property for life

Using property to plan your financial future

Mark Armstrong & David Johnston
With Fiona Marsden

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Introduction

Thank you for taking the time to read *Property for Life*, a book designed to help you identify how property can be used at different stages of your life to create wealth and fulfil your lifestyle dreams. Property is an emotive asset because we all live in it and have an opinion about it, but it is also a largely misunderstood asset.

In recent years, lack of financial regulation has meant that many property investors made decisions that have not been appropriate for their individual circumstances. In many cases they were sold a one-size-fits-all strategy that made outrageous claims of wealth and were designed to line the adviser's pocket rather than the investor's pocket. The focus has been on selling a product or strategy rather than advising the individual. The government has allowed this to continue unabated due to the fact that it fails to recognise property

as a financial product. As a result, property investors are not afforded the same protection that their sharemarket counterparts are. *Property for Life* has been written to help address this problem. Before deciding what or where to invest it is important to review your current position, be clear about the goal you are aiming to achieve and develop a clear strategy.

As advisers, we are asked the same question continually — 'What should I do?' Our answer is always the same — 'We really don't know what you should do because we don't know anything about you'. This book has not been written to provide you with all the answers — that would be an impossible task. It has been written to help you identify the right questions to ask and give you the tools to find the answers.

The authors of *Property for Life* together have over twenty-five years' experience analysing the property and finance markets and helping people to make informed decisions based on their individual circumstances. It is our aim to impart some of the knowledge we have gained over the years. We have used a story approach to help you identify with some of the characters in the book as they travel through different stages of their lives. You may find the scenarios that you relate to vary depending on when you read *Property for Life*, and by reading it more than once different lessons will be learned.

The story begins with our main characters Jim and Jane as they first develop their relationship in their early twenties and follows them through their lives until retirement. They come from average middle-class Australian families and have a desire to create the life they have always wanted. As Jim

and Jane grow, they cross paths with a cast of characters who they are able to learn from. In some cases they learn from the advice they receive and in other cases by observing what is happening to the people around them. By telling you Jim and Jane's story we aim to illustrate that by seeking advice and making informed decisions anyone can achieve their lifestyle and financial goals.

As you read *Property for Life* you may or may not relate to Jim and Jane directly. You may relate to some of their family and friends or a combination of both. The objective is for you to identify different scenarios and how they relate to where you are now.

Property is a unique investment because people will always need somewhere to live. Regardless of broader financial issues such as interest rates, inflation, mortgage stress or consumer confidence, property will always be in strong demand simply because people need a roof over their head. Along with food and clothing, shelter is a primary need.

Unlike most other asset classes, the property market is driven by two major sectors—homebuyers and investors. Homebuyers make decisions out of emotion and desire while investors make decisions based on sound financial logic. One uses the heart to make decisions, the other the head. This fact makes property a complex asset because many people confuse emotion with investment logic. We can't count the times we have spoken to people who have purchased an investment property near the beach or in the country because they loved holidaying there once a year. They never actually got to use the property—it was purchased because of their desire to live there at some stage in the future.

Within the property market there are a range of different types of assets you can buy to help you achieve your lifestyle and financial objectives. You can buy new or established property in the city or regional areas. You have the option to purchase houses, apartments or commercial property. On the other hand, you can buy run-down property to renovate or purchase land on which to build. In addition to the type of asset you purchase, the strategy you use can also vary. Your strategy can be aggressive or more conservative; alternatively, it could be a negative-geared or positive-geared strategy.

All of these properties and strategies will achieve different objectives and have different economic forces driving their long-term investment potential. Some will produce income while others will have capital growth as the primary benefit. Some are better for lifestyle purposes and others better suited to investment.

We are not suggesting property is the best asset class. In fact, investing in property should be done in combination with other investments. If selected well, property can make a great addition to your overall investment portfolio but can be a disaster if you make a poor decision. Mistakes in the property market can be extremely costly. Unlike sharemarket investments, when you buy property you are confronted with significant stamp duty costs. When you sell property you will again incur substantial selling costs due to real estate agent fees and advertising. These transaction costs will compound any losses and highlight the importance of making informed decisions before you act.

Property for Life is a guidebook to help you identify the principles of property investment and will assist you when making important strategic decisions at pivotal moments of

your life. These guiding principles do not change with your age, marital and family status or income levels. Everyone's personal and financial positions are unique—the principles however are consistent.

Property for Life has been written to be read through as a story with lessons learned along the way. The fact that Jim and Jane learn lessons at particular stages of their lives does not mean you have to learn them at the same point in your life. The one thing to remember when reading *Property for Life* is that everyone is different. Everyone has different goals and objectives and this means the property that may be right for someone else maybe completely different to the one that is right for you.

The answer to the question 'What should I do?' does not lie in the property market itself. It can be found by analysing your own personal circumstances, determining your goals and developing a clear strategy. We all have the power to observe, ask questions, seek advice and find answers. *Property for Life* has been written to start that process. We hope you enjoy reading it.

Chapter 1
Getting a foot in the door

Jim and Jane are in their mid twenties. After dating for a year, they decide to rent a place and move in together. Once they feel confident that their relationship is long-term, they decide it's time to buy a home of their own. This chapter will focus on the issues that face Jim and Jane before they start looking for a property, the options available to them, and the pros and cons of each one.

In this chapter, we will cover:

- saving for a deposit and related costs
- loan structure — principal and interest versus interest only, fixed versus variable interest
- getting a loan — what do lenders look for in a borrower?
- snapshot concept — the importance of putting your best foot forward.

Saving for the deposit and related costs

The hardest part of property is getting into the market—and the hardest part of getting into the market is saving for the deposit and major related costs such as stamp duty.

The reason that getting in is so hard is because history shows us that the Australian property market usually grows in value more quickly than your salary, and therefore faster than you can save. On top of this, most ordinary savings accounts return a negligible rate of interest. Even with a high-interest savings account, the return is somewhere around the official interest rate set by the Reserve Bank. In most cases this is not enough to keep up with the rate of growth in the property market. It's a bit like running after a bus that you've just missed. You can run at top speed hoping to catch up with it, but the bus will accelerate and leave you far behind.

Tip

Time in the market—not timing the market—is most important. Income usually grows slower than property, so the sooner you get into the market the better off you will be.

Time is working against Jim and Jane. That's why, rather than making deposits into a savings account, they should adopt a more creative strategy enabling them to save as quickly as the property market is growing. This way, when the bus passes, they'll have gathered enough speed to leap on board.

Mortgage insurance

Of course, if it was as straightforward as saving a deposit, Jim and Jane's task would be a lot easier. When they apply for a loan later in this chapter, their lender will ask them to take out *mortgage insurance*, which protects the lender in the unlikely event that Jim and Jane can't meet their repayments.

Nearly all lenders require anyone borrowing more than 80 per cent of a property's value to take out mortgage insurance—in other words, virtually all first homebuyers because they haven't built up equity in a previous property. The amount payable depends on how much, and what percentage of the property's value, they borrow.

Mortgage insurance is one of the few types of insurance where you pay to protect someone else. What's more, lenders often roll the mortgage insurance into the loan amount, so you end up paying interest on an insurance premium. It's not exactly a pleasing situation but look at it this way: it's the only way a lender will take the risk on someone who can't come to the party with a substantial amount of their own money.

Unless you've been saving like crazy since you were five(!) it's unlikely you'll have enough money for a 20 per cent deposit, so you'll have to find another way to get your deposit up to that magical figure. These days, lenders offer family equity packages that enable parents or other family members with sufficient equity in their home or other asset to chip in and help you.

That's what Jim's friend Richard did. When he decided to buy a home, he had just completed seven years of study and had begun practising medicine. This meant that, although he was earning an income, he didn't have any savings to put towards a deposit.

Richard's parents owned a holiday home and had paid off most of the loan, so they had a considerable amount of equity in the property. (*Equity* is the difference between the property value and the debt you owe. We'll explain this in more detail later in the chapter.) His parents were able to draw on some of this equity to help Richard raise a 20 per cent deposit. This not only helped him to buy a property, but helped him to avoid paying mortgage insurance.

In contrast, Jim's and Jane's parents don't have equity outside of their family homes. And with quite a few children between them, they don't want to be seen as 'playing favourites'. They're not comfortable with the idea of drawing on their equity to contribute towards Jim and Jane's first home, so Jim and Jane realise they'll have to save extra money to pay mortgage insurance.

Stamp duty

Then comes the real killer—*stamp duty*. Stamp duty is a strange old-fashioned term for a tax that state and territory governments levy on the purchase price of property. Stamp-duty rates vary from state to state and can change when governments change their policies or are trying to win elections, so we're not going to list them here. Let's just say that stamp duty is the second highest purchasing cost next to the deposit—so it's something you need to consider right from the very start of your savings strategy.

To save enough for their deposit, mortgage insurance premium and stamp duty, and save as quickly as the property market is growing, Jim and Jane realise they need to get serious. They decide to take a leaf out of Jane's cousin Ernie's book. Ernie bought his first home six months ago. He saved for his first home by combining several strategies.

First, he moved out of his rented property and went back home to his parents. This saved him a considerable amount of money which he put towards a deposit. We're not suggesting that living with your parents is the right thing for every aspiring first homebuyer, but if both parties are willing, it can make a big difference to your ability to save.

Next, Ernie went over his budget with a fine-tooth comb and worked out what he *needed* to spend his money on versus what he could do without. For example, he really wanted to go to Fiji for an extended holiday, but that would have blown at least six months' worth of savings. Instead, he decided to take a few short breaks closer to home. He also ditched his gym membership (it cost him a fortune and he rarely used it anyway) in favour of jogging around the local streets.

Once he'd worked out how much he was able to save each payday, Ernie decided to look beyond ordinary savings accounts, which wouldn't pay enough interest to keep pace with growth in the property market. He directed his payday savings into a managed fund with a balanced spread of investment types and the potential to provide a combination of capital growth and income. He then borrowed some money to buy a share portfolio, which offered stronger capital growth potential.

Because both of these investment vehicles include asset types other than cash, they offer a higher potential return.

The higher the potential return, the greater the potential risk that the investments could stagnate or even fall in value. Ernie's advisor told him that the best way to minimise this risk was to invest for the medium to long term, that is, at least five years. So, it took him a while to save for his first home—but he was able to take advantage of high growth periods when they occurred, and ended up saving more than someone who simply put their money into a low-interest bank account.

Unlike Ernie, who's single, Jim and Jane have the advantage of bringing in two incomes. They realise that, if they make a few adjustments here and there, they can afford to bank one wage and live off the other. This means they have more disposable income than Ernie, so they can save more quickly without relying on higher growth/higher risk investments. They don't borrow to buy a share portfolio, but instead decide to put some of their savings into a high-interest savings account, and some into a managed fund with a reasonable balance of capital growth and income potential.

This strategy, while less risky than buying a share portfolio, still carries some risk because the managed fund has a component that's invested in shares. For this reason, Jim and Jane know they're looking at a minimum time frame of three years. Whenever they have any spare money, they top up the savings account and/or managed fund to make their savings grow even faster.

Like Ernie, Jim and Jane are crystal clear on their goal—to save at a rate that keeps up with the property market so they can get in as soon as possible. Once they're in, time will begin working *for* rather than against them. The property's