December 2005 Newsletter

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Should you buy an investment property or a home?

Many of our clients wrestle with the decision about what to purchase first, an investment property and keep renting, or a home. It is often difficult to decide what is better from a wealth creation perspective. Let's look a little closer at these pros and cons to see if we can identify which option is the best for your long term wealth.

Disadvantages of buying an investment property and renting

- People have a strong emotional attachment with owning their own home. It is often referred to as "the Australian dream". To some people, purchasing an investment property before a home does not make sense. People get a lot of satisfaction, security and comfort from owning their own home. This can be a very strong factor. In my opinion, this is an important consideration, but probably shouldn't dominate your decision. Try to be as unemotional as possible so that you can assess the other pros and cons. Travelling down the wealth creation road does require some sacrifices.
- If you have spent most of your cash savings on an investment property, then you will either have to save another deposit for a home purchase or you will have borrow against the equity in the investment property. Saving a deposit might take a while, depending on your income situation. Borrowing against the investment property's equity also has some negative aspects because it means that you will end up with proportionally more non-deductible debt compared with deductible debt. Obviously, the reverse is better (i.e. lower non-deductible debt compared to deductible debt).
- Borrowing capacity might also be another issue to consider. If you purchase an investment property, will you have enough borrowing capacity to purchase a home as well? This will depend on your income situation but people are often surprised by their borrowing capacity level.

Advantages of buying an investment property and renting

- The interest on the mortgage is tax deductible. Therefore, the after tax cost of debt is a lot less for an investment property compared to a home. Assume you are on the second highest tax rate of 43.5% (including Medicare). If your investment loans interest rate is 6.62% then your after tax cost of debt is 3.74% because you are able to deduct 43.5% of the interest cost from the amount of tax that you pay. Whereas, with a home loan you cannot claim a tax deduction for the interest. Therefore, your after tax cost of debt is still 6.62%.
- Normally, when people purchase an investment property they do so on an unemotional basis. Therefore, they focus on the fundamental strengths and weaknesses of a property from an investment perspective. They are not influenced by the emotional factors that come into play when you are buying a home. It is for this reason that investors are more likely to purchase a property that will perform better from a capital growth perspective. Put differently, the risk of purchasing a property with poor capital growth prospects is a lot lower with investment property purchases because you are not influenced by emotional factors.
- Given the low rental yields in today's marketplace, you may be able to rent a home or apartment in a location that you wouldn't otherwise be able to afford (to purchase in). For example, the average rental yield of houses in the exclusive Melbourne suburb of Toorak is 1.11% according to Residex. Therefore, if you purchase a property in Toorak and borrowed more than 20% of the purchase price (i.e. 80% deposit), then the interest cost would still be higher than the rent that you would have to pay for a similar property. Whilst I am not suggesting that we all move to Toorak, it does show that some areas are better value for money for renters and it may allow you a "lifestyle" that you would not otherwise afford.
- By committing to an investment property purchase first, you have the benefit of getting a foothold in the market early. Whereas, when people purchase a home, they may plan to purchase an investment property within a few years, but it often doesn't eventuate. They are distracted with other things such as renovations, holidays and busy lifestyle. This is a very big advantage of buying an investment property before a home.

- I am not sure if this point sits on the pros or cons side. The investment property is likely to produce a negative cash flow only in the first 4 to 7 years because of the rental income increases with the property value (although capital values and rant amounts generally don't go up at the same time). In addition, the negative cash flow should decrease every year, especially in today's market where rental yields are increasing. The benefit of this is that you will have more money to save for a deposit (and reduce the interest bill in the meantime with an interest only offset product therefore maintaining the tax deductibility of the loan). By the time you decide to purchase a home, your investment property should be paying for itself (or only produce a small negative cash flow deficit).
- You might be surprised to learn that from a cash flow perspective, you are better off buying an investment property (by over $380 per month). I have based my calculation on both scenarios, purchasing a $500,000 property and borrowing 90% at a rate of 6.62% (they would need approximately $80,000 as a cash deposit). The investor receives a rental yield of 3.5% and rents a home for $350 per week (which will get you pretty good property).

Property Investor		**Home Buyer**	
Gross salary	$90,000	Gross salary	$90,000
+ Rent income	$17,500	- Tax	$30,114
- Interest exp.	$29,790	- Interest	$29,790
- Tax	$24,767		
- Rental exp.	$18,200		
Net p.a.	34,743	Net p.a.	$30,096

Neutral factor

Often, people think that they will not be entitled to the First Home Owners Grant if they purchase an investment property. This is not quite true. As long as you have never occupied a property that you own, then you should still be entitled to the First Home Owners Grant. However, buying an investment property will disqualify you from some State concessions (like the nil stamp duty concession in NSW for first home buyers).

Conclusion

Let's ignore lifestyle and emotional considerations in this assessment, because everyone's wants, needs and circumstances are different. Therefore, from a wealth creation perspective, there are two key areas to focus on being cash flow and capital growth.

The cash flow difference between the two scenarios is not dramatic. Sure, the investment property scenario is better, but not significantly better that it should strongly influence our decision.

The capital growth scenario is the critical one. In my opinion, it does really matter what you do if the capital growth prospects of both a home and investment property are equal. That is, if your home is going to increase in value by 10% over the long term then buying a home is a good thing to do from a wealth creation perspective because you can eventually borrow against the equity of your home to purchase an investment property. This will optimise the split between deductible and non-deductible debt (because you'll be able to borrow 100% of the investment property's value.

Therefore, if you are going to buy a home, then it is really important to approach the purchase from an investment property perspective. This is especially important for your first home or any home that you don't plan to hold for more than 10 years. You need to select a really good quality asset that will produce good capital growth. This will make sure that any cash you do contribute to the purchase will still produce a good net return. In addition, it will give you the opportunity to borrow against your home's equity to purchase future investments.

Are you being served?

Banking customer satisfaction is at an all time low according to a recent article in the Australia Financial Review. Worst hit is the Commonwealth Bank (which, from our experience, we would not disagree with). The best performer is St George Bank.

I have written an article for Australian Property Investor magazine about what service platforms the banks offer and how to get the best service. This article will appear in the January 2006 issue of API. This will be the newsletter topic for February 2006 (we don't produce a newsletter in January) where I will provide readers with a copy of this article.

Merry Christmas

We would like to thank our clients and friends for their support thought out the year. We wish everyone a safe and enjoyable Christmas break and a prosperous New Year. Our office will be closed from Thursday 22 December and reopen on Monday 16 January 2006. However, someone will be checking emails on most days so we are still contactable.

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