

# Measure your risk

## And consider the consequences, says Margaret Lomas

THROUGH talking to new investors every day, I have come to believe that the biggest concern they have is that, having worked hard to gain equity in their own home, investing further in property can result in the loss of everything they have worked for.

Since we usually do not use any of our own cash when we buy property, worries about interest rates increase the concern.

Understanding your level of risk and ensuring that you do not become over-exposed are crucial factors in your investing strategy.

Consider these two examples (note they do not include selling costs):

### Fiona

Fiona's home is valued at \$250,000 and she owes \$120,000 on it (so she has \$130,000 equity).

Her worry is that, if she invests in another property and the investment does not work for her, she will lose her own home.

She buys an investment property for \$140,000. To acquire it costs her \$146,000, and this money she borrows from a bank.

She now owes a total of \$266,000 and she has total securities of \$390,000. Her equity has fallen to \$124,000 because of those buying costs.

One year after her purchase, she finds that she can no longer afford the \$65 a week the second property is costing her. In addition, she is not getting the rent she thought she would, and the house is vacant often.

Because of the high weekly cost to her, she cannot afford to lower the rent to attract a longer-term tenant because this would then cost her even more. So she is caught.

She decides to sell. Although property values have increased by 5 per cent (thus valuing her investment property at \$147,000, and her home at \$262,500), she wants a quick sale, so she agrees to take \$135,000 for the investment property.

What is her position now?

She has a remaining debt of \$131,000, \$11,000 more than she previously had. She has a home valued at \$262,500, \$12,500 more than when she started.

She has a capital loss of \$5000 to carry forward and write off against future capital gains.

She has also lost \$3380, which represents the input to her investment property for 52 weeks at \$65 a week. Her net loss then is \$1880 (the gain on her home less the loss on the investment less her holding costs).

Fiona has suffered a loss but it is not nearly as drastic as would be the total loss of her home. She is in a position where she is only slightly behind where she was, and she has a chance of recovering her original position through the value of her remaining property growing, or by trying another investment.

### Henry

Henry owns an apartment valued at \$230,000. When he bought it, he borrowed 95 per cent of the purchase price (\$218,500), and funded the difference, plus costs of \$22,000, from his savings. He owns \$11,500 of this property, and so starts already \$8500 behind.

Henry has a further \$20,000 saved. He buys another apartment valued at \$160,000. He borrows \$152,000, and uses his cash

to fund the difference plus costs of \$20,000 (he has a high lender's mortgage insurance premium for borrowing more than 80 per cent of the value of the property). His position is that he owns \$19,500 of the two properties, despite having used \$42,000 of his own money to buy them.

After one year, when the properties have increased in value by 5 per cent, to a total of \$409,500, he experiences the same problems as Fiona, and is forced to sell. He takes \$5000 less than valuation for a quick sale on the investment property.

The result is, he gets only \$3000 more for the property than he paid. He pays this amount into his personal mortgage, reducing it to \$215,500. He has a home valued at \$241,500. He owns \$26,000 of this property. He has lost \$16,000 of his cash and can only write off \$5000 as a capital loss against future capital gains. He has also paid \$2860 to have the investment (\$55 a week for 12 months).

The difference between the two is that Henry, despite his enthusiasm, was not ready to buy. His risk was far greater than Fiona's, and his costs to buy were greater due to his need for mortgage insurance. Note, however, that neither Fiona nor Henry lost their homes, despite their investments performing poorly.

Be sure that you are aware of your risk profile, and invest accordingly. Assess the worst scenario. And then consider if that is an event you can manage. And don't forget the research necessary to help you mitigate risk and maximise success.

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