

February 2007 Newsletter

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Do nothing and lose \$161,000!

There is one thing that a lot of property investors fail to do. That is, dispose of poor performing property. I think there are two reasons for this. Firstly, a lot of people do not regularly review their investment assets performance and compare it to a benchmark (or investment goals). Some people may undertake a cursory review, but they do not do enough work themselves or fail to engage experts to do it on their behalf. Secondly, as humans, we hate to admit that we have made a mistake and crystallise a monetary loss. Instead, we'll say things like "I'll hold onto it until it turns around so that I at least break even". The purpose of this article is to try and convince you to be very hard on your property and demand the best. Stop making excuses for it and giving it second chances. You need to be strict. It needs to perform adequately. If not, it gets cut (sold). "Well, in my book you either do it right or you get eliminated" says Gordon Gekko from the movie Wall Street.



I am going to discuss a number of calculations in this article. Try not to get lost in the numbers (particularly if you are not a numbers person). Furthermore, do not let the numbers discourage you from reading the article. Focus on the conclusions. You do not necessarily need to understand how I calculated a result. That said, you must realise that property (and investing for that matter) is a numbers game. It has nothing to do with emotion or liking a property or area.

How do I review my assets correctly?

This topic is a whole article in itself (which I might do one day). However, as I have written in many other articles (which I continue to repeat!), investing in property is all about capital growth. That is, it is capital growth that will build wealth.

You do not need to worry about reviewing the income (or commonly referred to as the rental

yield). Hopefully, you have chosen a good property manager and it's their job to review the rent for each property at least annually (or when new tenants occupy the property). I find it good to challenge property managers every now and then and ask questions like, "do you think we can increase the rental on this property by \$10?"

The first step in reviewing your property's performance is to ascertain its current value. There are a couple of ways to do this. You can speak to some real estate agents (although be careful with the valuations that they provide as some might be inflated), do your own research (there are many websites which sell property sales data) or you could commission your own valuation. I probably would not pay for a valuation every year. Every three to five years is probably a good idea.

Once you have ascertained the property's current value, you need to compare it to a benchmark. Before you started investing, you should have determined what you wanted to achieve. Monique Wakelin from Wakelin Property Advisory suggested that investors should aim to achieve annual compounding capital growth rate of five to eight percent above inflation. Therefore, you should be aiming for a capital growth rate of eight to eleven percent. Let's say that your benchmark (i.e. the minimum you want to achieve) is eight percent. What you need to do is work out what your property should be worth, now assuming a growth rate of eight percent. The formula is:

Purchase price * ((1 + 8%) ^ number of years)
^ = to the power of

For example, if you purchased a property for \$250,000 five years ago it should be worth \$367,000 today.

Lastly, you should compare the current value to the benchmark value of \$367,000. The current value should exceed or be very close to the benchmark value. If not, there are some considerations that you need to take into account (such as the years of ownership, the property market cycle, forecast environmental or demographic changes, etc.) before concluding the property is a dud. However, for the sake of this article, let's assume that the property is a dud (that is, growth prospects are unlikely to be any different moving forward). Let's assume that its current value is \$260,000.

The cost of disposal

Disposing of property can be costly. Some of the costs might involve:

- ◆ Selling agent commissions – say 2% to 2.5%.
- ◆ Marketing costs – say \$2,000
- ◆ Mortgage discharge fees (bank and government) – say \$500
- ◆ Solicitors fees – say \$1,000

All up, it might cost \$8,700 to sell a \$260,000 property so the vendor of this property will receive \$251,300 net (sales price less expenses).

In addition, let's assume that he borrowed the full cost of the property when it was purchased. Purchasing a \$250,000 property would have cost \$262,000 including stamp duty so we will assume that is the loan amount. Therefore, the investor will still be left with a loan of \$10,700 after the net sale proceeds have been paid into the loan. The ongoing interest cost will be \$800 on the \$10,700 loan.

This is not an attractive outcome which is probably why many investors are reluctant to sell property.

The cost of holding onto the asset

It is obvious that an asset which only increases in value by \$10,000 after five years is not going to do much for your wealth. After all, we have determined that it should be worth \$367,000 by now, so the first investor has missed out on \$107,000 of capital growth. However, assume that he decides to hold onto this asset, because he thinks the capital growth rate will pick up. Assume that the property's performance does improve and grows in value by five percent per year from now on (still pretty ordinary growth!). The property will then be worth \$423,000 in ten years. The loan amount is still \$262,000 so the investor has \$161,000 of equity.

However, compare the scenario where the investor sells the dud asset (for \$260k) and purchases a much better quality property for \$260,000 which grows at nine percent per year, slightly above the benchmark rate (8%). Assume that the investor also paid a professional investment property advisor \$7,000 in fees to select this property for him. The property will be worth \$615,000 in 10 years. The investor borrowed the total cost of the purchase which would have been \$272,000 (on a

\$260,000 purchase) plus \$7,000 in professional fees. In addition, the investor still had \$10,700 of debt left over from the sale of the dud property. The investor's total loan is \$289,700 so the investor has over \$325,000 of equity (\$615,000 - \$289,700).

The investor who disposed of the property is over \$164,000 better off after 10 years. I am sure that you agree that it was worthwhile crystallising the \$10,700 loss (and paying more stamp duty and fees to purchase a superior property). After 20 years, the investor who disposed of the property is over \$730,000 better off.

Another consideration which is not reflected in the above calculations is how capital growth can assist with growing your investment property portfolio. For example, assume that you have calculated you need \$100,000 of equity in your existing investment property before you can purchase another investment property. It will take the dud property seven years to accumulate \$100,000 in equity (value less loan amount) whereas it will take the new property only five years (even taking into account the higher loan amount). This will allow the investor (who disposed of the dud property) to purchase another investment property two years sooner than the investor who held onto with the dud property. This means that he will benefit from two extra years of growth which amounts to just under \$70,000 at the ten year mark (assuming another purchase for \$260k).



For everyone, except maybe James Packer, borrowing capacity is a scarce resource. We have a limit to how much we can afford to borrow (the limit could be set by the banks, or our own comfort level). As such, we should use our scarce resources as wisely as possible. Assume you can afford to borrow \$1 million in total. This might allow you to buy two to three very good quality properties. You should always make sure that you have the best two to three properties possible. If you have experienced some excellent capital growth in the past, but feel the growth prospects are minimal going forward, then sell. If your property has performed poorly and you can't identify a reason why its performance will change in the future, then sell it. It's like managing the Australian cricket team. You can only have 11 players on the ground, so naturally you want the best 11 in the country regardless of the cost (especially when beating England!).

Simple solution - professional advice

Purchasing a good quality property from the start will save you a lot of money and heartache. The risk of selecting a poor asset (that won't perform well) is reduced, if you engage an expert to select or review the property before you purchase it. The difference in value between a five percent and a nine percent growth rate on a \$350,000 property after five years is over \$90,000 (and more than \$250,000 after 10 years). Therefore, why wouldn't you "invest" a bit more money now and pay a professional to select your investment property, increasing the chances of owning a property that grows at nine percent per year (rather than five percent).

Another thing to consider is engaging an investment property advisor to review your existing property. I think here are three main benefits of doing this. Firstly, it's not going to cost you any time. After all, most of us are time poor. Secondly, the advisor should be able to value your property accurately (saving money on a valuation report). Lastly, they will assess your property's performance without any emotion whatsoever. This is probably the most important benefit, because often we will come up with "excuses" (not reasons) as to why we should not sell our property. Once again, we need to be disciplined and dispose of underperforming assets as soon as possible.

For your information, we can refer you to investment property experts that can assist with a purchase or a review of your existing property. Please contact us for further details.

A simple conclusion

The conclusion is simple.

1. Do everything possible to purchase the best quality asset from the beginning. That might involve paying a professional investment property advisor or spending hours learning about the fundamentals of property investing and searching for the best property yourself.
2. Review your property on a regular basis. As soon as you determine that you have a dud property, sell it as quickly ! Holding onto it for any longer will cost you a lot of money.

It does not take a lot of time or money to review the performance of your investments. Not reviewing the property's performance can certainly cost you plenty!

Property prices poised for a giddy climb

(From The Age 28/1/07 - edited)

Every now and again you come across a statistic that signals a turning point. In later months you look back and say that figure was the trigger for all the drama that followed.

In the latest CPI figures, all the attention was on petrol prices, which fell a mighty 12 per cent in three months, bringing a slight fall in the overall measure of inflation. But the figure I'm thinking of is average rents. Buried in the CPI report is the news that rents rose by 3.7 per cent in 2006. Now, that doesn't sound big I know, but it was the biggest increase in 16 years.

Here's what I think is happening. Property prices have been flat for years, rents have not moved, new building approvals are sluggish but slowly and surely the property market has been restructuring. As a result, residential property is undervalued, there is not enough stock on the market, rents are rising rapidly and property prices must follow. Rental yields - the amount investors make from rent on the purchase price of a property expressed as a percentage - are now about 3.2 per cent.

In Sydney, the Real Estate Institute of NSW expects rents will rise by up to 20 per cent. Nationally, the figure will be closer to 10 per cent, according to AMP.

Now throw one more spoon of spice into this mix. Melbourne's average house price has gone nowhere for years. Believe it or not, the average price in Melbourne, at \$385,000, is lower than not just Sydney, but Brisbane, Perth and Canberra. I don't think this will be the case this time next year.

Our Best Interest Rates

Basic variable	7.24%
Offset	7.30% (0.77% ongoing disc.)
Offset (> \$500k)	7.27% (0.80% ongoing disc.)
Offset (> \$1 million)	7.17% (0.90% ongoing disc.)
1 year fixed	6.65%
2 years fixed	7.15%
3 years fixed	7.14%
4 years fixed	7.14%
5 years fixed	6.99%
10 years fixed	6.95%

Above rates are current as at 20/2/07 and are subject to change without notice. Standard lenders terms and conditions apply. Comparison rates are available upon request.