have to accept a higher risk. However, you don't hear much about the risks associated with investing in one property versus another. In fact, risk is the most important thing which separates the good properties from the bad.

What is risk?

Risk simply relates to the likelihood or chance of an investment meeting the projected return. For example, depositing your savings in an ING Direct savings account should earn you 6.15% p.a. The probability of you receiving 6.15% p.a. is very high (assuming interest rates don't change of course). One risk is ING going into liquidation and not being able to pay the interest due to its customers, but that is probably extremely unlikely. Hence, this would be regarded as a relatively low risk investment as it is virtually certain you would get 6.15%. Conversely, if you invest in a start-up company, you would be taking a higher risk. They say that only 20% of businesses last for more than 5 years. Of the 20% that survive the first 5 years, only 20% of those make it to 10 years. Therefore, only 4% of businesses make it to 10 years. That's why it's considered a high risk investment, because the probability of meeting your projected return is very low.

First, select a target return

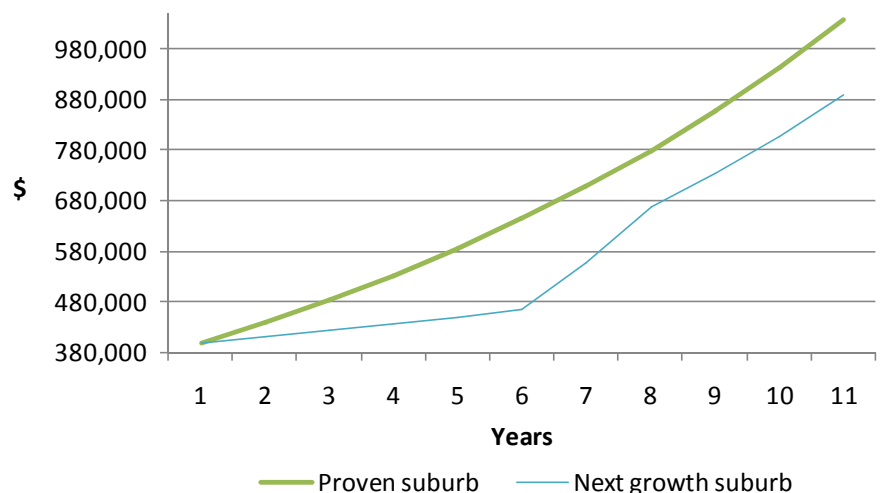
When investing in any asset you need to predetermine exactly why you are investing and what return you want from the investment. If anyone has read any of my past newsletters (and I'm hoping that's all of you!), you will know that it's my belief that you should focus almost solely on capital growth (i.e. property's ability to increase in value). For example, Bill has decided that he wants to invest in property to help his children in the future, given the housing affordability issues (this is becoming a more common issue). Bill has forecast that he needs (and demands) a long term capital growth rate of 8% to 10% (I think no one should invest in property and aim for anything lower than 8%).

So now the question becomes, what property (in terms of type, size, location, etc.) does Bill need to buy to achieve a capital growth rate of at least 8%?

Second, select the lowest risk property to meet that return

When many people get into property investing they think about ways of maximising their return. They rarely consider minimising risk. Some ways to maximise returns might include trying to pick the next growth suburb, doing a bit of property development and various other things. However, if your investment goal, like Bill's, is to accumulate a certain amount of wealth by a certain date, wouldn't you want to choose the least risky path from point A to B?

For example, the risk of trying to pick the next growth suburb is that; 1. It may never happen (growth that is) 2. It may happen but a lot later than you expected. If it never happens you'll end up having to sell the property and replace it with a better asset. In that case, you have lost money (stamp duty and selling costs) and time - that's your downside. If the second risk materialises (i.e. takes longer) you have lost time. Don't underestimate this effect. Consider a good quality property that grows at 10%, versus a property that does nothing for the first 5 years and then has two years of growth at 20% and 3 years at 10% (see graph below). The good property is worth approximately \$150k more after 10 years. Notwithstanding that, the good quality property builds equity in the early years and would have probably allowed the investor to purchase another property at year 5, allowing greater exposure in the market. So you have to ask yourself, is it worth taking the "risk" of trying to pick the next growth suburb?



Sure, it's boring but...

So how do you minimise risk? I believe it's about buying property in suburbs that have proven to provide strong capital growth over the long term (i.e. normally within the 5km to 15km band from a capital city). In fact, it's more than that. You need to consider the right architecture, orientation, streets, etc., that has proven to provide strong growth. It's about sticking to the fundamental factors that drive property values. It's not as sexy as picking the next growth suburb, but it's low risk. In fact, investing wisely is often boring, but slow and steady wins the race.

Another very smart way to minimise your risk is to pay an expert to choose a property for you. Engaging an expert that inspects and buys property every day of the week will surely reduce your risk of purchasing a dud asset. Look for a buyer's advocate that has experience and a firm understanding of investment property fundamentals. Many don't!

A crude but effective way to mathematically compare two properties is to look at the risk weighted return. I can demonstrate this by returning to my original comparison of investments; an ING Direct bank account versus investing in a start-up company. The likelihood of me obtaining the promised return from ING (6.15%) over a 10 year period is very high, say 99%. Assume investing in a start-up could return double your investment in 10 years (i.e. 100% return on original capital invested). We calculated the probability of that eventuating is only 4%. We can illustrate the risk weighted returns (projected return x risk) as follows:

	ING Direct	Start-up Company
Projected return	6.15%	100%
Risk	99%	4%
Risk weighted return	6.09%	4%

As you can see, once you factor the risk of an investment into a return, it doesn't look as favourable!

Some property more risky than others

When investing in property, you need to forget about what you are getting for your money. Sounds crazy doesn't it? Let me explain. Most people would balk at spending \$450,000 on a one bedroom apartment. However, \$450k would buy you an excellent one bedroom apartment – a very, very high quality investment. It would be a lower risk investment compared to spending \$450k on a house, as it's likely to be located in a less demanded area (for example). When investing in property, you need to choose the lowest risk investment possible. For example, \$450k may buy you:

- ◆ One bedroom apartment – located in the best suburbs (say 4km to 8km from CBD) with excellent access to amenities. Good condition, timely architecture, perfect location within apartment block, etc. A property that ticks all the boxes.
- ◆ Two bedroom apartment – still might be located in the best suburbs but will not be as strong as the one bedroom. Maybe location to transport might be a negative; floor plan might not be 100%, etc.
- ◆ Two bedroom house – located in a secondary suburb (maybe 10km to 15km from CBA). Good access to amenities, good floor plan, etc. Overall a good asset but not a perfect location.

- ◆ Three bedroom house – located more than 15km from CBA. Might have good access to amenities. House might be reasonable, but need cosmetic work. The biggest negative is location.

If your target capital growth rate was 10%, which property do you think has the most chance (or least risk) of achieving your target return? Maybe:

	Target return	Risk (likelihood)	Risk weighted return
One bed apartment	10%	90%	9.0%
Two bed apartment	10%	80%	8.0%
Two bed house	10%	75%	7.5%

Property always seems expensive. You get less and less for your money as the years go by. Don't worry about what you are getting. Just pick the best quality asset (and therefore, lowest risk) your money can buy and if that means a one bedroom apartment, then so be it! At the end of the day, if you purchase a property for \$400k and it grows in value at 10% p.a., do you really care if the property is a one bedroom apartment or 3 bedroom home?

The same goes for when you determine how much you would like to invest. I often suggest spending whatever you need to buy the best quality asset. For example, \$350k might buy you a good one bedroom apartment. However, spending an extra \$50k might buy you a much better investment thereby significantly reducing your risk.

In closing

I am not suggesting you can't make money investing in the "next growth suburb", undertaking property developments, etc. These strategies have merit and I am sure that many people have made a lot of money from them. However, in my opinion, I think people should choose the least risk path that will achieve their goals. You can allocate a small portion of your investments, to more high risk investments but you should be comfortable that your core low risk investments will achieve your goals.

Our Best Interest Rates

Basic variable	7.45%
Offset	7.55% (0.77% ongoing disc.)
Offset (> \$500k)	7.52% (0.80% ongoing disc.)
Offset (> \$1 million)	7.42% (0.90% ongoing disc.)
1 year fixed	7.15%
2 years fixed	7.74%
3 years fixed	7.59%
4 years fixed	7.74%
5 years fixed	7.74%
10 years fixed	7.89%

Above rates are current as at 17/10/07 and are subject to change without notice. Standard lenders terms and conditions apply. Comparison rates are available upon request.