CHAPTER 3

Why property?

> The best investment on Earth is earth.
> – Louis Glickman

So, once you have made the decision that you are going to take control of your financial future and invest, the next question is – what do you invest in?

There are several different investment vehicles and investment strategies you could use to grow wealth and build a better financial future for yourself and your family. For example, you could consider cash/ savings, shares, superannuation and/or property. All of these investment vehicles have pros and cons, and all of them can help lead you to a better financial future if managed properly. What is important is that you don't procrastinate. Instead, choose a strategy and a vehicle for achieving your financial dreams, get the right advice and support and implement your investment plan as early as possible.

The strategy that I chose to focus on in my wealth creation journey was property investment. The main reason I like property investment as a strategy, and particularly the buy and hold strategy (which I will explain in more detail in Chapter 8), is because it is easy to understand, easy to implement and it is proven and predictable over the long-term.

Being risk averse, I also love the fact that I can mitigate almost all risk associated with my investments. I also prefer to be a lazy investor in the sense that I don't want my investment strategy to consume too much of my time. I wanted an investment strategy that was set-and-forget, that would give me passive income and grow without me needing to work hard for the income or growth.

This is why property investing has worked so well for me and for so many people I know. If you do it properly, property investing can be one of the lowest risk investment vehicles you can use to build wealth over the long-term. And with the right knowledge and strategies, it can produce a predictable outcome over the long-term.

So, let's explore the reasons why you should consider making property investment your chosen wealth generation strategy, too.

Real estate cannot be lost or stolen, nor can it be taken away. Purchased with common sense, and managed with reasonable care, it's the safest investment in the world. – Franklin D. Roosevelt

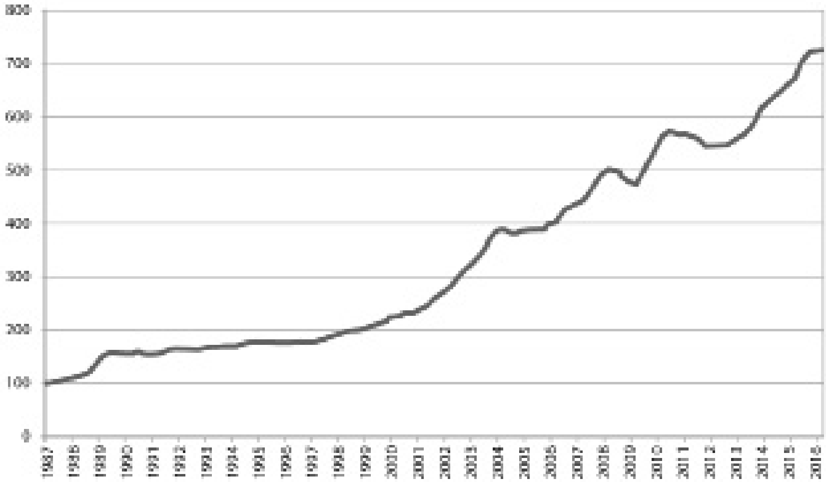
Consistent and predictable growth

Historically, property investment has delivered consistent and compounding growth. Over the long-term, we have seen property values in metropolitan cities in Australia double every 7-10 years on average.

Check out the graph on the next page showing how Australian median house prices have increased over the past 30 years. As you can see, over the past 30 years Australian median property prices have grown by more than seven times.

Whilst no one has a crystal ball, the supply and demand factors that have resulted in the historic growth of our property market still exist in Australia today. As a result, it is fair to assume that the property growth we have enjoyed historically will continue throughout our lifetime and beyond. Let's explore the supply and demand fundamentals in detail.

Figure 3.1: Australian median house price (1987-2016)



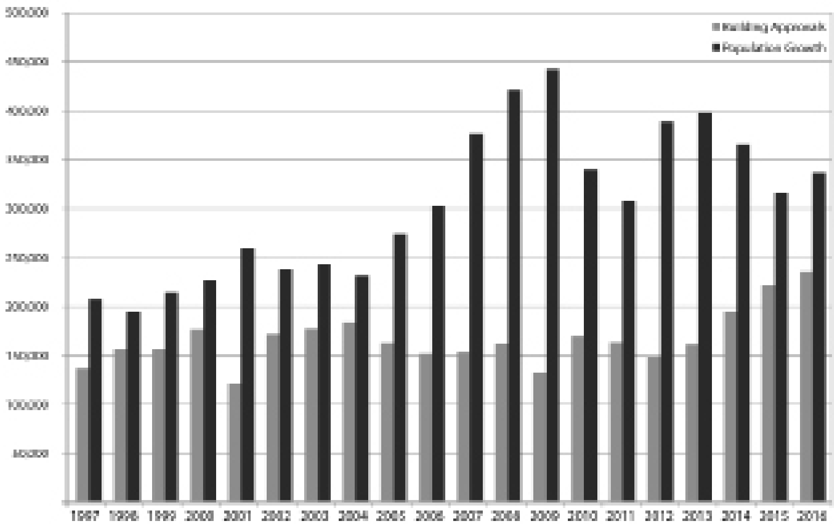
Demand

There are two key drivers for growing demand for Australian property. Firstly, one of the major demand pressures on property comes from our growing population. With one new person every minute and eighteen seconds, our population is expected to double in the next 40 to 50 years, with a prediction that our population will increase to 42 million by 2050. You can keep track of the population growth by referring to the ABS Population Clock available on the ABS website. Secondly, there is another interesting statistic that investors should be aware of that will put even more pressure on demand. That is household formation and the number of new households as Australia's demographics change over time. According to the ABS, the number of people living in the traditional family (i.e. Mum, Dad and kids) is expected to increase by 15%. However, over the same timeframe, single-person households are expected to increase by 24%. With the average number of people in each household reducing over time, this is going to put further pressure on demand for housing. As demand grows, this will continue to put pressure on house prices, suggesting that strong capital growth of Australia's property will continue.

Supply

We have already established that in the future, there will be greater demand for housing due to our growing population and due to a reduction in the number of people per home. But is our supply of property going to keep up with the new demand? The answer is no, and the gap between the supply and demand is one of the reasons property values will continue to grow. The chart below shows the gap between building approvals and population growth. As you can see, this gap has only grown over time, putting even more upward pressure on housing values.

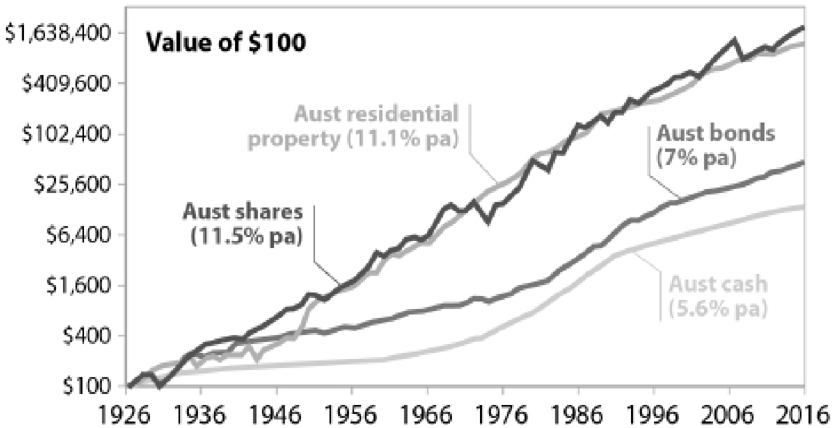
Figure 3.2: Building approvals and population growth (1997-2016)



Property performs well when compared to other investment vehicles

The chart on the next page demonstrates that over the long-term, property has continued to provide strong returns when compared with other investment vehicle options.

Figure 3.3: Long-term average asset class returns (1926-2016)



Less volatile than shares

If you have ever invested in the share market, you will know first-hand that the value of your investment can fluctuate dramatically overnight. Often these fluctuations can stem from emotional reactions of the shareholders based on something in the media and/or unjustified fear that the short-term value of their shares will change.

Whilst the value of shares can change dramatically in an instant, the same is not true for property. There are multiple reasons for this, but one of the main reasons is that about 70% of houses in Australia are owned by owner occupiers rather than investors.

Unlike investors, home owners, who are emotionally attached to their homes, are less concerned about the value of their property and more concerned about having the security and stability that their home brings. I also believe that most property investors take a longer-term view than share market investors. Most property investors understand that property investment is a long-term strategy and so they will not react hastily and irrationally if there is a fear that the property market may soften in the short term. Because of these factors, we don't experience mass exoduses in the Australian property market like you can in the share market. As a result, the property market is less volatile.

Low risk

Of course, where there is reward, there is risk. However, the thing I love about property investing is that, if done properly, property investment can be very low risk because you can easily mitigate almost all risks associated with it (as I explain in detail in Chapter 4).

Easy to manage

We all live busy lives and your wealth generation strategy should complement and enhance your lifestyle, rather than take up all your spare time. What I love about property investment is that you can be a lazy investor and let the property do the work for you. Once you buy the property and find a great property manager, you can sit back, collect the rent and watch your asset grow. Doesn't that sound nice?

You are in control

Another big benefit of property investment is that you are in control. You are not leaving your future in the hands of a superannuation company, with little knowledge of what they are doing with your money. If shares are your strategy, the people that really control your investment are the directors of that company, not you. But if you own a property, you can decide whether you make improvements to it, you can decide what tenants you put in it, you can make the choices about how that property runs and what income you generate from it. Property is a popular vehicle for investment because it is a tangible investment that you can see and touch, and you are in full control of what happens with your asset.

People will always need a roof over their head

Simply put, people always need a roof over their heads. And at the end of the day, investing in property is allowing you to create a home for somebody to live in and rent. There will always be Australians who need to rent affordable homes.

Tax effective

Property is also a tax effective investment strategy and may help you manage your income tax during your working life. This will be explained further in Bonus Chapter 2.

Passive income at retirement

Whilst the tax benefits might be attractive when you are working and paying high levels of tax, the ultimate goal as a property investor should be to have a positively geared portfolio by the time you want to retire. In other words, you should be aiming for your properties to be at a point where the rental income you receive is not only covering all the costs associated with holding the property, but is also providing you with an income to support the lifestyle you want. If you build a positively geared property portfolio (i.e. a property portfolio where the rental income you receive exceeds your expenses), property investment can give you a great reliable and regular income stream in retirement.

Leverage

We have already discussed so many great reasons why property investment is a great investment vehicle to use to grow your wealth, but there is another big advantage that property investment has over all other investment vehicles. Arguably, the number one benefit of property investment is the ability to leverage greater than any other asset class. But, what is leverage and why is it so important?

Leverage is using someone else's money (i.e. the bank's money) to build your personal wealth! In other words, leverage is when you borrow money to buy a property so that only a small percentage of the purchase price comes from your savings, and the majority of the purchase price is funded by the bank.

For example, you could buy an investment property for $300,000 – i.e. you put in $30,000 (plus stamp duty and purchase costs) and the bank puts in the remaining $270,000. The best bit about it is that the growth is not just on the money you put in, but instead the growth is on the full $300,000 value of the property. So, whilst you have only had to contribute $30,000, you are getting a return based on a $300,000 asset. Of course, this debt is not free so there is an interest expense attached to it. But, if you buy the right property and hold it long enough, the rental return plus the capital growth of the property should well and truly outweigh the interest costs over the long-term.

Sounds too good to be true, doesn't it? You may be wondering why the banks would allow you to use so much of their money and so little of your money to build your wealth. Please let me explain.

Banks understand property and understand the growth that property values will have over time and it is for this reason that banks are willing to lend up to 90% (even up to 95% in some cases) of the value of the property to their clients. Banks do this because they believe property is a safe and reliable form of security. This level of leverage is not possible for other investment options such as shares, where you may only be able to borrow up to 60%-70% of the value of the share portfolio and you would be subject to margin calls and would have to reduce your loan amount if the value of your shares drops.

Key Message

This leverage means you can use less of your own money and get a better return on your own money. In other words, your dollar goes further and you build wealth faster.

Check out the table opposite that shows how your investment dollar can go further because of the power of leverage. In this example, the investor has $100,000 of their own cash available to invest. He is considering three different investment options including property, shares and cash.

Figure 3.4: The power of leverage (invest the same $100,000)

PROPERTY		
Invest	$100,000	
Loan-to-value Ratio	90%	
Growth p.a.	7%	
Value (purchase)	$660,000	
Loan	$594,000	
Value in:		*less loan*
10-years	$1,298,000	$704,000
20-years	$2,554,000	$1,960,000

SHARES		
Invest	$100,000	
Loan-to-value Ratio	60%	
Growth p.a.	9%	
Value (purchase)	$250,000	
Loan	$150,000	
Value in:		*less loan*
10-years	$592,000	$442,000
20-years	$1,400,000	$1,250,000

CASH		
Invest	$100,000	
Loan-to-value Ratio	0%	
Growth p.a.	3%	
Value (purchase)	$100,000	
Loan		
Value in:		*less loan*
10-years	$134,000	$134,000
20-years	$181,000	$181,000

This table simply focuses on capital growth expectations and does not even consider the great ongoing rental return or tax benefits the investor would receive annually. Despite this, and the fact that I applied a higher rate of expected return on the shares, this table still clearly demonstrates that this investor would build greater wealth if he puts his $100,000 into property. The reason why his $100,000 can convert into almost $2 million net assets in 20 years is largely due to leverage, allowing him to purchase a more expensive asset.

It is important to note, this example is hypothetical only and has made a number of assumptions based on historical data. If you are considering how to invest your savings, it would be great for you to sit down with an expert and create a similar table based on your circumstances to determine the best investment strategy for you.

Chapter 3 – Exercise 1 – Why property investment?

Download the Why Property Investment Worksheet from the following webpage, **www.risehighinvestor.com.au/bonus/ch3** and highlight your three favourite Property Investment Advantages that give you comfort in choosing property investment as an investment vehicle.