BUSINESS *Perspectives*

Compiled by Stuart Wemyss

Makings of a successful investor

In my line of work, I come across many successful property investors that have built a significant amount of wealth. I 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 (or wealth generally). 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 five 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.

The biggest thing that puts people off is that investment properties generally cost money to hold. 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. In addition, the cash flow deficit reduces every year. Therefore, with every investment you must assess its viability over the investment term. That way, you can fully appreciate the pros 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 most important characteristic of successful investors is that they take action - they don't procrastinate. You will always be able to think about reasons why you should not invest in property (or another asset). Most property experts predict that the market will be flat over the next few years. However, most successful investors view this potentially negative issue as a positive one. 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 were property sells for 30 per cent above reserve). They see higher interest rate resulting in 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. 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 probably never invest in property (or anything). What they should be focusing on is taking a longer term view and putting their plans into action.

But where's the true 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 per cent 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 is a property's capital growth is 10 per cent and rental yield is 3.5 per cent. The second scenario is the reverse – capital growth of 3.5 per cent and rental yield of 10 per cent. 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 1 produces more rental income in dollar terms compared to Scenario 2. On the face of it, it looks like Scenario 2 is better.

TABLE 1.

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

However, 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 (Table 2).

TABLE 2.

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

As you can see, after 20 years Scenario 1 has created more than $1.6 million of equity compared to Scenario 2. The total difference in income and capital growth between Scenario 1 and 2 is over $1.4million! That equates to just under $800,000 in today's dollars, i.e., allowing for inflation at 3 per cent per annum over 20 years. This shows that capital growth is the key and true benefit of property investing.

If you own a number of properties that have enjoyed good capital growth then you have the opportunity to be able to sell one of your properties and repay all outstanding debt. You can then live off the rental income.

10 PER CENT 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 cent 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 per cent is certainly not out of the realms of possibility. In fact, it is generally the benchmark for quality investment properties.

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

THE ONGOING COST

Most properties produce a negative cash flow in the first few years. It's important that you are comfortable that you can afford to finance the property costs before 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 above, i.e., growth rate of 10 per cent and rental yield of 3.5 per cent, I have projected the property cost (rent less expenses) 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 six years (let's not forget that the property is projected to increase in value by approximately $270,000 over the same period of time.

The point of this analysis is to demonstrate that funding the property's ongoing costs is not that significant relative to the capital growth you can generate. In addition, the cost reduces over time.

IN SUMMARY

Successful investors have a long-term plan. They understand how property (or any other investment) will create wealth. Secondly, they put their plan into action. If they have limited spare time, they outsource the work, e.g., using investment property advisors, etc. They realize that procrastination or delays cost a lot more than professional fees. Beginning your investing today is much better than planning to start tomorrow.

In my next article, in March 2007, I will weigh into the investing in property versus shares debate. I will take a totally different approach and come up with a surprizing conclusion.

Stuart Wemyss is a qualified Chartered Accountant and is a director of mortgage broking firm ProSolution Private Clients which specializes in arranging residential home and investment loans for dentists.