

The property bubble and market timing

In the past week, I have been asked a lot about whether I believe there's a property bubble and if so, when will the bubble burst? In my opinion, a better question is "where will property prices be in 10 to 20 years from now", because as long term investors, we should base our decisions on long term outcomes and not be influenced by short term volatility along the way. However, it did make me think about a few questions. Firstly, what affect does perfect timing have on overall return? That is, if we bought at the exact bottom of the market versus the peak, how much difference does it make on our return? Secondly, if we wait to "see what happens", how much does that potentially cost us? These two questions are interrelated as you'll find out.

Is there a bubble?

I recently had the pleasure of spending an hour with William Baldwin, the Chairman of National Association of Personal Financial Advisors, which is a leading association for fee-only advisers in America. We had an interesting discussion about our approach to financial planning and the fact that we embrace and advise on direct property investments. We discussed the historic performance (from a capital growth perspective) of residential property – I suggested that good quality, well-located property produces an annual capital growth rate of 7 to 10%. He nearly fell off his chair! In his opinion, "property cannot continue to grow at that rate perpetually. At some point, property will end up being unaffordable for nearly every Australian". Unfortunately, William missed my point (initially). When I talk about those returns, I am not referring to the median rate of return or the "average" property. Nor am I talking about super-premium property. I am talking about blue-chip, well-located property in areas that have exhibited strong performance in the past (proven suburbs). In regards to land area that these proven suburbs occupy, I'm probably talking about a few percent (maybe less than 5%) of land area in all of Australia.

Therefore, the question should be more correctly stated, "is there a price/value bubble in blue-chip areas?" I am pretty confident that the answer to that question is a resounding NO! Supply is fixed and demand is growing. Often this demand comes from people earning above the "average weekly earnings" (which is an affordability measure often used when analysing property prices). Also, a lot of people demanding to live in these blue-chip areas either derive income from investments and/or business (so they aren't subject to deliberate income increases that employees are subject to), or they are young professionals that probably have more

discretionary income than most of us (particularly if you have sons like mine who constantly demand a "surprise" when I arrive home from work every night. Maybe the surprise this week can be me watching something other than cartoons on TV!?!?). Therefore, the people that demand to live in these blue-chip areas can afford to continually pay "more" for property. There's always someone with more income that's willing to pay more. This is why, as an investor, you should ignore the commentary about housing affordability, because it's less relevant in blue-chip areas.

What about the wider, non-investment property market. Is there a bubble there? Maybe. I have noticed some outlying suburbs (> 30 kms from CBD) that have demonstrated strong capital growth at the levels we would expect blue-chip suburbs to produce. To me, that feels like a bubble, because they just don't have the fundamentals to underpin that sort of growth. For example, the suburb of Melton in Melbourne has grown at an annual compounding rate of 9.2% between 2001 and 2009. Melton is 35 kilometres west of Melbourne's CBD and its median value is \$226,000. Over the past 10 years, people have been building new homes there and infrastructure has improved a bit over this time. However, I'm almost certain that Melton property will not continue to increase at the rate of 9.2% per annum. My point is if there is a bubble in the Australia market, it's my opinion that the bubble is more likely to be in the outlying suburbs surrounding our capital cities, and less likely to be in the blue-chip suburbs.

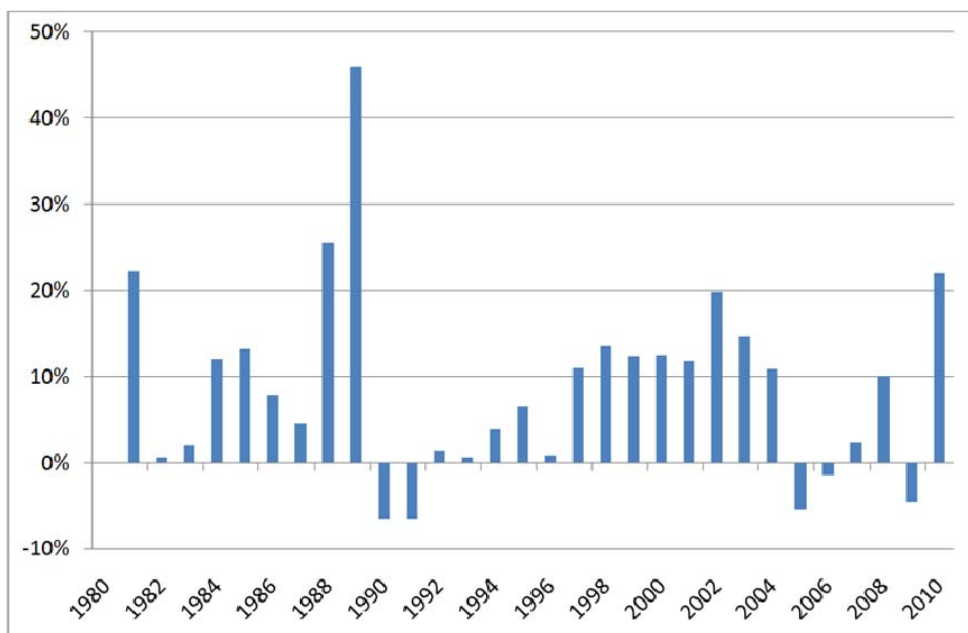
For what it's worth, my gut feeling is that there isn't a bubble yet (in either market segments) and it's our population growth and housing undersupply that is driving this growth. Time will tell.

Buying at the peak versus the bottom of the market

A lot of people (home buyers and investors) fear buying at the peak of the market. They fear buying a property for say \$800,000 today for it to be worth \$750,000 in 6 months time due to a fall in prices. This fear cripples a lot of people and results in them procrastinating and not buying anything. The most frustrating thing is that 99% of the time they are proven to be incorrect and the \$800,000 ends up eventually costing them \$900,000. Even more interesting is that when property did fall in value (as it did in 2007/08), they still didn't buy!

The question is; if we do buy an investment property and the market falls in value, what is the affect on the overall return? The graph below charts the annual change in median value (average of Melbourne and Sydney) since 1980. As you can see, there have been 5 years of negative returns over the last 30 years (I've compared calendar years). The biggest change has been in 1989 when the median price increased 46% and 1990 and

1991 when the median price dropped by 6.5% in each year (during the "recession we had to have").



what this analysis suggests is that the long term affects of buying at the very peak of the market (even after a 46% rise) versus buying at the bottom (after 2 years of negative growth) isn't that significant in the long term (and this is the starkest comparison we can find over the past 30 years). The key message here is "the long term". When investing in property, we are (or should be) making very long term decisions. We should not be influenced by what the market will do over the next 1, 2, 3, 4 or 5 years. We should be focusing on periods of 10 or more years (so that it includes at least one full property cycle).

The cost of "waiting" for the market to fall

Let's look at a year where we have experienced some high growth and therefore, we may be excused for thinking that property has peaked. For

Therefore, let's compare a situation where an investor purchased a property in 1989 (at the peak of the market after a 46% rise for \$174k) versus 1991 (being the bottom of the market after 2 years of negative growth for \$152k). The tables below set out the compound annual growth rate for each cumulative 5 year period following the investment property purchase with the final comparison against the March 2010 median (data from the Real Estate Institute of Australia).

example, in 2002, the median value increased by 20%. One investor purchased in March 2002 and one investor waited 2 years and purchased in June 2004.

Investment in 1989 for \$174,000			
Investment period	Median Value	Compound annual growth rate	Equity (\$)
5 Years	161,000	(1.5%)	(12,750)
10 Years	245,000	3.5%	71,250
15 Years	469,500	6.8%	295,750
21 Years	575,000	5.9%	401,250

The March 2002 investor purchased for \$369,250 and the median is now \$575,000 which means he has \$205,750 of equity and the property's compound annual growth rate was 5.7%.

Investment in 1991 for \$152,000			
Investment period	Median Value	Compound annual growth rate	Equity (\$)
5 Years	173,000	2.6%	21,000
10 Years	308,000	7.3%	156,000
15 Years	437,750	7.3%	285,750
19 Years	575,000	7.7%	423,000

The June 2004 investor purchased for \$454,950 and the median is now \$575,000 which means he has \$120,050 of equity and the property's compound annual growth rate was 4.2%.

Therefore, there's a difference in equity of over \$85,000. This is a relatively short period of time to compare performance. The difference over a longer period (like the 20 years in the previous comparison) would be even more substantial due to the compounding nature of growth.

What to do about it

In real terms, the difference in equity (\$401,250 compared to \$423,000) isn't that significant – only 5.4% or \$21,750. This analysis doesn't take into account the difference in holding costs (i.e. the 1989 investor may have had to borrow more and therefore pay more interest). However,

The above analysis suggests that, over the long term, we have little to lose by buying at the peak of the property market, but a lot to lose from delaying a purchase and waiting for the market to fall. This makes sense given

there has only been 5 calendar years in which property actually did fall and the maximum drop was only 6.5%. However, the maximum rise over the same period was 46%. The average rise is 10.7% and the average fall is 4.9%. Therefore, while you might be waiting for a 5% drop, you

might actually miss out on a 10% rise in prices (or more).

Astute and experienced property investors do not get caught up with (or influenced by) short term predictions with regard to property price movements. They make long term decisions. They also focus on the quality of the asset they buy. High quality, investment-grade property is normally more resilient to price movements. This means that they are more likely to hold their value in a more volatile market. The best thing you can do is to NOT try and time the market or try and identify the bottom of the market, but instead focus on the quality of the property you are buying. It is the quality of the assets we invest in that determines the returns we enjoy, not the timing when we bought those assets.

Another problem with the bargain mentality (i.e. wait for the market to fall to pick up a bargain) is that often (but not always), the properties that fall in value the most (and appear to be bargains) are often the lesser quality properties. In this situation, you might not be buying a bargain. You might be buying a dud!

Finally, if you insist on waiting for property to fall, make sure you actually do buy when property has fallen in value! The problem in a declining market is that most people are too scared to buy and therefore don't follow through on their intended actions. They miss the boat, because they're waiting for the bottom of the market.

Median data can be meaningless

One of the problems with my analysis is that sometimes the median can be meaningless and I admit that. The median is the middle value of all the property sales in a 3 month period (listed from highest to lowest). It can be skewed by the types of properties sold during any one period. For example, if the first home buyer market runs hot, then more lower-valued homes will be sold, which will pull the median figure down. Unfortunately, the median is the best data we've got.

How we can help

Our Wealth Advisory team (including me) work very closely with clients on an ongoing basis to mentor and coach them through their investing decisions. Our main job is to prevent them from making the common mistakes that many investors make, being; investing in the wrong assets or not investing at all. If you feel you'd benefit from

an ongoing relationship of this nature, do not hesitate to contact [Jery Mourelatos](#) (one of our Wealth Advisor's) or myself.

Jery Mourelatos: Direct (03) 8624 4606

Special Offers

PLAN Lending

PLAN Lending will waive the application fee on all new loans submitted for the **month of May (saving \$700)**. PLAN already has a good basic product and this makes it even more competitive. Key details include:

<u>Interest rate:</u>	6.55% or 6.45% if the LVR is less than 65% (the Big 4's standard variable rates range from 7.24% to 7.51%)
<u>Upfront fees:</u>	\$105 (title insurance)
<u>Ongoing fees:</u>	Nil
<u>Redraw:</u>	Free online (min \$100)
<u>Offset account:</u>	Not available yet
<u>Extra repayments:</u>	Yes, without penalty
<u>Early repayment fee:</u>	1 month's repayments if repaid within 5 years.

PLAN Lending is owned and funded by NAB and generally has a very good (high) borrowing capacity (particularly for investors) and quite flexible credit policy.

Commonwealth Bank Valuations

We can order valuations through CBA at a reduced cost of \$99 until 30 June 2010. Valuations normally cost \$264. If you are a CBA customer and/or would like an updated bank valuation, let us know.

Current Interest Rates

Basic variable (LVR < 65%)	6.45%
Offset (\$700k—\$1.1m)	0.80% disc off Std Var.
Offset (> \$1.5 million)	0.90% disc off Std Var.
2 years fixed	7.10%
3 years fixed	7.49%
5 years fixed	7.79%
10 years fixed	8.24%

Rates current as at 07/05/10 and are subject to change without notice. Standard lenders terms and conditions apply. Includes effect of May's RBA rate hike.

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