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Real Estate Investment

Our company (and in particular Rodney) has always said there are better things to invest in than residential real estate. I will provide reasons for this in a minute but there are different aspects to property investment.

Australians however have a long standing love affair with property and I would imagine this will be even greater with the recent share-market turmoil. We must remember though property too does experience volatility and prices in some segments are down quite a bit from what they have been.

A home to live

Buying a property to live in is a sensible option for many but this is **not** an investment. Many smart people know this can in fact be a liability, as you receive no income from it and usually have to only pay money out. If you look to the capital gain as the return, when you eventually sell, this can in some cases be good but you then have to appreciate that **all** house prices have gone up too and you only benefit if you do not need a place to live. This is not the case for many people so property merely provides a hedge against inflation in this case.

You do have to live somewhere and stability for the family is quite often highly desired, so buying a house to live in is very important for many people. Many of our clients do however choose to rent and invest in things other than residential property. Each to their own!

Many people tell us “it costs me nothing to live in my house because I own it.” This is not really the case though. If you consider a house worth say $500,000 and you owned it outright you would actually have invested a sum of money that you are getting no return on. If you took that $500,000 and invested it and earned say 10% you would actually receive $50,000 a year. So if you are living in a house worth $500,000 it would be costing you around $1,000 a week in missed opportunity. Of course you may have to pay rent if you did not own a house so the net amount would be less than this but you could definitely rent a $500,000 house for well less than $1,000 per week.

Utilising equity

Many people have commented, especially since the Storm Financial case, that you should not use your property as security for a loan. I think this is rubbish! Done sensibly it can be a sound strategy.

The problem with the Storm model was that they simply were too aggressive with their strategies and did not ever expect the market to fall as far as it did. They also believed they could time the markets telling everyone to go to cash when the market had fallen. The problem with timing the markets is not so much when you get out but when you get back in.

If you adopt a conservative and sensible approach, borrowing to invest makes sense. Utilising the equity you have in your property is one of the cheapest forms of borrowing you can get – especially today with interest rates so low. You also do not get any margin calls if your investment does happen to drop in value.

Getting back to property investments.

If you do choose to invest in property it is vital that you do it correctly. Many people we see have created major problems for themselves by not seeking advice and understanding how the investment should be structured. Once you sign a contract it could be too late.

Some of the questions you need to have answered before signing the contract are:

What type of property should you buy for investment?

How much will I invest?

Should it be a house or unit?

Should it be new or established?

Whose name should the investment be in?

Should it be owned in the highest income earner or the lowest or jointly?

If jointly should it be tenants in common or joint?

Should the investment be held in an entity such as a company or trust?

What are the CGT issues with structures?

How will I pay the deposit, stamp duty and legal fees?

What can be done to maximise available deductions?

Are you eligible for depreciation? If so what rate?

What is capital work and what is maintenance and repair?

What is the yield on the investment?

How am I going to handle the extra tax I will pay on this income?

Who will manage the property?

What insurance do you need?

What happens if I die?

And the list goes on................

Advice is essential

A good financial planner can help you to answer all of these questions and make sure you start off on a good footing. We provide advice to people on these matters on a flat fee basis just covering our time for the advice provided. A small investment up front could save you thousands in the future.

Why don't we like residential property as an investment?

There are many types of property investment that can be fantastic investments. For some reason though the first thought for many people is for residential property.

When investing in anything you should follow some pretty basic principles. They are:

Diversification

When investing; it is very important to diversify. We have all heard don't put all of your eggs in the one basket. A property investor will usually invest all of their investment in one property. If you happen to be lucky and get a good one this can be good – however if you are unlucky and get a bad one it can ruin you. For me this is too great a risk to accept.

Liquidity

If you make an investment it is important to consider how you will get your money back should you need it. Property can take a long time to sell and settle. Also you cannot sell part of a property.

Yield

You should know what return you will get after all expenses and taxation. There are no tax breaks on property income (rent). It is fully assessed and added to your taxable income. Sure if you spend money by way of interest on a loan or repairs for the property you can claim a deduction but the rent is fully assessable otherwise. If for example you owned the property within a super fund and you were drawing an income from the fund and over 60 you would pay no tax at all on the income.

Capital Gain

Gains are nice but it is very important to manage them correctly. You need to keep very good detailed records right from the start. Many people do not do this and struggle later to get reductions in CGT they are entitled to. You need to keep the property for more than 12 months to be eligible for the CGT discount as with any investment you own personally, jointly or within a trust.

It is also important to consider some other things

Depreciating asset

The house or unit itself is a depreciating asset and will need repair, maintenance and eventually replacing. The value is in the land but land alone does not produce yield.

Your time

Anyone who has ever owned a property will tell you that no matter how good your property manager or tenants are you will still find yourself investing plenty of your own time in the property.

Tenants and property managers

Unfortunately there are many horror stories of both tenants and property managers that have done the wrong thing. You can get some types of insurance that help but again this is an unacceptable risk to me.

Other types of property

Many people do not for a second consider many other types of property that we do think can make a great investment. Investing through a good property fund can address many of the issues identified above.

A perfect storm

Many commentators have identified a few things that people should be wary of before investing in residential property and these are some of my major concerns too. The commentators call it the perfect storm and no I do not mean Storm Financial.

The market under $400,000 is going quite well and is where most of the action is at the moment. The government's first home owner's grant and low interest rates are stimulating this part of the market. This also happens to be where most investors are. I fear that if the first home owners grant was ever stopped and interest rates started to rise again this part of the market could see major problems.

I bought my first property in 1990. I paid $105,000. I sold that property in 2006 financial year. If I had sold that property for the first 10 years I would have lost money. That is I would not have been able to sell it for $105,000; 10 years later. Fortunately for me we had a property boom in the early 2000's. I eventually sold the property for $240,000 which sounds great; a $135,000 profit. When I did the calculations of legal fees, stamp duty, interest on loans and maintenance (not to mention my time invested) I actually lost money. Sure it was possible I just bought badly; but I would argue otherwise and many people I know can remember well that period through the 90's.

Take it from me there are risks you need to consider and wherever possible you need to try and minimise these.

In conclusion

We could probably go on forever discussing the various positives and negatives with residential property investment. If you love property and this is the medium for you then my advice is - make sure you know what you are getting and make sure you do it right. Mistakes can be very costly.

Come and see us for a no obligation discussion. Phone 3252 9990 or visit www.rodneygibson.com.au