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HOW TO STRUCTURE YOUR PROPERTY PORTFOLIO

What property types, when and where

According to ATO data, over 27% of property investors own more than one investment property which equates to over 470,000 property investors. The vast majority of established dentists own more than one investment property. The interesting (or perhaps disappointing) thing is that the vast majority of dentists hold all their investment properties within close distance of each other. There are many reasons for this, with 'comfort' probably being at the top of the list.

An experienced property investor friend of mine (who owns quite a number of properties in Melbourne) said to me "I'd like to own a property in Sydney but I don't know the area well enough. I like to invest in Melbourne because I know the good and bad areas." That's an interesting comment because share market investors don't take the same approach. Have you heard a share market investor suggesting they only buy stocks in companies that have a head office in their domicile State? Maybe property investors are too hands-on for their own good.

Throughout this article, I will try to demonstrate that astute property portfolio construction can make a material impact on your overall wealth. That is, you can significantly increase your chances of achieving financial freedom if you develop a deliberate and well thought-out investment property strategy, even if it means stepping out of your comfort zone.

The two most common mistakes made by property investors include not getting advice in regards to which property to buy and not planning out their portfolio.

THE VARIABLES

One of the good things about investing in property is that there are arguably fewer variables to consider than in the share market. However, it is absolutely critical to get them right. They include:

- **Location –** different locations will perform differently from an investment perspective. This performance might vary over the long and short-term. For example, South Yarra in Melbourne and Bondi in Sydney might both be blue-chip suburbs and have very similar expected long-term returns (in terms of capital growth and rental income). However, over the short-term, i.e., year to year the returns might be very different.
- **Property type –** there are many options: house, apartment, high-rise, low-rise, units, attached, semi-attached, detached, single-fronted, double-fronted, dual-occupancy and the list goes on. Probably the major impact of these options is the actual or attributable land value component the property has. A house sits on its own land and the 'land value' portion is more easily identified. A high-rise apartment also has an 'attributable' land value. However, given the number of individual apartments that sit on the block of land, the land value component is much smaller and is 'indirect'. The proportion of land value will often drive capital growth and the amount and quality of accommodation will drive income – renters will pay for accommodation and owners/investors will pay for land.
- **Bedrooms –** the number of bedrooms will appeal to different types of renters. A three bedroom home will appeal to a family. A one bedroom apartment will most likely appeal to an older (established) person rather than someone who has just moved out of home (due to earning capacity). Different tenant types will have different levels of risk and longevity.
- **Tenant –** the age, occupation, earning capacity, marital status and renting history will all impact on a tenant's risk profile. Some types of tenants are better in some locations. For example, a one bedroom apartment in a trendy area will most likely attract a high income earning professional. Whilst most professionals will pay rent on time and take good care of the property, they tend to be a little more transient and possibly less likely to occupy the property for many years.
- **Architectural style –** different architectural styles will enjoy different levels of demand from various renters and potential purchasers, and these 'trends' can change over time.
- **Investment return characteristics –** different properties will have different rental yields and different capital growth prospects. For example, a high land value house might have a rental yield of 2% whereas a brand new apartment might yield more than 5%.

TAXING CONSIDERATIONS

There are two State-based taxes property investors need to be aware of – stamp duty and land tax.

Whilst stamp duty isn't a reoccurring tax, i.e., only payable once it can still make a difference. The higher the stamp duty cost, the less residual money you have to use as a deposit thereby reducing your purchasing power. Transfer stamp duty, i.e., what you pay when you buy it on a $350,000 investment property can range from $11,075 to $17,177 depending on the State the property is located in – a massive difference of 55%. If an investor had a $50,000 deposit, they would be able to afford to spend up to $380,000 in one State versus only $335,000 in another – due to the higher stamp duty. If both these properties increase in value at 8% per annum, the difference in value in 15 years will be $140,000. As you can see, the repercussions from higher stamp duty extend beyond the initial cost. This might be important to be aware of when developing an investment property portfolio strategy – particularly for younger dentists with limited equity/deposit. Maybe these investors would be better off investing in a

State with lower stamp duty first, and then investing beyond that State when they have accumulated some equity.

Land tax is particularly insidious because investors only feel the consequences of land tax after they have held the investments for a few years. Land tax is often most costly in retirement – a time when you need to be paying less tax, not more. Therefore, when developing your portfolio strategy, you must consider how your property is owned and where it is located as this will affect your potential land tax liability in the future – particularly in retirement. Many investors own all their property in one State and one ownership structure, e.g., all in the dentist's name. This often means they'll pay quite high land tax. I compared an example of an investor owning five investment properties in NSW with a land value of $2 million ($400k each) versus an investor that owns one property in each of VIC, NSW, QLD, WA and SA (against $400k each). The land tax expense based on current rates would be $26,084 under the first scenario versus $1,789 when investments are spread across various States. That is a massive annual difference and might mean the difference between being able to retire or not. When we produce financial strategies for our clients, we identify that land tax can often eat up 30% or more of an investors net rental income if left unchecked. That is a large proportion of passive income to give away in retirement. Investors can minimize land tax by spreading investments across a number of States and using different ownership structures in different States. However, one caution in regards to structuring is to be mindful that laws can, and probably will, change. Therefore, structuring your portfolio solely on the basis of land tax is a flawed approach. Land tax is one of many considerations.

PORTFOLIO STRATEGY AIMS

The overriding aim of portfolio construction is to maximize wealth and minimize investment risk.

Diversification involves reducing risk by investing in different types of properties in different locations. If each property's value and income do not move up and down in perfect synchrony, a diversified portfolio will have less risk as it smooth out unsystematic risk, i.e., risk that's inherent to each property or location so that the positive performance of some investments will neutralise the negative performance of others. A smooth investment return is important for investors that use leverage (borrowings) to build wealth. The reason for this is that most investors use equity in investment properties to acquire further assets. If all your property values are stagnant for an extended period of time (maybe because they are similar property types in the same location) then the investor's capacity to acquire further investment will be hampered. However, if you own three investment properties in different locations and two increase in value while one remains stagnant, you can revalue only the two that increased and continue to invest. Holding all your properties in one location can delay further investment. This can be very costly in the long-term and may prevent you from meeting your financial goals.

A perfect property portfolio should diversify location, property types and tenant types. In terms of locations, we tend to stick to proven and established suburbs in major capital cities. Generally, we like to see a client hold their investments across two to three States. When it comes to property types, we like to see clients hold a diversified portfolio of houses and apartments ranging from one to three bedrooms. This will also appeal to different types of tenants. Considered property portfolio construction can and should be tailored to an individual investor's requirements and goals for example, planning around an existing asset, preparing for retirement, or just a strong bias for investing in the client's domicile State (initially).

As well as constructing a portfolio to minimize risk and maximize investment returns, we need to consider tax. Not only do we need to consider stamp duty and land tax as discussed above, but also income and capital gains tax. Certain properties with certain income and capital return characteristics will be more suited to certain ownership structures. For example, assuming we have identified that a client should own at least one property in a discretionary trust and at least one (two bedroom) apartment, we may be inclined to allocate this investment to Queensland because it has one of the highest land tax thresholds for properties held in a trust. This is because an apartment is likely to have a lower assessed land value compared to a house and therefore is more likely to remain under the land tax-free threshold. Similarly, we might plan to put an investment property (a house this time) in a Self Managed Super Fund knowing that the client will probably need to sell one property soon after retirement to eliminate debt, potentially taking advantage of CGT concessions inside super.

Property types, locations, ownership structures and tax are all major variables that need to be carefully considered when structuring a property portfolio. One is rarely more important than the other – they all need to be balanced out.

WHO CAN HELP?

Who can provide this advice? Some buyer's agents (or investment property advisors) can assist with certain aspects of structuring a property portfolio. However, be aware they are property professionals and not financial advisors. Therefore, their advice will be limited to property. They will not necessarily be able to comment on other issues such as taxation, estate and retirement planning and so on. Your accountant might be able to help with structuring an ownership and tax strategy, but might not know enough about property investing or other non-tax related issue (such as estate planning and retirement strategies). A financial planner will be able to develop a financial and retirement strategy (as well as other things such as risk management, estate planning, asset protection, etc.,) but won't necessarily have much knowledge and experience with property. Assuming you can't find one professional to cover off all these issues (there aren't many of us around), you really need to assemble a team and have all these advisors provide input into your strategy.

Once you have an astute strategy, an absolutely critical element in executing it is selecting the right properties to invest in. You must seek advice on this aspect – particularly if you are investing outside your domicile State (as you might not be as familiar with the local market or markets). Make sure you locate a reputable investment property advisor (buyer's agent) that you are comfortable with. Whilst there's a cost associated with appointing an investment property advisor, the long-term benefits of achieving diversification should more than offset this additional cost.

Most property investors tend to 'accumulate' a property portfolio on an ad hoc basis without any predetermined strategy. This can result in tremendous inefficiencies and financial 'waste' many years down the track (when it's too costly to correct a broken structure). Therefore, it makes good sense to invest time proactively structuring your property portfolio in advance. Good luck (although this shouldn't really come into it if you have done all the 'right things').

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