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A nuts and bolts
guide to switching loans

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HIGH GROWTH**
areas per state

**YOUR ULTIMATE
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Over 4,000 suburbs listed!

your investment

property

May 2008

\$9.95 (GST inc.)

47 scorching suburbs to invest in

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Increase your
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(even if you don't have
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Why negative
gearing sucks

How to profit from the
ripple effect phenomenon



How does
leveraging
work in
practice?



NEW TAX SAVINGS: USING SUPER
TO BUY REAL ESTATE

Property vs shares: and the winner is...



While shares are often considered a cheaper way to invest, *Chris Gray* argues that properties could make you more money in the long run

The recent dramatic news about falling stocks and margin calls have created panic in the investor market. The last few years have seen a downturn in the property market in many Australian cities. All of this might have you wondering whether to invest in shares or property.

Many people say a major reason why shares are attractive is because they're a liquid asset, while property isn't liquid at all. But is that really the case? There are a number of other myths about 'property versus shares' that people believe. But when you look at both forms of investing over the long term, a clearer picture forms. I have personally found that if you have a sound property investment strategy and understand the numbers, property can bring you most of the benefits that shares bring – and more.

Performance: Shares vs property

Pro-share sites like the Australian Securities Exchange (ASX) quote their commissioned reports show that gross returns over 10 years were as follows:

10yrs to 2000
 Shares: 13.5%
 Residential property: 9.3%
 10yrs to 2004
 Shares: 11.7%
 Residential property: 11.6%

Statistics can easily be manipulated and massaged to show whatever you want (I used to be an accountant), and so normally I wouldn't take the results from a pro-share company. However, if we gave them the benefit of the doubt and assume that the figures aren't weighted in favour of shares, then you would normally conclude that shares have a better return. But is that always the case? Just as with shares, gross returns depends on the type of properties you choose.

Leveraging shares vs property

When investing in property, shares, artworks, or anything at all, it's important to look at the bigger picture and find out how to make these investments work for you. In property, leverage is the key for me. Well-purchased investment properties often double every seven to 10 years, which

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is equal to 10% a year (confirmed in the ASX figures).

I find that most banks are happy to lend up to 80% of the extra equity on a property (or even 90–100% on your first few properties). So if you have \$100,000 to invest, then you can roughly buy a \$500,000 property. High-income earners can buy a \$1m property with a deposit like this. These are likely to grow by \$50,000 and \$100,000 a year respectively. However, the rent won't quite cover the mortgage, so after other expenses, depreciation and tax back it will probably cost you \$10,000–15,000 in cashflow. That gives you a net result of about \$35,000–40,000.

Shares, on the other hand, aren't so easy to leverage. For one, it's usually only blue chip stocks that can be leveraged to higher levels, because banks prefer to lend against strong stocks. This limits your choice straight away. If you do have blue-chip stocks, you can often only borrow against 50% of their value. If you borrow more, you may be subject to a margin call – and if you don't have the cash to hand you'll be a forced seller, which is never good.

In shares, a \$100,000 investment will normally buy \$200,000 worth of shares if you leveraged at 50%. So what do \$200,000 in shares need to rise by to equal the \$35,000–40,000 you can make in property? About 17.5 to 20%! This means the share market really needs to rise by almost twice the rate of the property market just based on the ability to leverage safely – and even then there's still a chance of a margin call.

Liquidity

Many share investors and financial planners suggest that property isn't a liquid asset, and that's a major reason for avoiding it as a major investment beyond your main residence. But is this really the case?

In my experience, property can be cash-flowed. If you have \$100,000 and want to purchase a \$500,000 property, the bank will often lend you the balance of 80% (or \$400,000). Say the property then grows to be worth \$600,000. You could do either one of two things: sell it, or refinance.

If you sell the property, you then realise a profit of \$100,000, with the view to buy another property for, say, \$600,000 again. However, there are selling costs of \$10,000 and buying costs (stamp duty and legals) of \$30,000. So with your original \$100,000 plus the \$100,000 profit, you have \$200,000; less selling and buying costs, leaving you with \$160,000 in cash for re-investment.

In buying the subsequent \$600,000 property, the bank would lend you \$480,000 at 80% LVR, so you'd have to provide \$120,000 deposit, leaving you with \$40,000 spare.

Or you could refinance rather than sell. Since your property is now worth \$600,000, the bank will lend you \$480,000 (or 80% LVR). You already owe \$400,000 from the original mortgage, so the bank will then give you a new facility of \$80,000 (which is 80% of the \$100,000 increase in your property's value).

In both examples, you end up with a \$600,000 property and a \$480,000

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Sale	\$600,000
Less mortgage	- \$400,000
Equity	\$200,000
Less costs	- \$40,000
Funds available	\$160,000

mortgage. If you sell the property, you end with cash of \$40,000 after a one- to two-month sales campaign. Not very liquid! However, refinancing can happen within a few weeks, and gives you \$80,000 in cash. Very liquid!

To ensure that my property portfolio remains very liquid, I revalue my properties every year to ensure I always have a spare buffer zone of cash I can withdraw whenever I want. It's as simple as pulling the cash from the ATM or making an internet transfer – that's seems pretty liquid to me.

Knowledge

A good advantage of shares over property is that you don't need large chunks of money to enter the market – just a few hundred dollars will get you started. But what do you invest in?

While the share market does tend to rise in the long term, there are certainly a number of shares that do actually become worthless – that is, the businesses go bust. If you're to achieve the market average, you either need plenty of knowledge or enough money to buy a very large diversified portfolio.

With residential property, however, it's a lot simpler. We all live in one, so most of us understand property. If you stick to a few simple rules of thumb, the chances are you can get the market average return. Following are four general rules to follow:

1. Buy in high-demand areas that are close to people's work, leisure and transport routes
2. Buy properties that are affordable to rent by the majority of the

population. That is, buy median-valued properties

3. Choose properties that are attractive to tenants – those that are clean, light and well maintained

4. Get an independent valuation so you ensure you never go over the initial purchase price

You don't need to be a genius to invest in residential property. If you buy well and can hold onto it for the long term, you'll almost definitely make money. However, if you want to make a fortune, you just need to develop your strategy, know your numbers, be comfortable with debt and keep buying better.

Taxes

When you make a profit in shares, you often get paid in dividends. These get taxed at the normal income tax rate. If you decide to sell your shares to buy something else, you'll also be required to pay capital gains tax. Both of these taxes gives you, the investor, less cash to re-invest.

But the beauty of property investments is that they normally produce a negative income and a positive capital gain. This means you get a tax rebate for your cashflow losses and depreciation, which reduces that loss. And the real wealth from property, the capital gain, only gets taxed when you sell. But if you refinance, you get 80% of the cash to reinvest – without having to pay tax until later. And if you never sell, you never pay the tax.

In my example under liquidity, the truth is, rather than shares requiring a 20% return to equal property, they really they need a 30–40% return, as often tax will have to be paid on the shares' profits.

Conclusion

While I'm an expert in residential property, I don't profess to have the same knowledge of shares. But the

above insights reveal my personal reasoning behind building and holding the majority of my current wealth in property. I gather that the majority of entries in the BRW Rich List tend to do the same!

Saying that, I do believe in the benefits of diversification and, as shares and property markets cycle at different times, it's wise to have a balance of both.

The 'shares versus property' debate will never be won. If you enjoy trading shares, reading up about them and making judgments, you'll probably end up making more money trading shares than investing in property. And if you love property as an investment, as I do, then I believe your destiny is to make money through property.

Whatever you decide to do, do *something* and always consult a professional advisor before making a financial decision. ■



Chris Gray is the Property expert on Channel 9's MyHome TV, CEO and founder of Empire, a property investment consultancy, and author of *Go For Your Life: How to turn your weekdays into weekends through property investing*. He builds property portfolios for property investors – finding, negotiating and renovating properties on their behalf. For more information and for chapters 1-3 of his book for free, go to www.goforyourlife.com.au