

# Balancing risks and rewards

**Some experts are saying that investing in property now is less risky than during the boom. Is this right? If so, why? What are the risks investors face and how could they get around them? Margaret Lomas, founder of Destiny Financial Solutions, explains**



**T**he world is in economic meltdown and Australian analysts are divided. Half of them are saying that property is about to face its biggest challenge in 50 years, with predicted losses of around 40%. The other half are claiming that our housing shortage and prudent lending practices will protect us from a US-style property crash and that we have already hit the bottom of the market. Well, 50% of them will be right, but on which side?

It has been claimed that a country's economy will grow comfortably when household debt levels are 2.8 times the median household income. That means that when median household income is, say, \$50,000, debt levels should sit at around \$140,000 per household.

In the US, debt levels are around 3.6 times the median household income, which seems to account for their present slide into recession. In Australia, our debt levels are over seven times the median household income. This is causing analysts to grab their calculators and attempt to predict just how quickly we will fall into the second Great Depression – and how hard.

There is no doubt that we are yet to see the true fallout of the unique

economic circumstances in which we find ourselves, and I challenge any analyst to be able to use historical data to predict the next phase. There are simply no numbers that can possibly forecast the future for us, because our present reality is different from anything we've ever seen – this particular set of circumstances has never existed before.

There's always been, and still is, a risk associated with investing in property. All investing carries risk and property is no different. There's the market risk, that the sector will not do as well as other investment sectors; the specific risk, that the property chosen will not do as well as other properties; and, of course, the pure risk, that investing anywhere is not as good as keeping your money in a jar in the kitchen!

Is now a less risky time than any other? I personally don't think so. However, I also think that now is a great time to buy property for anyone who is prepared to understand the risks and learn how to manage them well.

## **Risk #1: Will property fall in value?**

If we considered the property market in Australia as a single market, I would have to answer that question with a yes.

If we combined the value of all property in Australia today, the sum total would be lower than a year ago, and it's likely to be lower again in another 12 months.

This is because we have come through a 10-year period of wage increases, enthusiastic spending and low inflation. People have had access to money and have enjoyed spending it. This enthusiasm spread to property, when people who found themselves more financially stable than ever before bought real estate in areas they were previously unable to afford. The result was pressure on prices everywhere, with the greatest increases occurring at the top end of the market.

Just as the highest rung is the greatest height from which to fall off a ladder, so it goes that properties at the higher end of the market drop the most in value. Those who purchased these properties are the ones hardest hit by the downturn, probably because they overcommitted when they did so.

The rapid fall in premium property prices has had a significant impact on overall 'average' statistics. These properties, in fact, skew the results.

Since we have a severe undersupply of housing, and more people pouring

into the rental markets than we have had for many years, property in the lower price ranges, which attracts the greatest number of tenants, is at far less risk of losing value. If it does, the impact will be minor. While I expect very small upward movements, if any, properties in the lower price ranges are much more likely to remain stable throughout this current crisis.

The important task for investors is to be sure they can afford a small shortfall between income and expenses, not to gear too highly (capping at 80% to provide a margin) and not to overcommit themselves. In addition, investing for growth needs to be put aside temporarily in favour of finding those properties most likely to attract the best yields.

### **Risk #2: Will property perform less well than other assets?**

The debate has long raged about which has the better long-term outcome – shares or property. At the risk of being bombarded with e-mail, I would respectfully like to suggest that the recent stockmarket turmoil will severely affect the long-term growth reading of shares for many, many years to come.

I don't know which one is going to perform better over the long term but I do know that over the past three months I have had no fewer than nine margin calls on my share lending, but the bank has not once suggested that I think about some additional repayments of the debt I hold on my investment properties. In fact, I had seven properties revalued recently and, from an original total purchase price of \$700,000 three years ago, they had risen to \$1.1m – that's a 57% increase in the three years that we were supposed to be having a quiet time in property!

A good friend suggested to me that the reason my property values seemed not to have been affected was because of their illiquidity – try selling them for cash in three days and see what you get, he said. The point is that I don't have to sell them that quickly because I am not being asked to pay back my debt. I can ride out this storm and wait until a better time. Even if the properties do lose value in the next few years, they are all in areas of high rental demand and I can still afford to hold them because they are rented consistently.

### **Risk #3: Is it better not to invest anywhere, including property?**

If I keep my money or the equity in my property uninvested, I do have a guarantee – the guarantee that I will lose nothing. I can also be certain that, if the 50% of analysts who say that property is going to fall by 40% are wrong, I won't be taking advantage of the current bottom of the cycle and getting in now, while the yields are on the increase and property in many areas is still relatively low in price. So my risk is that I will lose any potential growth.

Investing does carry risk, but don't think that if you avoid all investing, you are avoiding risk. There is, in my opinion, just as big a risk in doing nothing as there is in taking the chance and investing carefully.

### **Which analysts are right?**

I think that they are all a little wrong. While there will be property that most definitely loses value, I cannot see property in areas of high rental demand suffering too much.

I have always encouraged investors to invest with their brains, not their hearts, and this will now become the most crucial skill you can possess. Ignore the experts making money from their endless theories about sea change, CBD

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properties and location, and accept that the best way to buy real estate in the current climate is to buy bread-and-butter property that renters will want to lease from you.

Then, understand that the next five years probably won't bring you stunning growth, if any at all. For some, you might even see a small decrease in value. But that doesn't matter a lot, as long as your yields and tax breaks are paying for all – or most – of your expenses and you don't have to sell to fund a retirement in the next few years.

In many areas, we are close to the bottom of the market and, as soon as more investors realise that, the choices will become less abundant and you will be forced to take whatever is left.

## **5 Key steps for managing risks**

**If you feel that opportunities definitely exist for buying well-priced property, keep this risk checklist handy:**

- 1** Buy property in areas where vacancies are low and rental demand exists, as this puts pressure on rental yields
- 2** Buy in the bottom third of the market, as this is where the tenant demand is
- 3** Look for intrinsic growth drivers such as infrastructure plans that indicate a council is managing population growth and increased demand
- 4** Buy in areas where the population and the median household income has increased over the past three Census periods
- 5** Be prepared to have a minimum five-year investing period, with a preference for 10 years, as this is how long it takes to reach the next growth phase

The key to successful investing has always been 'time in the market'. For property investment, you should always take the long-term view. This way, you can ride the peaks and the troughs.

Since now seems to be a great time to buy, it could be one of those rare moments in history when market timing and time in the market work together to produce sound results. 🏠

*Margaret Lomas is the director of Destiny Financial Solutions, a qualified financial advisor and author of a number of books about investing in property. Visit [www.destiny.net.au](http://www.destiny.net.au)*

