

## October 2005 Newsletter

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## Makings of a Successful Investor

In our line of work, we come across many successful property investors that have built a significant amount of wealth. We also see people who may have high incomes, but very little wealth. I think the biggest difference between these two types of people is twofold. Firstly, successful investors have a plan, maintain perspective and understand how they are going to build their property portfolio. Secondly, they don't procrastinate. They put their plan into action.

### Have perspective

Investing in property is a long term investment. I think the minimum investment term should be at least seven to eight years. However, many property experts advocate never selling investment properties. The reason investing in property requires a long term commitment is because of the transactional costs (i.e. paying for stamp duty at acquisition and capital gains tax when you sell). In addition, property cycles can last 5 to 10 or even 15 years. Therefore, you really need to hold onto property so that you can benefit from at least one boom cycle.

I think the biggest thing that puts people off is that investment properties generally cost money to run. That is, the rental income does not pay for all the property's expenses such as interest payments, council rates, insurance, etc. This is often referred to as negative gearing (where you are able to offset investment property losses against other income). Most people that are contemplating investing sit down and work out a budget. They calculate how much an investment property would cost and then decide that it's too much to continually fund such an investment. However, they fail to take a long term view. Most investment properties will cost money in the first five to eight years of ownership. After about eight years, most wisely chosen investment properties will become cash flow positive.

Furthermore, the cash flow deficit reduces every year. Therefore, what you must do with every investment is assess its viability over the investment term. That way, you can fully appreciate the pro and cons of every investment and get a better perspective (as opposed to just focusing on the first year's performance).

### Take action

The second, and probably the most important, characteristic of people that have successfully created wealth is that they take action. Put another way, they don't procrastinate. You will always be able to think about reasons why you should not invest in property. Most property experts predict that the market will be flat over the next few years. Petrol prices are high and could continue to climb, which might put pressure on interest rates (via higher inflation). However, most successful investors view these potentially negative issues as positive ones. They might take the view that a flatter market is easier to operate in because you can get a good appreciation for a property's market value (as opposed to a hot market where property sells for 30% above reserve). They see higher petrol prices meaning fewer buyers in the market and therefore more opportunities. However, the biggest thing is that they do not procrastinate. They seem to be self-motivated to buy the next investment property. Perhaps it's because they have seen first hand how investing in property can increase wealth. I have family and friends who always talk about investing in property. They have done so for at least the last three to four years. However, they have not taken action. Their procrastination has cost them \$50,000 to \$65,000, probably more (assuming they purchased a property for \$300,000 and it appreciated by 5% per year – which is modest growth over the past four years). As the saying goes; it's time in the market, not timing the market. Therefore, the sooner you start the better.

Taking a long term view, which aids in your understanding of the true value of investing in property, and taking action, are the only two things people must do. It's that simple. The rest is easy and takes care of itself. Many people mistakenly focus on doing more research, waiting for the market to turn around, waiting for a better time in their life, etc, etc. In a slow market they say "I'll wait until it picks up" or "I'll wait until the market drops more" (ironically, the only properties that are falling

in value are the poor quality ones). In a rising market, they say "I have missed the boat" or "I'm too late". Their focus is misplaced and as such, they will never invest in property (or anything). What they should be focusing on is taking a longer term view and putting their plans into action.

**Where's the value?**

Where is the true value of investing in property? Put another way, how is investing in property going to help you retire earlier?

The true value of investing in property is two fold. Firstly, you can magnify your cash. You can take \$88,000 in cash and invest in a property worth \$350,000 by borrowing 80% of the purchase price. Secondly, your capital growth (amount the property increases in value) is reinvested each year tax free. You don't pay capital gains tax until you sell the property. Therefore, while you own it you can benefit from large increases in wealth without paying for any tax (on the capital growth).

Perhaps this is better demonstrated by an example. I have constructed a simple spreadsheet model to compare property investments. Let's compare two scenarios based on purchasing a \$350,000 investment property. One scenario where a property's projected capital growth is 10% and rental yield is 3.5%. The second scenario is the reverse - capital growth of 3.5% and rental yield of 10%. The second scenario produces more income over 20 years because scenario one has a lower rental yield and it produces a loss in the first six years. However, by year 20, scenario one produces more rental income in dollar terms compared to scenario two. On the face of it, it looks like scenario two is better.

	Gross rental income per year			Net Income Over 20 years
	After 5 years	After 10 years	After 20 years	
<b>Scenario 1</b> 10% growth, 3.5% yield	\$19,729	\$31,773	\$82,412	\$157,335
<b>Scenario 2</b> 3.5% growth, 10% yield	\$41,569	\$49,371	\$69,643	\$376,338

However, as I said previously, the true value of property is being able to reinvest (or compound) the capital growth of property. Let's look at the properties estimated values.

	Projected Market Value		
	After 5 years	After 10 years	After 20 years
<b>Scenario 1</b> 10% growth, 3.5% yield	\$563,679	\$907,810	\$2,354,625
<b>Scenario 2</b> 3.5% growth, 10% yield	\$415,690	\$493,710	\$692,426

As you can see, after 20 years scenario one has created more than \$1.6 million of equity compared to scenario two. The total difference in income and capital growth between scenario one and two is over \$1.4 million. That equates to just under \$800,000 in today's dollars - i.e. allowing for inflation at 3% per annum over 20 years. This shows that capital growth is the key and true benefit of property investing.

To download the Excel spreadsheet model I used, go to [www.prosolution.com.au/articles/ipa.xls](http://www.prosolution.com.au/articles/ipa.xls)



**10% capital growth rate**

According to Residex, the average increase in residential housing prices from 1970 to the year 2000 (i.e.30 year period) in Sydney was over 11% per annum. I would imagine that Melbourne has produced similar results, although I didn't hunt down the statistics.

Therefore, aiming for an average long term capital growth rate of 10% is certainly not out of the realms of possibility. In fact, it is generally the benchmark for quality investment properties.

Of course, the capital growth rate will not be 10% every year. Some years it will be lower, some higher. However, over the long term, the average rate should exceed 10%. In addition, rental income may not increase every year in line with capital growth. Over the long term the rental yield should stabilise and remain constant (especially if you chose a professional property manager).

The critical thing here is property selection and assessment. It's important to select a good quality asset, regularly assess the assets performance and quickly dispose of underperforming assets.

**The cost**

Most properties are negative cash flow in the first few years. It's important that you are comfortable that you can afford to finance the property costs be-

fore you embark on any purchase. However, it's also useful to consider that the negative cash flow that a property will produce should decrease each year. Continuing with the same example (i.e. \$350,000 purchase, capital cost of 10%, rental yield of 3.5%, borrowing 80%), I have projected the property cost as follows:

Year 1 = Cost of \$99 per week  
 Year 2 = Cost of \$86 per week  
 Year 3 = Cost of \$71 per week  
 Year 4 = Cost of \$55 per week  
 Year 5 = Cost of \$37 per week  
 Year 6 = Cost of \$17 per week  
 Year 7 = Profit of \$7 per week

This property will cost (or produce a loss of) just under \$19,000 in total over the first 6 years. Let's not forget that the property is projected to increase in value by approximately \$270,000 over the same period of time. You would have had to invest \$88,000 of cash when you first purchased the property (to pay a 20% deposit plus stamp duties) plus an extra \$19,000 over 6 years (therefore total investment of \$107,000).



Therefore, the return on your cash invested is over 21% per annum (compound annual growth rate). This return will only improve after year six, as the property starts to turn a profit.

The point of this analysis is to demonstrate that the cost is not huge, the cost reduces over time and the extra investment required is certainly worth it.

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### In Summary

From my observations, successful investors have a long term plan. They understand how property will create wealth and they take a long term view. Secondly, and probably more importantly, they don't procrastinate and put their plan into action. If they have limited spare time, then they outsource the work (e.g. using investment property advisors, etc). Procrastination or delays cost a lot more than professional fees. Good luck with your investing!

*Written by Stuart Wemyss, director of ProSolution.*

## Market Update

- ❖ Macquarie Bank is offering its Mortgage Saver product at an interest rate of 6.59% (which equates to a 0.73% discount off the standard variable rate) for loans over \$500,000. The product offers an offset account as an option. Macquarie is also waiving the genuine savings requirement for loans under \$650,000. That is, an applicants' deposit doesn't have to be sourced from savings (can be a gift, bonus, etc.).
- ❖ ANZ has reduced its mortgage insurance premiums (in line with reductions by Westpac, CBA and St George recently).
- ❖ St George is waiving application fees on loans for more than \$150,000.
- ❖ Most lenders have reduced the minimum period for genuine savings from six to three months. Therefore, the definition of genuine savings is money held or accumulated in a bank account for a minimum period of three months.
- ❖ There are some very attractive 3 year fixed rates at the moment. CBA = 6.44% (for loans over \$350,000), NAB = 6.47%, Westpac, Sun-corp, ING, AMP = 6.49%.
- ❖ Westpac has reduced the interest rate for its Rocket products by 0.10%. These products used to cost 0.10% more than the standard variable rate.

## Online Investment Property Forums

There are a number very useful investment property forums. These forums attract a large number of experienced property investors who discuss all aspects of property. You can learn a lot just by reading the forums or you can post your own questions. The major two forums in Australia are:

1. PropertyInvesting.com — <http://www.propertyinvesting.com/forum>
2. Somersoft — <http://www.somersoft.com/forums/index.php>