

Three cheapies or one blue chip property?

Should you spread your risk and buy three cheaper properties or put all your eggs in one basket and buy a single premium property? Margaret Lomas weighs up the options

After much procrastination, you have finally decided that you would like to buy property as an investment. So that you know exactly where you stand, you have been to the bank and, according to your income and equity, have been told that you can borrow up to \$600,000 to buy property.

You are keen to get going and so you begin reading as much as you can, and pop along to a few seminars. You feel that you have acquired a lot of education, but the time has now come to take the plunge and make your choice. And this is where the trouble begins. Do you spend the \$600,000 on that one blue chip property, which everyone says is bound to go up in value, or do you split it up and spread it around a little, buying three properties at \$200,000 each instead?

The decision about which pathway to take must come about as a result of two important things that you must consider, rather than because of any

emotional attachment you may have to one or the other, or to what your friends and relatives may think is best.

The first one takes into consideration the risk the actual economic climate poses, considering both its short and long term implications on your investing period. The second assesses the financial implications and risks to you – you may very well be able to afford one more than the other, which makes the question of choice a little moot.

The economic risk

While property does behave in cycles, an added dimension occurs when factors are affecting our economy as a whole. While it is crucial to consider the global impact of a world economic crisis, we must also take care to apply local factors to any prognosis about investing at these times.

Proponents of blue chip properties have always used the growth argument

to support the concept of buying property with low rental yields. Exceptional capital growth has always been held out as the carrot for the pain of weekly losses on low rent returns. For some years it paid off, as investors in high priced, blue chip property saw good gains which repaid them for supporting the property financially on a weekly basis.

During this time, a second group of investors also began to emerge – the cash flow investors. Around 10 years or so ago a few clever people started buying up property in low priced, regional areas, simply because the rental yields were always so good. These were areas with an itinerant population and people who are planning on a short stay of only a year or two in an area will usually be renters, rather than buyers. In any area where the demand from tenants is greater than the demand from owner-occupiers, rental yields will be

higher than the norm – the basic laws of supply and demand apply and the shortage of rental properties equals better yields. Those who recognised this purchased on the basis that they had a long period to invest, and so could wait for growth to occur, but not enough money to support the lower yield, higher growth properties which would deliver a return on capital in a shorter period of time. In essence, the trade-off for waiting longer for the growth of capital became the fact that properties such as these often supported themselves and the investor did not have to continually plough more cash into the investment.

These two types of investors happily subscribed to their own theories which worked well. Those with shorter time frames to invest were generally closer to retirement and more able to afford the negative cash flows required until that growth occurred. Those with time on their hands gladly watched their properties support themselves and waited patiently until growth occurred (and sometimes struck luck when that growth came sooner than expected).

A new world of investing

That was then, before the greed and *uber* confidence of the new world wrought a catastrophic meltdown upon the global economy. Since then, previously bullet proof, blue chip property has borne the brunt of the fallout, as those who

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sported their overpriced property spoils as proof of their success are suddenly finding themselves scratching to exist in this new economy and frenziedly selling in a soft market. Those top-end, blue chips have plummeted alarmingly, with prognosis for recovery a long time off, putting a hole in the wealth of those who had expectations of early retirement on the back of property portfolios.

For those closely watching the property



markets in Australia and analysing the varied impact that is occurring, an interesting phenomena is emerging, as government stimulus, low interest rates and skyrocketing rental yields in the lower end boost low priced, high yield property into a mini boom of its own.

What this means is that for now, and most probably for the coming three years or so, the greatest benefits from both a cash flow and a growth point of

growth in the next few years from lower priced property, and more likely to see a stabilisation, and even further losses, in higher priced property. Economically speaking, the choice to buy three at \$200,000, as long as your research indicates potential growth from intrinsic drivers such as population growth and economic vibrancy, seems to, for now, be a better one than buying just one, higher priced property.

The yield risk

Let's assume that you buy a property valued at \$600,000 which has, at the time of purchase, a yield of 4% (\$24,000 per annum). After making tax claims for real and on paper losses you most likely will see an actual after-tax yield of around 5–6%.

Now imagine if the value of the property grows, but the rent return, which usually behaves separately to growth, remains the same. This may mean that after-tax yield would drop to, say 4–5%. In essence, your entire investment is now earning less than it was when you first acquired it. Conversely, of course, your rents may go up, in which case the entire investment is now earning more than it was when you first acquired it.

Let's also assume that the property



in this way is a crucial feature of an early investment portfolio – at the time when your costs are highest and your yields the lowest, you will want to make sure that you have the best occupancy possible.

When considering vacancy risk one must also consider the fact that, during a recession, properties in lower price brackets (both value and rental yields) will have the lowest vacancy rates. In effect, buying from this market means you have the greatest chance of securing a tenant during the tougher economic times.

Liquidity risk

When you commence, or continue a property portfolio, your exit strategy must be one which you plan and consider. Even if your strategy is one of buying and holding, the possibility that you may have to liquidate for any number of reasons must be acknowledged and prepared for.

Depending on the circumstances which are requiring this liquidation, when you have all of your assets tied up into the one, higher priced property, your options are limited. To realise your gain, reduce your debt, offload a poorly performing property or for any other reason, you will need to sell the entire asset – as there is only one.

If, on the other hand, you had spread this investment over three properties, you might have more options available.

Depending on the reason for the need to liquidate, selling just one, or two, may suffice, meaning you can retain some exposure to the market.

In addition, the ability to sell a property in the lower part of the market is always much easier than in the upper end. In a recession, with low rates, more first home owners can buy. In a climate of rising rates, fewer people can afford higher priced

advantage of additional bargains which may arise. Spreading your borrowing capacity out over several properties tends to increase the aggregate yield and growth and ensures you have a continually growing asset base.

Vacancy risk

Owning one property with a cap on yield potential also means that you have exposed yourself to a greater vacancy risk. At \$24,000 per annum,

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each week that the property is vacant equals a \$480 loss in income. If you spread the \$600,000 over three properties, however, even at the same rate of yield it is unlikely all three will be vacant together, especially if you have been sure to buy from different markets. If one becomes vacant, you are only out of pocket \$160, and while not ideal, this is far more manageable. The ability to spread vacancy risk

does grow, for a year or two, and then for another year or more it stabilises. For the first year or so the value of what you own increases, potentially providing leverage for you, into more property. But, for the years that it stabilises, your investment stops growing and also stops providing leverage.

What would happen if you spread that \$600,000 among three properties instead, and you chose those three properties from three entirely different areas, all subject to entirely different, and separate, growth drivers?

Since, as I mentioned earlier, property behaves in cycles, but not the same cycle all over the country, it is likely that while one property may have a period of time where rents stagnate, it is highly unlikely that all three will stagnate together, as long as you have chosen them from different markets. So, as an overall summary, your rental yield total may continue to increase every year, as one or two of the three should, at any one time, be growing. The same can be said for the growth issue – it is unlikely that three properties from three different areas will all stagnate in value at the same time – and so at any one time something in your portfolio will be growing, allowing you to continue to leverage and take

properties. In the event that you must downsize your portfolio, spreading your investment over several properties provides you with more options, and most probably more likelihood of a quick sale too.

Other factors to consider

In addition to the obvious economic and financial factors, which make now the time to spread your investing across properties in the lower section of our markets, there are other things to consider.

Stamp duty to purchase one property valued at \$600,000 is considerably higher than it is to purchase three properties for \$200,000 each. This is because stamp duty becomes proportionately higher as the value increases – unfair but true.

Yields on lower priced property can tend to be higher than those on more expensive properties. This is because rental yield does not have as great a variance in an area, town or city as does capital value. It is not unusual

to find a property in an area valued at \$400,000 achieving a \$300 a week rent return, while a property elsewhere valued at \$200,000 achieves \$225 a week. From a rental yield perspective alone, lower priced property does seem to have better weekly yields.

Land tax is also a big consideration. Most states have a tax free threshold – a certain value of property that you are allowed to own in that state, aside from your family home, which will not attract tax. After that, the combined value of all held property is used to calculate land tax, and in many states this tax can be brutally high. By spreading your purchases among many states, you are provided with a tax free threshold in every state, and can have a large portfolio of property without ever paying any land tax!


Summary

A basic investing rule is to never put your eggs all in one basket. In a nutshell, this is just another way to suggest that diversification is the key.

In property, too, diversifying tends to add not only protection to your portfolio, but it also seems to boost yields, guard against serious vacancy issues and ensure that your portfolio is a constantly growing one. You simply cannot argue the logic – unless property is experiencing a major boom where you can make money quickly while you also see good yields, now, and most of the time, lower priced property will offer a better all round property investment than a higher priced one can. ■


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