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## Chapter **1**

# Comparing Real Estate to Other Investments

**T**he vast array of choices available to Australians can be both a privilege and a burden. Go to the supermarket in search of something as simple as bread and you'll know exactly what we mean. Choice is even more widespread when it comes to the world of investment. You have thousands of choices among property, managed funds, shares, bonds . . . the list is seemingly endless.

Allow us to help you through a portion of the cluttered world of investment. In this chapter, we start to explain how, why, when and where to invest successfully in real estate. And, even though we're advocates for property investing, we also take you through some issues to weigh up if you're wondering whether you have what it takes to make money and be comfortable investing in real estate. We share our experiences, insights and thoughts on the long-term strategy for building wealth through real estate that, at its core, is a fundamentally simple and low-risk investment strategy that virtually everyone with a long-term time frame and determination can understand and achieve.

# Finding Your Motivation

It's never too early or too late to formulate your own plan into a comprehensive wealth-building strategy. Such a strategy can help with improving your financial future and ensuring a comfortable retirement.

One of the challenges involved with real estate is that it takes some real planning to get started. Without doubt, calling a stockbroker and purchasing a few shares in your favourite company is a lot easier than purchasing your first rental property. But buying good property can be more time-consuming than difficult. You just need a financial and real estate investment plan, a lot of patience, and the willingness to do some research and legwork, and you're on your way to building your own real estate portfolio — and you can even hire an expert team to do the heavy lifting for you.



REMEMBER

The vast majority of people who don't make money in real estate made easily avoidable mistakes, which we help you steer clear of.

In this chapter, we give you some information that can help you decide whether you have what it takes to make money and be comfortable with investing in real estate. Unlike almost any other type of investment, real estate is hands-on. When you own shares in a company, you can't personally dictate how that company operates, or influence how profitable it is. Direct investment in property is the opposite. You're in control. Major decisions are in your hands. You can determine how to lift your income and how to raise your profits (or capital gains or equity). We compare real estate investments with other investments you may be considering. We provide some questions you need to ask yourself before making decisions. And, finally, we offer guidance on how real estate investments can fit into your overall personal financial plans.

Throughout history, some of the wealthiest people — regardless of their industry — have also increased their net worth via property investment in both residential and commercial assets. They have done so because they understand the profit potential of strategic real estate holdings. They invest in property not only for diversification and capital growth reasons, but also to supercharge their income streams.

# Stacking Up Real Estate Against Other Investments

You've surely heard about or even considered many different investments over the years. To help you appreciate and understand the unique attributes of real estate, in the following sections we compare it with other wealth-building investments such as shares and running your own business, using key economic attributes.

## Returns

Clearly, a major reason many people invest in real estate is for the healthy *total returns* (which can include both ongoing income and the capital appreciation of the property). Real estate can generate robust long-term returns because, like shares and small business, it's an ownership investment. By that, we mean that real estate is an asset that has the ability to produce income and capital growth.

Our research and experience suggest that total real estate investment returns are comparable to those from shares (about 7 to 10 per cent annually, measured over decades). And you can earn returns better than 10 per cent per year if you select excellent properties in the best areas and manage them well. That said, investing in real estate is accompanied by the following:

- » **Few knockout wins:** Your returns from real estate probably won't approach the knockout wins that can be achieved by the most accomplished entrepreneurs in the business world or by picking penny-dreadful shares on the stock market and doubling your return in a month, but that is speculation rather than investment strategy. Real estate profits take time — profits are gained through hard work, good judgement, plenty of research, and tapping into expert advice and guidance when needed.
- » **Ups and downs:** You're not going to earn a 7 to 10 per cent return every year. Although you have the potential for significant capital growth, owning real estate isn't like owning a licence to print money. Like stocks and other types of ownership investments, real estate goes through down as well as up periods. Most people who make money investing in real estate do so because they buy and hold property over a number of market cycles.
- » **High transaction costs:** If you buy a property and then want out a year or two later, you may find that, even though the property has appreciated in value, much of your profit has been wiped away by the high transaction costs. Typically, the costs of buying and selling — which include stamp duty, real estate agent commissions, loan fees, property taxes, and other settlement costs — can amount to up to 10 per cent of the purchase (or selling) price of a

property. So, although you may be elated if your property appreciates 10 per cent in value in a short time, you may not be so thrilled to realise that most of the capital growth disappears in selling costs.

» **Tax implications:** Last, but not least, when you make a profit on your real estate investment, the Australian Taxation Office (ATO) is waiting with open hands for their share. So, throughout this book, we highlight ways to improve your after-tax returns. As we stress more than once, the profit you have left after the ATO takes its bite is all that really matters.

## HOW LEVERAGE AFFECTS YOUR REAL ESTATE RETURNS

Real estate is different from most other investments in that you can borrow (finance) a large percentage of the cost of the asset. The loan can often amount to as much as 80 or 90 per cent of the actual purchase cost of the house, depending on your other assets and what your bank will agree to. Thus, you can use a relatively small deposit to buy, own and control a much larger investment. You can borrow money to invest in shares — although we don't recommend it. If you do borrow to invest in shares, you're unlikely to be able to borrow as high a percentage of the purchase cost and your mortgage rate is likely to be higher. (You're also likely to be subject to *margin calls* if the value of your security drops in relation to the loan amount, meaning you need to reduce your loan amount, contribute additional security or sell part of your investment.)

So, when your real estate increases in value (which is your aim), your returns are leveraged to take into account your total investment (your own deposit, plus the borrowed amount).

Take a look at this simple example. Suppose that you purchase a property for \$600,000 and pay a \$60,000 deposit. Over the next three years, imagine that the property appreciates 20 per cent to \$720,000. Thus, you have a potential profit (on paper) of \$120,000 (\$720,000 minus \$600,000) on an investment of just \$60,000. In other words, you've made a 200 per cent return on your investment. (**Note:** This example ignores cash flow — whether your expenses from the property exceed the rental income that you collect or vice versa and any potential lenders mortgage insurance — and the tax benefits associated with rental real estate.)

But don't forget that leverage magnifies all of your returns and those returns aren't always positive! If your \$600,000 property decreases in value to \$540,000, even though it has only dropped 10 per cent in value, you actually lose (on paper) 100 per cent of your original \$60,000 investment. See the 'Income- and wealth-producing potential' section later in this chapter for a more detailed example of investment property profit and return.

## Risk

Real estate doesn't always rise in value. That said, market values for real estate don't usually suffer from as much volatility as share prices do. You're far less likely to experience roller-coaster ups and downs with real estate market values. The reason is land — even if the building is removed from a piece of land, the land itself generally retains its value. With an apartment block, the value of the land might be as little as 10 per cent of the full purchase price, which is far from ideal for investors. For some houses, the value of the land could be as much as 70 per cent.

Keep in mind, though (especially if you tend to be concerned about shorter term risks), that certain types of real estate in some areas, such as industrial locations, can suffer from price declines. If you make a deposit of, say, 20 per cent and need to sell your property after a 10 to 15 per cent price decline, after you factor in transaction costs, you may find that all (as in 100 per cent) of your invested dollars (deposit) are wiped out.



REMEMBER

You can greatly minimise your risk in property investment through buying and holding property for many years — preferably a decade or two.

## Liquidity

The ease and cost with which you can sell and exact your money out of an investment — known as *liquidity* — is one of directly held real estate's shortcomings. Real estate is relatively illiquid: You can't sell a piece of property with the same speed as you can whip out your ATM card to withdraw money from your bank account or sell some shares via an app. You generally also can't sell part of a house, although you can sell part of a shareholding.

We actually view property's lack of liquidity as a strength, certainly compared with stocks that people often trade in and out of because doing so is so easy and seemingly cheap. As a result, many stock market investors tend to lose sight of the long term and miss out on the bigger gains that accrue to patient buy-and-hold investors. Because you can't easily track the value of investment real estate daily online (although you can find out this information, it's not advisable to track it daily), and because real estate takes considerable time, energy and money to sell, you're far more likely to buy and hold properties for the longer term.

## Income- and wealth-producing potential

Compared with most other investments, real estate can excel at producing income and capital growth for property owners. So, in addition to the longer term

appreciation potential, you can also earn income year in, year out. Real estate can be both a true growth *and* income investment.

The growth in value of your investment properties compounds over years of holding them. The best part about capital growth is that you don't have to pay any tax on it until you sell the property and pay capital gains tax (CGT) — unlike any positive income from the property, on which you generally have to pay tax each year.

If you have property that you rent out, you have money coming in every month in the form of rent. When you own investment real estate, you should also expect to incur costs that include your mortgage repayment, property management agent, land tax (if your portfolio is above certain state-based thresholds), insurances as well as maintenance and repairs. The interaction of the revenues coming in and the expenses going out tells you whether you're positively geared or negatively geared (see Chapter 15 for a full explanation of gearing).

For income tax purposes, you also get to claim an expense that isn't really an out-of-pocket cost — depreciation. Depreciation enables you to reduce your income tax bill and hence increase your cash flow. (We explain this tax advantage and others in the 'Tax advantages' section, later in this chapter, and in further detail in Chapter 15.)



TIP

Unless you have a large deposit, a positively geared property can be difficult to achieve in the early years of ownership — although some investors can achieve this from day one. During soft periods in the local economy, rents may rise more slowly than your expenses (and rents may even fall). That's why you must ensure that you can weather financially tough times. In the worst cases, we've seen rental property owners lose both their investment property and their homes. Please see the section 'Fitting Real Estate into Your Financial Plans', later in this chapter.

Over time, your net rental income, which is subject to ordinary income tax, should rise as you improve the property and increase your rental prices faster than the rate of increase for your property's overall expenses. What follows is a simple example to show why even modest rental increases are magnified into larger positive incomes and healthy returns on investment over time.

Suppose that you're in the market to purchase a family home that you want to rent out and that such properties are selling for about \$800,000 in the area you've deemed to be a good investment. (*Note:* Housing prices vary widely across different areas, but the following example should give you a relative sense of how a rental property's expenses and revenue change over time.) You expect to have a 20 per cent deposit and take out an interest-only mortgage (at an initial rate of 5.5 per cent) for the remainder of the purchase price — \$640,000. Here are the details:

Monthly mortgage payment	\$2,933
Other monthly expenses (maintenance, insurance and so on)	\$700
Monthly rent	\$3,000

In Table 1-1, we show you what happens with your investment over time. We assume that your expenses (except for your mortgage payment, which we assume averages out at your initial rate) increase 4 per cent annually and your rent increases 4 per cent per year. We also assume that your property appreciates at 6 per cent per year. (For simplification purposes, we've ignored depreciation in this example. If we had included the benefit of depreciation, it would further enhance the calculated returns.)

**TABLE 1-1**      **How a Rental Property's Income and Wealth Build over Time**

Year	Monthly Rent	Monthly Expenses	Property Value	Mortgage Balance
0	\$3,000	\$3,633	\$800,000	\$640,000
5	\$3,650	\$3,783	\$1,070,580	\$640,000
10	\$4,400	\$3,968	\$1,432,677	\$640,000
20	\$5,353	\$4,192	\$1,917,245	\$640,000
25	\$6,512	\$4,464	\$2,565,706	\$640,000

Now, notice what happens over time. When you first bought the property, the monthly rent was below the monthly expenses (of \$700 plus \$2,933 mortgage repayments). Keep in mind that only the \$700 monthly expenses are rising by 4 per cent annually.

By about year 6, income equals expenses. By year 10, income now exceeds expenses by around \$432 a month. Consider why this increase in income happens. Your largest monthly expense, the mortgage payment, will rise and fall roughly in line with official interest rates (but for the purposes of this example, we assume that it has averaged the same rate of 5.5 per cent over the period). Rent is likely to stay a relatively stable percentage of the value of the property. So, even though we assume that the increase in expenses is 4 per cent per year, the compounding of rental inflation begins to produce larger and larger positive cash flow to you, the property owner. By around year 6, the asset is paying its own way — that is, it has moved from being negatively geared to being positively geared.

The real story, however, is in the Property Value column of Table 1-1. While the net income from the investment has been growing more modestly, the property has continued to increase in value. At the end of 25 years, the property has appreciated by more than \$1.7 million! Granted, \$1.7 million in 25 years' time is not going to have the same purchasing power as \$1.7 million now but, combined with a positive income from the property, here is an asset that has some real value. (And remember, if you factor in the tax deductions for depreciation, your cash flow and return would be even higher.)

In choosing an interest-only mortgage option, a debt of \$640,000 is still attached to the property, which is the most tax-effective way to hold investment property if you still have other debts that are not tax-deductible (such as a home loan). But your equity in the house could be further improved if you change the loan from interest-only to principal and interest when the net income turns positive.

## **Capital requirements**

Although you can easily get started with traditional investments such as shares and managed funds with a few hundred or thousand dollars, the vast majority of quality direct real estate investments require far greater investments of hundreds of thousands of dollars. (We devote an entire part of this book — Part 2, to be precise — to showing you how to raise capital and secure finance.)

## **Ability to add value**

With shares in a company listed on the stock market, you're usually a small owner of a large company and your ability to make actual improvements to the company or its business is limited. With your own rental property, however, the biggest hurdle to improving your property is your budget and your imagination. You're in control of your property and, therefore, have the opportunity to improve the property to make it more valuable. You can fix up a property or even develop it to allow you to raise the rental income. Perhaps through legwork, persistence and good negotiating skills, you can also purchase a property below its market value, which is why we often say you make money when you buy property.

## **Tax advantages**

Real estate investment offers numerous tax advantages. In this section, we contrast investment property tax issues with those of other investments.

## Deductible expenses

Owning a property has much in common with owning your own small business. Every year, you account for your income and expenses on a tax return. (We cover all the taxing points about investment properties in Chapter 15.) We can't stress too strongly the need to be diligent about your accounting. If you're not prepared to learn how to file properly (or pay an expert to do it for you), property investment may not be for you.

## Depreciation and capital works allowances

Two types of expense that you get to deduct for rental real estate on your tax return don't necessarily actually involve spending or outlaying money. The first is depreciation. This is an allowable tax deduction that's essentially an acceptance that parts of the investment property have a finite life span and will need replacement one day. These depreciable items are largely fixtures and fittings, depending on the legislation at the time. The second deduction is the capital works allowance, often referred to as the building or capital depreciation allowance, which is a special write-off for structural costs. This book uses the more common term of *building depreciation*.



TECHNICAL  
STUFF

Buildings, technically, can last for hundreds of years. However, the ATO allows buildings built after September 1985 to be 'depreciated' (at various rates), allowing investors to claim an annual cost until the building, for taxation purposes, is worth zero (in most cases, that will be 40 years after it was built). The other sort of depreciation is for fixtures, fittings and other items that largely will have to be replaced — for example, every 5, 10 or 15 year, depending on the legislation at the time.

## Negative-gearing losses

Unlike some countries (including the United States), at the time of writing Australian tax law doesn't limit deductions for income losses made on investments being applied to regular income. This is partly why some property investors have earned their reputation for being fans of negative gearing; however, capital growth is what will make you wealthy, rather than the ability to negatively gear for a few years before your property becomes neutral or positive.



REMEMBER

Strategic investment is about purchasing the best property in the best location for the best price. No-one ever got wealthy owning negatively geared properties.

If, according to the accounting treatment of your investment, your property 'lost' \$15,000 for one year, you can write that off against the income you earn from your day job. So, if you earned \$120,000 from your full-time job, but your property was negatively geared to the tune of \$15,000, you have to pay income tax on only \$105,000 (\$120,000 - \$15,000).

Sure, you've lost \$15,000 on your investment but, if your property has increased in value by, say, \$40,000 or more, you're ahead, possibly on several fronts, because of the way properties are taxed differently for income versus capital gains.

## **Halving of capital gains tax**

Capital gains tax (CGT) has been tinkered with many times since it was introduced in the 1980s. Assets owned prior to 19 September 1985 are exempt from CGT. Any investment purchased after that date is a CGT asset, and tax is likely to be required to be paid on profits.

The most significant changes to CGT occurred in 1999. In a nutshell (it's covered in more detail in Chapter 15), any asset that's held for longer than a year qualifies for a 50 per cent reduction in the gain itself, before it's added to other income to be taxed. This reduction is not particular to property investment but, because property is an asset that usually requires a longer holding period, property owners tend to benefit from this change more so than share owners.

# **Determining Whether Investing in Real Estate Is for You**

We believe that most people can succeed at investing in real estate if they're willing to do their homework, which includes selecting top professionals to work with. In the sections that follow, we ask several important questions to help you decide whether you have what it takes to succeed and be happy with real estate investments that involve managing property.

## **Do you have sufficient time?**

Purchasing and owning investment real estate and being a landlord can be time-consuming in the beginning. If you fail to do your homework before purchasing property, you can end up overpaying or buying real estate with a mass of problems. Finding competent real estate professionals takes time. (We guide you through the process in Chapter 4.) Investigating suburbs and zoning also soaks up plenty of hours (information on performing this research is located in Chapter 10), as does calculating market value and understanding contracts (see Chapter 11).

As for managing a property, we recommend engaging a real estate agent to manage the property for you, which includes interviewing tenants, solving problems such as leaking taps and broken appliances, and completing entry and exit

condition reports, to name but a few of the agent's duties. Of course, their fees do cut into your investment income, and this option still requires some of your time (see Chapter 13 for information on property management).

## Can you hire and fire?

Even extensive research of the people you engage to help you with your property investment journey can't create perfect relationships. Sometimes your advisers (such as buyers' agents, solicitors, property managers and accountants) will stuff it up. (By the way, you will, too.) Accepting the occasional problem or two is okay. But if problems persist and those errors continue to cost money, you have to be strong enough to end relationships — it's *your* investment, after all, and *you* are ultimately responsible as the owner of this investment.

## Does real estate interest you?

In our experience, some of the best real estate investors have a curiosity, interest and passion for real estate. If you don't already possess it, such an interest and curiosity can be cultivated — and this book may just do the trick.

On the other hand, some people simply aren't comfortable investing in rental property. For example, if you've had experience and success with stock market investing, you may be uncomfortable venturing into real estate investments. Some people we know are on a mission to start their own business and may prefer to channel their time and money into that outlet.

But, even if you prefer other investments, we hope you consider the diversification value that real estate offers. When the stock market tanks from time to time, investors in real estate are always grateful their holdings are generally appreciating in value and offsetting the fact that their stock market investments have turned sharply south.

# Fitting Real Estate into Your Financial Plans

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For most non-wealthy people, purchasing investment real estate has a major impact on their overall personal financial situation. So, before you go out to buy property, you should thoroughly examine your money life and be sure your fiscal house is in order. The following sections explain how you can do just that.

## Ensure your best personal financial health

If you're trying to improve your physical fitness by exercising, eating junk food and smoking are going to be barriers to your goal. Likewise, investing in real estate or other growth investments, such as stocks, while you're carrying high-cost consumer debt (such as credit cards or car loans) and spending more than you earn impedes your financial goals.



TIP

Before you set out to invest in real estate, you should try to pay off or pay down your non-home-loan consumer debt. Not only will you be financially healthier for doing so, but you'll also enhance your future mortgage applications.

Eliminate wasteful and unnecessary spending (analyse your monthly spending to identify areas for reduction). This exercise enables you to save more and better afford your investments, including real estate. Try to live below your means. As Charles Dickens once said, 'Annual income twenty pounds, annual expenditure nineteen nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.'

## Protect your property and yourself with insurance

Regardless of your real estate investment desires and decisions, only the foolish would enter into a property investment wealth-creation strategy without having comprehensive insurance for themselves and their major assets, including the following (in order of importance):

- » **Home and contents insurance:** You want homeowner's insurance because it not only protects you against the financial cost caused by a fire or other home-damaging catastrophe, but also provides you with liability protection.
- » **Landlord insurance:** This specialist insurance is non-negotiable for investors because it provides additional insurance coverage for tenant-related losses. Things covered include loss of rent due to tenants breaking their lease or being evicted, or damage caused to your contents by tenants, such as drink spills on carpets. This insurance provides additional peace of mind for investors.
- » **Income-protection insurance:** For most working people, their biggest asset is their future income-earning ability. Income-protection insurance replaces a portion of your employment earnings if you're unable to work for an extended period due to an incapacitating illness or injury.

- » **Life insurance:** If loved ones are financially dependent on you, term life insurance, which provides a lump-sum death benefit, can help to replace your employment earnings if you pass away.
- » **Car insurance:** This coverage is similar to homeowner's insurance in that it insures a valuable asset and also provides liability insurance should you be involved in an accident.
- » **Health insurance:** Major medical coverage protects you from financial ruin if you have a big accident or illness that requires significant hospital and other medical care.

None of us enjoys spending our hard-earned money on insurance — insurance is universally known as a 'grudge purchase'. However, having proper protection gives you peace of mind and financial security, so don't put off reviewing and securing needed policies. See Chapter 14 for more detail on the different types of insurance policies that can aid or protect your strategy to create wealth from real estate investment.

## Consider superannuation and property investment

Most working Australians have a superannuation account. And, due to how the money managers who run those super funds invest that money, most Australians have some of their super invested in property. A high percentage of Australians' super invested in managed funds sits in balanced funds (where about 60 per cent is invested in growth assets and 40 per cent in income assets — see the following section). About 5 to 15 per cent of any given super fund is invested in property. Those real estate holdings are generally commercial property — office, industrial and retail buildings.

Self-managed super funds (SMSFs) are also able to own property, but with some restrictions. One favourite way is for a self-managed super fund to hold the commercial property of a related business entity. Consider, for example, a sole trader — we've named him Michael — who owns a business called ABC. Michael also runs his own self-managed super fund, and the super fund owns the premises that ABC operates from. ABC pays the super fund rent.

Super funds can also own residential investment property and, since late 2007, SMSFs can actually borrow to invest in real estate. However, some strong restrictions exist on how the borrowings can be undertaken, and anyone considering a geared property investment inside a SMSF needs to talk with suitably qualified financial advisers, accountants and lawyers. (We cover using an SMSF to invest in property in Chapter 8.)

## Think about asset allocation

With money that you invest for the longer term, you should have an overall game plan in mind. Financial advisers use phrases such as asset allocation or, more simply, diversification. This allocation indicates what portion of your money you have invested in different types of investments, such as shares and real estate (growth assets), or lending vehicles such as bonds, cash or term deposits (income assets).



TIP

Here's one simple way to calculate an asset allocation that takes into account your age (but doesn't take into account your ability to cope with risk): Take your age and subtract it from 100. The resulting number gives a rough indication of what percentage of your assets you should have invested in growth assets (property and shares). For example, a 40 year old would take  $100 - 40 = 60$  per cent in growth investments. If you wish to be more aggressive, you can take your age and subtract it from 110, so that a 40 year old would have 70 per cent in growth investments.



REMEMBER

The preceding calculation provides simple guidelines, not hard and fast rules. If you want to be more aggressive and are comfortable taking on greater risk, you can invest higher portions in growth assets. What the preceding example is trying to show is that younger people should have more of their investments in the higher risk assets of shares and properties, because they have more time on their side to weather the ups and downs of riskier investments.

## Being Mindful of Performance Statistics

Since the beginning of investing, the supporters of property and the supporters of share-based investments have been at war. The 'property versus shares' debate will, no doubt, be one that never ends. Blinkered proponents of either asset class will swear that theirs is the top long-term performer. And they'll have the studies and statistics to prove their argument.

This book doesn't enter that debate. So many different numbers can 'prove' both sides of the argument. Property and shares are both growth assets. They both have long-term total returns that (depending on which study you're looking at or which stage of the cycle you're comparing) are in the range of 8 to 10 per cent. In the case of property, that return is made up of rents and capital growth. With shares, the return is in dividends and capital growth.

We believe in both asset classes and believe that diversification is important for all investment plans. Importantly, we always recommend that you seek expert advice to learn which is the best investment path for you personally.