

INVESTING IN PROPERTY

In 1991 I gave up my first job after only four years and decided to spend my meagre life savings on a trip around Europe. The money went very quickly and I found myself in London, at the end of the post eighties boom. The UK was in the grip of a severe recession and it was difficult to find work that paid more than a few pounds an hour. On top of that, I had no idea how to market myself. I eventually found a job with Barings Bank in the futures division that paid me about £3 per hour. I was basically the odd job boy and had no idea what financial futures were. I hated the job and the people that worked there were very unhappy. I remember coming in one morning to find that some of the operations staff had been working all night trying to reconcile the trader's positions. Of course, Barings was the bank that later collapsed in spectacular fashion after Nick Leeson "The Rogue Trader" covered up millions in losing trades.

I quit the job after only two weeks and decided to try my hand selling art work door to door. A bad choice. I failed miserably and quit after two days.

I had no money, had been paying rent on my credit card, and had 20 pence left in my pocket. I walked to Hyde Park and sat and watched the squirrels gather nuts for the oncoming winter. I was cold, miserable, and was dreading the task of asking my parents if they could lend me my airfare home. As I sat on a park bench, a beggar came up to me. "Could you spare 20p for a cuppa tea?" He asked in a strong Irish accent. How could I refuse? I gave him my last coin and he was gone.

Back at my flat, I lifted the phone to place a call to my parents and noticed there was a message on the answer machine. It was from an employment agency that I had registered with weeks ago but had given up calling. "There's a job at JPMorgan's back office in Stratford. Can you start tomorrow morning? The assignment is for two weeks."

I was with JPMorgan for nearly 14 years and eventually left as a Vice President in the Sydney office.

OK, I admit the leprechaun story is a very tenuous connection for an introduction to a chapter on property, but here's the rest of it: After being so broke and living on virtually nothing, I saved my few pounds an hour and eventually saved a small amount. I thought to myself, "What am I going to do with this?" Should I travel again and have nothing left to show for it, or should I invest it? I was sick of paying rent, and the living expenses in London were high. One of my mates at work was in the same position, so we went and checked out how much we could borrow to buy a flat. At that stage, the London property market was almost at rock bottom. We worked out that we could actually SAVE money by borrowing and buying. Within weeks, we each had ourselves a flat in an Edwardian conversion in Streatham. I only stayed there 18 months. I had had enough of the London winters and managed to convince my bosses that I'd be much more useful to them in Sydney office. I rented the flat out and headed to Australia.

A few years later, I made enquiries about selling my London flat. I had bought it for £62,000 using a £3000 deposit. It sold in 2002 for £145,000. My £3000 deposit had made me £83,000 in seven years!

Unfortunately for me, in the time I'd been in Sydney, the property boom had also taken off. I had checked out prices in the Eastern suburbs in 1997. A small two bedroom terrace was over \$400,000. Too expensive I thought. By the time I wanted to buy in 2002, the same place was nearly one million dollars!

How was I to get in to the Sydney market without an astronomical mortgage? I still wanted to keep some of the cash I got from London, and didn't want to put all my eggs in the property basket so to speak.

In 2005 I found the answer...

There are a few reasons for buying property; for you to live in yourself, for income (rent), or for capital growth.

If you're looking to build wealth, focus on capital growth. Don't buy a property just because you like it. The residential property market in Australia is worth well over \$25,000,000,000 per year.

The single most important factor for capital growth is land. Land appreciates in value. Buildings do not! If the house goes up by 10%, the land will generally go up by 20%.

The only reason you would lose money in real estate is because of greed or not doing your homework. It is the buyer's responsibility to make sure that they find out how much marketing and commission fees the vendor is paying. Their interests are to get the highest possible price for a property. It is also the buyer's responsibility to make sure that the bank's valuation of the property is reasonable. It is not always the same as the purchase price.

It's no secret that income by itself does not make you wealthy. You will never save yourself to wealth. On the other hand, capital is material wealth which can be used to produce more wealth. There is nothing wrong with borrowing to get an asset that appreciates in value and generates income.

To build your wealth, you need to establish a structure or system to manage your cash flow, acquire assets, and let capital growth increase the value of your investment over time.

So why real estate - why not invest in shares?

Residential property has historically doubled in value every eight or ten years. It also offers the security of bricks and mortar as opposed to the fluctuations of the share market.

Your returns depend on your investment strategy - where you buy, what you buy, the land content, and how you finance.

Most importantly - leverage. Residential real estate represents security or collateral for loans. Most banks will lend up to 90% of the property's value. Leverage means gearing your investment so that the proportion of capital you invest is low in relation to what you borrow.

Wealth Building

Residential property is one of the most affordable and sound investments available to you. In choosing a property that will give you capital growth you need to consider carefully where you will buy, the sort of property, and the method you will use to utilise your cash resources most efficiently. Just one property won't make you wealthy, but you can easily build a portfolio of several properties over a few years.

The method or structure you use is made up of a number of elements:

- land and buildings
- loans and equity
- tax and benefits
- rental income and outlays
- time.

The mix of these elements is vital if you are to get the best returns in the shortest possible time.

The land is your vehicle for achieving capital growth, and the building on the land enables you to generate an income. You need to select the right property in the right location. How you finance your property becomes fuel for your investment.

If you optimise the rental income and maximise the available tax benefits you can offset your outlays - the interest on the loan, maintenance, rates, and more. If you cover your costs correctly you have nothing to lose and a lot to gain.

Over time, the value of the property increases but, since your debt remains the same, your equity (the value of your asset minus the debt) also increases. Once you have a 10 to 20% increase in value you can use the extra equity to purchase a second property. Once you have a few properties you may choose to sell one to minimise the loan on your portfolio. If you have deposited only 10% of the property's value and the property grows by 10% in one year you have made a 100% return on your investment. With good cash flow management (rental income + tax benefits - outlays) you can start with as little as \$25,000 in cash or equity.

In a nutshell: Buy property that will return capital growth, optimise your income, maximise your tax benefits, manage your time, and think big! Why not aim high? Have a portfolio of 10 quality properties to hold, and a bucket of 10 that you trade?

Choosing the right land

Remember - land appreciates, while buildings depreciate in value. Land is in limited supply and the demand for it grows while the population increases. Land value increases in value by twice as much as the value of the building on it. However, there is little point in buying land unless you can generate an income (rental property) to service any debt. To achieve significant capital growth you need to have at least 30% land content. Units with little or no land content are generally not good investments.

The best performing residential properties are in areas with high population growth and good opportunities for employment where housing is still relatively affordable. A good example is Western Sydney.

Although it seems like a good idea at the time, buying an investment property just because it is close to where you live is not a smart idea. If your potential property is within 45 minutes drive of a capital city you may be on to a good thing.

Rental income

The number of renters is increasing as the Australian population ages and property prices rise above what most younger people can afford.

The best part about gearing and leveraging an investment is that you can begin with little capital. Residential property has the potential to generate rental income so that you can offset your cash outlays.

The market for rental income is generally made up of people on lower incomes. It is important to buy a property that can be rented out at an affordable percentage of the average income. As a rule, anything over 30% of the average income is too high. You do not have to charge the highest rent, but you can ensure that your investment property remains attractive and affordable and maintains constant rental. Consider setting your desired rental a little below the going rate, but don't forget to keep in line with inflation. This will generally attract good, loyal tenants and gives you discretion when choosing the best people to occupy your property. Good tenants will not mind being asked about their past history.

For most people, it is important that where they rent is safe, close to shops and public transport, near schools, and is in proximity to employment and recreational facilities. When choosing a property, make sure that most of these needs are met.

Make sure that the rental vacancy factor in the area you want to buy in is not over 3 or 4%. You can find this out by asking a few of the local agents.

Don't forget to cover your losses. You can insure yourself against damage to the building by fire and damage as well as loss of income in the event of the tenant defaulting on rent.

Landlord protection insurance is a must. It is also a good idea to keep aside a small contingency fund.

Managing your investment property can seem like hard work, but if you are willing to pay a good agent, they will take care of advertising, selection of tenants, maintenance and so on.

Tax Breaks

Gearing is borrowing money for the purposes of investment. Negative gearing is the tax benefit that accrues when the income from an investment fails to cover the outlays on that investment. For example, an investment property is negatively geared if the interest on the loan and other items exceed the income from rental. The difference between your outlays and your income is tax deductible. It can be offset against your salary and other income to reduce your taxable income.

You can claim deductions such as interest on the loan, insurance premiums, fees, rates, upkeep, and other expenses.

If you have ever claimed depreciation on an investment or assets you will know that it can be significant. The biggest item you can claim for in the case of property investment is the building. Depreciation on newer buildings (built after the late nineteen-eighties) can bring significant benefits and you can also write off the fittings over the first five years. Other perks available to you include being able to pay up to 10% of the total rental income to someone else as a fee for managing the books of your rental property. You can also travel to inspect the property twice a year and claim a night's accommodation.

Negatively geared rental property is one of the most tax efficient vehicles you can choose. Depending on your portfolio, it also makes sense to hold some positively geared or "cash cow" properties as well. These will generally have lower growth but generate a higher yield.

Finance

You must make a basic assessment of the value of a property in order to make sure you are paying a fair price.

One way of doing this is to divide the value of your investment in to the land value component and the replacement cost of the building.

Ask the real estate agent what the land component is and try to get a forecast of future development and projected land values.

The replacement cost can be calculated by multiplying the total size of the house by the building rate per square metre (usually about \$850 per square metre.)

The value used by your lender should be the same as the purchase price or greater. If the bank's valuation is much lower than the purchase price (by 5% or more) the bank may lower the security value of the property. Consider taking out a separate loan with a different bank that has your home loan to avoid this.

Make sure that any valuers you use yourself are acceptable to your bank. Valuer's calculations are not an exact science so do your homework and compare the valuation of the home you are using as security to recent local sales.

In choosing who you are going to use to provide your loan remember that you need to make sure the bank knows that your intentions are to build an investment portfolio. Ensure that the bank will lend up to 90% of the valuation price - some banks don't lend this much.

Banks will also want to make sure that your ability to maintain repayment on the loan is not greater than a percentage of your gross income, so make sure that at least 80% of the projected rental income from the investment property is included in your income.

Don't forget to check for any hidden fees, administration charges or penalties for paying the loan out early. Make sure the bank is comfortable with revising the valuation on the property every twelve months and that they are prepared to disclose their appraisal of the security value of the property (to be compared with the purchase price.)

Don't be afraid to negotiate the best interest rate and shop around. The smaller banks will often have the best deals. A finance broker may be able to do the shopping around for you and often has the negotiating power you need.

Finance options include zero-cost financing (using the equity in an existing home as collateral instead of having to pay a cash deposit.)

Interest only loans are good for attracting maximum tax deductions.

Don't be afraid to lock in the best rate you can find for as long as you can.

The best deal

There will always be upturn and downturn cycles, just as there are in foreign exchange and the share market. Affordability is the key. As long as the mortgage repayment is not above 35% percent of the average wage then the investment is reasonably affordable. The lower end of the market is less prone to the boom and bust cycle and therefore often the safest investment. Most people can afford a property of around \$250,000, but after this level it becomes affordable to only around 5% of the market.

The longer term view

The key is to buy, keep buying, and to hold on to the property if you can. If you can establish the discipline and commitment to acquire several properties over a few years you will reap the benefits. With average property growth, you will have opportunities to use your increased equity to build on your portfolio.

Keep in mind that the times to keep out of the market are when the market is out of step with the average income and beyond the affordability level. Try not to buy when everyone else is buying, and buy when everyone else is selling! Hold on to your property if you possibly can.

Take one step at a time, manage your resources and have faith that there are always options available to you.

For More Information

I've experienced the benefits of property growth, but I know it can be a daunting task to enter in to your first investment. If you have any questions there is a wealth of information in the 21st Century Home Study package. There are many different strategies that you can use depending on your goals and current financial position.

Contact details are on our websites:

<http://www.learntobewealthynow.com/>

<http://www.crystalclearconsulting.com.au/>

Recommended Reading and Sources:

Seven Steps to Wealth by John L. Fitzgerald

21st Century Home Study