

RISK FACTOR

Property, like any investment, comes with risks. However, you can control and even minimise these risks if you know how. Margaret Lomas offers a few insights into making real estate less of a risky business.

If you visit a financial planner to work out where to invest some of your hard-earned money, nothing will take place until you have completed a risk profile. This questionnaire is designed to assist the planner in guiding you toward investments which are not only appropriate to your attitude to risk, but which suit other important characteristics, such as the time you have available till you retire, and your current assets and liabilities.

Why then, do people who decide to buy direct property totally ignore the subject of risk, relying totally on their emotions to buy or, worse still, on the recommendations of unqualified opportunists who have a vested interest in selling them an actual property?

It would seem that few people realise that this one purchase, which can represent a substantial investment even when property equity rather than cash is being used, takes as much care, consideration and attention to your future needs and present financial circumstances as any other investment. Since it is a rare investor who takes the right amount of care when choosing, and most choose badly because they used the wrong parameters to make the choice, it's no wonder that investors end up with property which doesn't fulfil their expectations.

I have been assisting property investors for many years, and in all that time I have found that property rarely fails people – but people fail property every time. The poor choices that are made are usually always made because

firstly, the right kind of research is not done and secondly, because the risk factor attached to the property does not match that of the investor.

The topic of risk encompasses two main areas. The first one is the general risk – the factors that are attached to investing in property as an asset class. These can often be exaggerated or actually not in existence at all, and can be psychological factors which hold us back from taking the plunge. The second type of risk is specific risk – the very real risk factors which are attached to buying property of specific types. This risk must be identified and then considered in line with your own personal attitude to risk and the available time you have in which to invest.

GENERAL RISK

When the topic of general risk is raised, most people automatically assume that this means 'losing everything you own'. Put into perspective, this is usually an unlikely possibility. In financial terms however, general risk can be divided into four categories:

1. The chances of losing your money.
2. The extent to which returns may vary from expectations
3. The safety of an investment vehicle in comparison to other vehicles
4. The risk of market timing

Let's have a look at these risks as they apply to investing in property.



THE CHANCES OF LOSING YOUR MONEY

When investing in any financial instrument, the most common worry is you will lose everything you own. For some, this means their life savings. For others, it may be their home, or their retirement savings. While indeed you can,

and people do, lose their money in all sorts of investments. In the main, the chances of losing everything is usually quite limited. There could, however, be a loss of the original value of your money, and in rare cases, the loss of all that you invested. It is considered rare to end up owing more than you originally invested, although in the case of property this could eventuate where the property was a truly bad choice.

It is more likely that a bad choice of property will result in you either being returned to your original position, or finding yourself without the investment property, and a larger debt on your own home than you had when you started.

For example, say you had an owner-occupied property valued at \$300,000 on which you owed \$150,000. This means that you own \$150,000

You increase this debt to \$200,000, using the \$50,000 as a deposit for a property worth \$240,000. You access an additional debt of \$200,000, giving you a total of \$250,000 to buy the property and pay the costs. The rent and tax breaks cover the expenses and so you do not have to contribute funds from your own pocket.

You now have total property worth \$540,000 and total debt of \$400,000. Your equity is temporarily reduced to \$140,000 as you had costs to pay.

You choose badly, and the property lacks a tenant for a while, attracts the wrong sort and goes down in value. You have had enough and want out, so you sell. Due to the loss in value, you can only get \$225,000 for the property and after selling costs only have \$220,000 left.

You pay this into the remaining debt, leaving you with a debt of \$180,000. This is now \$30,000 more than you started with, which feels bad to you. However, at 6 per cent interest rate, the cost of this additional \$30,000 in debt is just \$35 a week. While not ideal, this is also a long way from losing your own home

All investors have a different capacity to withstand loss. This capacity is based on the amount of money they have to lose, the capacity they have to earn money to replace

any loss, and the time they have left available to earn – that is, the time available till they retire.

Before buying property, work out what the worst case scenario would cost you. How much extra loan repayment could you afford without having to sell your own home? It is likely you have a reasonable capacity to fund an extended loan if you had to. This then becomes the true extent of this risk – a far cry from losing everything you own.

THE EXTENT TO WHICH RETURNS VARY FROM EXPECTATIONS

All too often the returns on any investment may be enthusiastically quoted or could be based on present market conditions rather than the examination of likely future market conditions. Sometimes people invest based on past performance and this can be a trap, especially when the normal economic cycle (boom, downturn, bust, upturn) is not taken into account.

An investor who expects a 15 per cent return may be unhappy with a 10 per cent return, while another investor in the same vehicle who only needs an 8 per cent return would be exceptionally happy with that outcome. Therefore the risk factors affecting these two investors, for the same vehicle, totally alter their satisfaction with the results!

From a property perspective, this risk equates to establishing the amount of negative cash flow you can afford to carry while you wait for rents to increase and values to grow. You can ascertain ahead of time what your net cash flow position will be after settlement of the new property by using some basic cash flow calculators which take into account potential depreciation. From there the return may vary due to possible vacancy, or if you cannot achieve the quoted rent return.

Knowing how much of the shortfall you can afford to fund if either of these two situations eventuate is a crucial part of your investing plans and will help you to avoid getting into a tight financial situation.



Property rarely fails people – but people fail property every time

THE SAFETY OF AN INVESTMENT VEHICLE COMPARED TO OTHERS

The stock market crash in the 1920s brought devastation to hundreds of thousands of investors. People jumped off tall buildings, unable to face life any more as they saw their wealth disappear in a few short days.

In 2001, we saw the collapse of HIH, One-Tel and Ansett. This not only affected those people who had invested in these companies, but other smaller businesses such as suppliers, who were left with unpaid bills, forcing them into a financial ruin of their own.

Now we are in the grip of a major global financial meltdown and every day people, especially retirees with no time left to recover, have found themselves with at least 30 per cent wiped of their wealth of 2007.

When you buy property, you have no guarantee of success, but you always have the property, which limits the risk of total wipe-out as compared to other vehicles. The risk of investing anywhere must be compared against the risk of choosing something else, and then measured against your own personal profile.

MARKET TIMING

The time you have available in which to invest also impacts on how safe you perceive an investment to be, and on how it may perform for you. Let's take a look at the following example to illustrate how timing can be all important.

Brad and Stacey both work for LMN Company. Brad is 48, with 12 years until he retires, and Stacey is 57, retiring in three years.

Both have \$100,000 to invest, and Brad buys shares in the ABC Company. He buys 200,000 shares at 50 cents per share.

After 6 months the shares are worth \$1 a share, effectively doubling Brad's investment. He tells Stacey about this as he knows that, with only \$100,000 available to retire, Stacey is keen to boost these savings. Stacey buys 100,000 of these shares and waits for them to perform. Another six months pass and all is well with ABC shares now worth \$1.50. →



But two months away from Stacy's final day of work the share market corrects alarmingly, and the shares plummet to just 50 cents a share. Stacey has now wiped 50 per cent off her original investment and is in trouble. Brad, however, not only retains his original investment, but still has nine years left to ride this correction through.

Applying this concept to property investing, the time in which you have to invest becomes crucial when you make the choice of what to buy and where to buy it. You must know as much as you can about the future as you can and match expected outcomes to your own time frames. Those with shorter time frames will need property in areas with immediate intrinsic growth drivers which are impacting on values quickly. These areas will probably have lower yields and therefore smaller, or even negative cash flows. Those with longer terms till they retire can take longer for growth but may need more cash flow today, since they are more likely still raising children and meeting personal mortgage costs. What maybe right for one person may be wrong for another.

Timing for any investment is the key, and the amount of risk you take should directly correlate with the amount of time you have available to ride the highs and lows.

SPECIFIC RISK

Specific risk relates to that risk which is attached to different types of property. Often I am asked why it is that we should not all be simply buying commercial property, since the yields are higher. The answer is, of course, that as with all investments these higher yields

also bring greater risk, of vacancy, of falling values and of business tenants going broke and breaking their leases.

Knowing about the level of risk each property type carries is crucial before making your choice. In a nutshell, property risks are as follows:

RESIDENTIAL PROPERTY

Includes houses and units in residential areas with populations of more than 20,000 people. These will have a low risk compared to other property and low to medium risk compared to other investments.

HOLIDAY APARTMENTS

Includes homes let out during holiday periods and serviced apartments which are of standard residential size. These have medium risk when compared to other property, as if the holiday market fails they can be converted to standard residential. They are medium risk compared to other investment vehicles.

COMMERCIAL PROPERTY

Includes factories, shops and offices. These have high risk when compared to other property and medium to high when compared to other vehicles. The risk is very high if geared. This is because vacancies can last years and even a secure tenant can have a change of fortune and break their lease.

NICHE MARKET PROPERTY

Includes hotel rooms or small hotel apartments, seniors accommodation and

student accommodation. These have a high risk when compared to other property and investments because they cater for a specific market and usually have no second end use – if the market they are built for fails, they can be used for no other purpose.

YOUR OWN RISK

You might think you are pretty familiar with your own attitude to risk. Risk when investing, however, is not the same as other risk. You may be happy to go bunjy jumping, but losing \$50,000 might make your blood run cold!

Before deciding on any type of investment, you must complete a risk profile. This applies even if you are buying property. Then you must research your market carefully and thus take responsibility for defraying some of the risk yourself. Time taken and a property chosen wisely may not break any records, but at least it shouldn't fail spectacularly and result in total devastation for you. Most importantly, avoid the temptation to make it easy for yourself by placing too much faith in the guidance of people who are trying to sell property to you. Their concerns lie purely with themselves, despite what they may tell you. Become educated about investing, know your risk profile and stick to buying properties which cater for it. From there you will experience success, as long as you allow time to do its work. **W**

Margaret Lomas is a commentator, author and host of Moneymakers, a property show on SKYNews Business Channel. Her latest book, 20 Must-Ask Questions For Every Property Investor, is out now.



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