

September 2006 Newsletter

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Buying well or buying right

When purchasing a property, most people focus on the value equation. That is, they compare the asking price to what they think the property is worth. Most people are aiming to buy a property for less than what it's worth. Often, this is the dominant focus. However, I am going to suggest that it doesn't matter if you pay a little too much for a property. In fact, I think the main focus should be on the capital growth prospects of the property.

Buying well

Everyone wants to think they have purchased well. Let's face it. No one wants to think that they have paid too much for a property. After all, we work too hard for our money, just to give it away. Sometimes it's a property buyer's main focus. They may compare a property with a sale price of \$500,000, which might only be worth \$490,000, with another property for sale at \$520,000 which might be worth \$550,000. Purchasers may pick the second property because they think it represents "good value".

Buying right

Buying right is a concept that is not really influenced by price and value. It is more concerned with the quality of the asset. That is, a good quality asset should outperform the market in terms of capital growth over the long term. There are many things that influence capital growth, which I will discuss later on.

Comparing the two

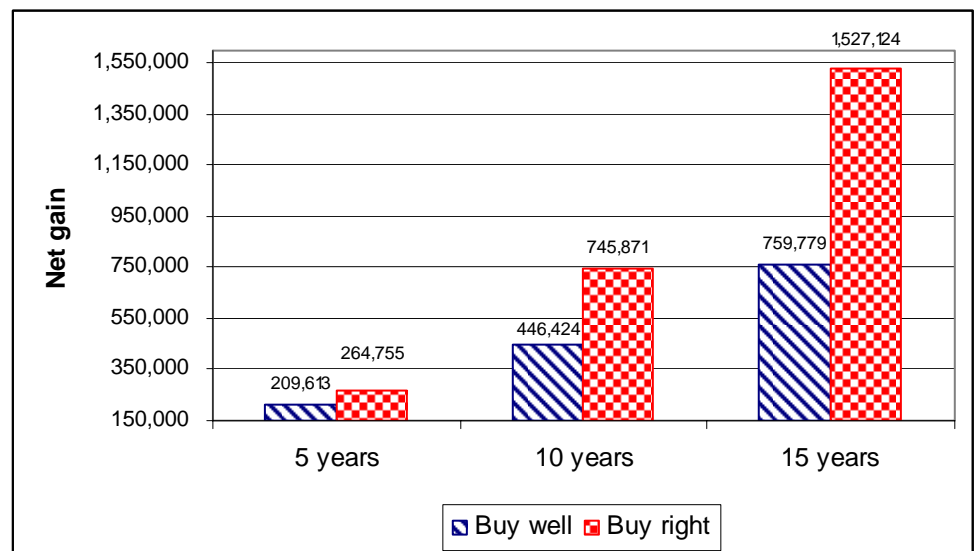
So what is more important? Some people say you make your profit when you buy? Is that true? Or is it more important to focus on other things.

I compared two scenarios associated

with purchasing a property with a fair market value of \$500,000. The first scenario involved someone purchasing the property for \$470,000 (i.e. below market value) with average capital growth prospects (say 6% p.a.). The second scenario involved someone purchasing a different property for \$530,000 (i.e. more than market value). However, the second property has superior capital growth prospects (i.e. 10% p.a.). There are two issues to consider:

- ◆ The capital gain for the first purchaser will be assisted with an immediate gain of \$30,000. In addition, the capital growth rate of 6% will be applied to the market value (\$500k), not what they paid for the property (\$470k). However, the reverse is true for the second purchaser because they have paid \$30,000 too much for their property.
- ◆ We need to factor in the interest costs. The first purchaser saves interest on \$30,000 (because they purchased for less than market value), whereas the second purchaser has to pay interest on \$30,000 more than they should have to.

Intuitively, you may think that buying well is the winner. Incorrect, the second purchaser (buying right) is over \$55,000 better off after five years. However, the gain increases over time. The second purchaser is \$300,000 better off after 10 years and over \$750,000 better off after 15 years. The graph below illustrates the difference in net gain (i.e. taking into account the increase in equity and the cost/saving in interest).



Based on the above scenario, you can pay up to 10% too much for a property and still be better off after five years. Therefore, to some extent, it doesn't matter what you pay for a property as long as it's a very good quality asset. That's not to say you pay whatever they are asking. However, your focus should be on the quality of the asset, rather than the attractiveness of the price. Someone that pays a fair price for a property could end up being far better off than someone who gets a bargain.

Buying well is sometimes important

The above calculations assume that you will hold the property for at least five years. This is reasonable because property is a long term asset (due to the high transaction costs such as stamp duty) However, should you not expect to hold the property for at least 5 years, then you probably should (to some extent) focus on buying well rather than buying right.

How do you buy right?

The answer is simple - stick to the fundamentals of property investing (even if it's a home purchase). You need to choose a property that will always benefit from strong demand. Some factors that drive demand include:

- ◆ Surroundings – look for factors that encourage people to live in that location. Some factors might include access to transport and roads (however, not too close to a main road), number and quality of local schools, shops and shopping centres, parklands, entertainment such as restaurants, distance from major employment centres (e.g. CBD) etc.
- ◆ High land value – land appreciates in value and buildings depreciate. Therefore, it makes sense that a greater proportion of your purchase price should represent land value.
- ◆ Construction of dwelling – a good workable floor plan, good location within the block, timeless architecture, etc.

Ultimately, you want scarcity. It is the simple rule of supply and demand. You want to choose a property that is in short supply, but benefits from strong demand. This will drive the value higher over time.

Can you achieve both?

Can you buy a property for less than fair market

value which will still outperform the market in regards to capital growth? It is highly unlikely. Generally, high capital growth properties are quite scarce (i.e. there are more buyers than properties). Therefore, it's likely that these properties will be hotly contested and sought after when they are put onto the market. This means there will be multiple bidders and it's unlikely you are going to pick the property up for a bargain. I think the only time you'll be able to purchase for less than market value is when a property is not subject to a full sale campaign. Some vendors might want to sell without an invasive and time consuming sales process (e.g. open for inspections, etc.). Therefore, the real estate agent will approach people that they know who will be ready and willing to buy (e.g. a wealthy person that is able to organise their finances quickly).

Importance of capital growth

Capital growth is important, because it increases your wealth and creates opportunities. There are many benefits of capital growth. You can use the equity to invest in other assets (via borrowing). If you sell the property, you will realise a capital gain (which is tax free if it's your home). It can be the most tax effective investment we ever own.

Focus on what's important

If you are buying a property and you are going to hold it for the longer term (i.e. greater than five years), then you should focus on the factors that are going to influence the value of that asset over the longer term. Focusing on the value and price equation is only going to impact your wealth initially. It is the growth prospects of the property that are most important. Don't be afraid to pay fair market value for something if it's a quality asset. You don't necessarily need to purchase a "bargain" to be a smart property buyer.

Best Rates

Basic variable	6.99%
Offset (>\$250k)	7.00% (0.82% ongoing disc.)
Offset (> \$1 million)	6.94% (0.88% ongoing disc.)
1 year fixed	6.49%
2 years fixed	7.09%
3 years fixed	7.12%
4 years fixed	7.25%
5 years fixed	7.25%

Above rates are current as at 11/9/06 and are subject to change without notice. Standard lenders terms and conditions apply. Comparison rates are available upon request.