Retiring on rental

Margaret Lomas **explains what you need to do today to create the rental income you want tomorrow**

The economic turmoil of recent months has been enough to rattle even the hardiest investor. While the collective wealth of our country – and that of many others – which was largely tied up in superannuation funds and sharemarket investing, has taken a major battering, investors have fled the market in droves and are now left pondering just what to do.

It's been clear for decades that Baby Boomers were going to be left high and dry in terms of financial support to help them enjoy a stress-free retirement. Thus, they were encouraged to save towards it and this was facilitated significantly by compulsory contributions from employers. But the confidence that these savings would fill the gap left by an insufficient welfare system has all but dissipated.

In addition, the gloom surrounding our property markets has left many feeling that there's no solution.

To top it all off, the current crisis is unpredictable in the extreme. The way in which our globalised financial markets operate today is unlike anything we have ever seen before.

It's a reflection of the huge advances in technology that have been made this past decade. As a result, we have no reliable precedent for how our markets will behave. Economic predictions made today largely use history as a starting point, and as we've never been in this position before, history is basically irrelevant.

Why Australian properties continue to defy predictions

The Australian property market is already showing signs of defying the supposed logic. The thinking behind forecasting a freefall in property values is based around the economic cycle, which draws a circle of boom and bust. In addition, the sad state of property in both the UK and the US is serving as a basis for the predictions made here.

What these assumptions fail to take into account, however, are our particular circumstances, which are unique and appear to be setting our property markets on a different course.

First, the shortage of property predicted for the coming five years, estimated by some to be in excess of 150,000 dwellings by 2011, provides an impetus for purchasing by both homeowners and investors now, while interest rates are attractive.

> You most probably can retire on rents alone, but only if you apply a diligent approach to acquiring property sooner rather than later

Second, the level of affordability we're experiencing at this time is allowing more people to buy – and when people buy, others sell, providing buoyancy to a market and facilitating the flow of money through our economic system.

But the one factor that economists ignore – one that is hard to calculate in any financial terms – is the impact that our tax rules have on Australians' capacity to invest in the property market in a way that's nonexistent in many other countries. Here, where property investment is not only fostered but also encouraged through generous taxation benefits, we have a nation with one of the highest proportion of property investors in the world. And as interest rates fall, rental yields rise and the sharemarket continues to stumble – and tumble – more people are turning to property investing, giving falling values a floor, as well as a much-needed and continued stimulus to our economy.

Can you live on rents alone?

The short answer is yes. However, simply buying one or two properties down the road from where you live isn't a strategy that will provide any lasting retirement benefits. Developing a property portfolio that caters suitably for retirement involves an entire process starting with effective planning through to an implementation strategy requiring constant attention and education.

Rather than focusing on each property as a physical asset, it's important that investors develop their strategies as individual people, taking their own income, assets, personal expenses and how they'd like to live out their retirement into account. Once this skeleton plan is established, it becomes easier for the investor to know what to buy – and when and where to buy it – as they're now working to a plan.

To answer the question of whether you can retire on rents alone, you must first have a picture in your mind about how you'd like to live in retirement. Someone who's happy to live on $25,000 per annum can most probably do so by buying two properties and keeping them for 15 years, repaying the debt as quickly as possible and waiting till the rents have risen enough to create a $25,000 difference between expenses and income. Others, however, might not consider $25,000 a year as 'living', and so they need to develop a strategy that has a more aggressive approach.

Forming your strategy

A great place to start establishing what you need as your retirement income is the salary you're likely to be earning just before you retire. Since no one wants to think that they'll live in retirement in a manner less comfortable than they've come to enjoy, it should be considered that an income at least equal to your salary in the final year of working is a prudent target.

Then, once you have this target, you just need to work backwards. That way, you can calculate what has to happen today in order to create the income you want for tomorrow.

I have a fairly complex approach to establishing just how much property you require to achieve this income goal. It's neither scientific nor completely accurate, and it can change dramatically if interest rates skyrocket, but at least it does provide a suitable benchmark. Like all benchmarks, however, it must be tempered with an understanding that all investment strategies must be flexible and constantly under review, so

that they can reflect current and future economic expectations better as well as changing personal goals.

To start your calculations, you must work with a number of assumptions – and these will, of course, change each time you review your situation. For now, though, assume that a property, on average, provides a 5% return on its value. This takes into account the fact that, when you have a number of properties in your portfolio, some will return more than this and some less. When you first buy the property, the value will be what you paid. Then, after a few years, it is market value, even if your actual return on purchase price has grown by then, as a result of rising rents.

Let's also assume that the costs of holding a property are around 6%. This figure is based on its original cost and takes into account the yearly expenses, the loan interest and the tax benefits you receive. As the property grows in value, the percentage costs remain on the original purchase price, not the growing value.

Now the process of working backwards begins. In order to establish how much property you need to give you the income you want to get in retirement, you must determine what percentage of an entire portfolio you need to own to enable you to meet the costs. Note that the value of the portfolio will be greater than the amount you own, as you're probably using debt to buy it. The important part of this calculation is that it's only the part of the portfolio you own that contributes to your income – the part that's encumbered (that is, the value of the debt against the portfolio) must use its income to pay loan interest and other costs.

Let's take a look at the following example. Say you'd like a net income of $60,000 per annum. This means that your income (or rent returns on the entire portfolio) must exceed your costs (that is, the yearly expenses for maintaining the whole portfolio, including loan interest charges) by this amount.

Original property portfolio value when purchased: $1,000,000

Costs on the original purchase prices @ 6% = $60,000

Income required to achieve this and have $60,000 remain = $120,000

At 5% income return, value of the portfolio needs to be $2,400,000

Assuming 5% growth rate per annum, the $1m in property would need to be held for 18 years to grow to $2,400,000.

This is where all the tweaking starts. If we assumed that you had the financial borrowing power to buy, in total, $1,500,000 worth of property, it would only take just over nine years to grow to the required amount. On the other hand, applying a potential growth rate of 7% reduces the time for a $1,000,000 portfolio to grow to the required amount to 13 years.

In addition, you must remember that if the properties you acquire are bought well, based on an abundance of research, they are a growth asset. And, as such, the net income will also grow, as rent return is generally a percentage of the value. This, of course, changes from city to city and is driven by rental demand at any one time, but keep in mind, for the purposes of this exercise, we're working with average rent returns of 5% of property values. In practice, this can mean that by your 10th year of retirement, as long as you've held the assets and not sold them to fund another goal, the net income may have doubled what it was in the first year!

Case study

Look at the following example:

Property purchase price:	$200,000
Loan to buy:	$210,000
Current interest rate:	6%
Loan interest repayments:	$12,600
Yearly costs to hold:	$3,000
Total costs:	$15,500
Then calculate:	
Total income @ 5% =	$10,000
Actual loss:	$5,500
Further on-paper loss: (depreciation, etc)	$2,000
Tax back on actual and on-paper loss @ 30%:	$2,250
To ascertain the net costs to you of holding this property:	
Deduct the tax back from the actual costs.	
In this example, net total costs after tax back:	$13,250

Important considerations

There are things that you must establish in order to ascertain whether you can live on rent returns alone, and how much property you must acquire to do so. They are:

When you're considering what your financial position will be at retirement, you must calculate in terms of the net rent return. Often, marketers may advertise their properties by quoting rents that can be gained. Always remember that this is a gross return, and your costs decrease it to what is the real return to you.

These calculations don't account for the fact that, after the property and its rent return begin to grow, it becomes positively geared and therefore, on-paper losses become on-paper gains. Although this increases your return, it also provides a taxable yield. It's safer simply to assume the lower, negative position and understand that any extra gain received is going to be a bonus.

These calculations take tax into account, so the income remaining is a net income.

If your properties grow faster in value (and hence in rent return) the time will be shorter, and vice versa.

So many other factors actually affect these calculations. These can include a sudden increase in interest rates or an unexpected slow-down in the growth of property values. If, however, you work with conservative figures and hold your property for long enough, you'll most likely get an average gross return of around 5–6% of the value of the portfolio, and your holding costs will be around 6% of the original purchase prices.

> The important thing to do is work out how long you think it will be until you'd like to retire and establish the actual income goal you want then

To establish the actual time it takes for you to achieve your retirement income goals, remember that it doesn't begin until you've purchased the number of properties required. So, in the previous example, the 18 years starts after you've acquired $1m worth of property. Your borrowing capacity, your income today and current property equity all determine how much property you can buy – and when you can buy it.

These calculations assume that property expenses, including loan interest, are always 6% of the original value. In reality, the percentage of a property's value that expenses take up decreases as the value grows, since loan interest is only accruing on, at most, the original balance.

If you also undertake a debt reduction plan, you'll bring the time you reach your financial goal forward, as you'll increase your equity and also the amount of income you get to keep.

The important thing to do is work out how long you think it will be until you'd like to retire and establish the actual income goal you want then. This then tells you how much property you actually need to buy. The more property you can afford now, the less time you need for it to grow.

It's also prudent to note that, at the time of retirement, some government benefits may still apply and, at the very least, generous taxation allowances for those who are earning an income from their investments and supporting themselves post-retirement usually always feature in government policy. Add to that the fact that, by the time we retire, we usually need less funds to be available for daily expenses – our debts are normally smaller and the costs of daily living also reduce. This means that, to maintain the lifestyle you have in your final year of work, you most probably need less income, and you'll also be taxed less on the income you do receive.

You could probably retire on rents alone, but only if you have a diligent approach to acquiring property sooner rather than later. You can't buy a second property until you buy your first, and it's crucial to know that you must have a substantial portfolio if you want it to become your sole source of retirement income. Be cautious though – now is a great time to buy, but not all types, and it's during times like these that the opportunists emerge in droves with all manner of new schemes designed to line their own pockets. You simply cannot take investing advice from people who have a vested interest in selling you property, and you must take responsibility for your own investment property literacy.

Luck, timing and any number of 'property secrets' aren't what you need right now. Knowledge, attention to the research phase, good old-fashioned hard work and a commitment to your strategy is what will see you successful over the long term.

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