

# Expand or contract?

**In these uncertain times, it can be unnerving for property investors to think about expanding their portfolio when everybody else is sitting on the sidelines. But, as Helen Collier-Kogtevs explains, getting in the thick of the action is the best way to beat the doldrums**



**T**here's been quite a lot of negativity in the media recently, including predictions that the sky is about to fall because of the impact of the US sub-prime and credit crisis. This situation is causing some investors to think twice before buying more property and, in some cases, they're even shying away from taking up deals they would have snapped up just months ago.

The big question on most investors' minds right now is: Is the current market the right one to expand my property portfolio in, or should I contract my portfolio and do nothing until the uncertainty in the economy passes? And, if I do contract, when should I bounce back into the market?

The answer, as always, depends on your personal circumstances, as there isn't a one-size-fits-all solution.

In my view, the best strategy will always be one that's tailored to what your lifestyle and budget can sustain, regardless of market conditions.

It's been interesting to observe the impact that the US sub-prime and credit crunch crisis has been having on the Australian economy and, in particular, the property market.

My take on it is that, because economists are predicting the worst will be over by early next year, now is the time to take advantage of the abundance of opportunities available. All you have to do is go out and find them.

## Rising rates, rising rents

Australia's strong economy has created inflationary pressures that have resulted in the Reserve Bank of Australia having to raise interest rates in order to stifle demand. This has hurt many people with a mortgage.

To some extent, investors have been able to counter these rises by increasing rents.

For tenants who are looking for a place to rent, I understand it must be difficult putting in applications, queuing and competing with up to 50 other people to rent a property – but that's what's happening now in the world of the rental market.

However, as an investor and landlord I must say that I'm enjoying the extra cash flow, especially from what were previously my 'very negatively geared' properties.

## Don't wait

During uncertain times, many investors tighten their belts or hold off making investment decisions until the market turns.

I frequently hear investors saying that in a time of downturn in the market they're waiting for property prices to bottom out before getting back into the market.

Unless you're brilliant, or just plain lucky, adopting a strategy like this doesn't work, because you won't be able to pick the point at which the market bottoms out, and you'll then get panicked into buying something you shouldn't have in a market that's rapidly climbing.

In my opinion, it doesn't matter what the market conditions are because if you plan your investment buying strategy well, you can invest and make money in any market.

## Be conservative

I've come across many investors who have one or two heavily negatively geared properties and haven't fully considered the 'hip-pocket' impact of these properties on their lifestyle.

They struggled to meet the original property mortgage payments and are now faced with an exacerbated situation caused by a number of recent interest rate increases. Forward planning was not part of the equation when they decided to purchase their investment properties, and the consequence was disastrous.

Their view was: 'If the bank is prepared to lend me the money, then I must be able to afford it.' Wrong.

The reality is, many investors are now hurting and have discovered that they really can't afford to support their investment properties without severely impacting their lifestyle.

In extreme circumstances like this, I've even suggested to investors to move out of their own homes, turn them into investment properties, and then find rental accommodation to live in themselves. Renting out their own home enables them to have their tenant – and the tax man – help them to come up with the mortgage repayments.

When the market is booming, every man and his dog thinks that buying an investment property will make them rich; however, when the market is heading south, many speculators rapidly leave the market and lose a lot of money in doing so.

If you're an investor, stick with it – just work out a strategy that leaves you with a lifestyle and the properties.

## Case in point

### Consider the following scenario

A married couple have a combined salaried income of around \$120,000 pa. They currently live in their own home, which is valued at \$800,000. The mortgage on their home is around \$400,000. Therefore, mortgage payments, using current interest rates, are \$36,000 pa. They also jointly own one investment property which they purchased for \$500,000. The mortgage repayment on this property is \$45,000 pa because they used the equity in their own home as a deposit on the investment property.

The rent they earn from the investment property is \$400 per week, giving them an annual income from the investment property of \$20,800.

### Let's do the simplistic calculations on the properties

The investment property earns an annual income of \$20,800. The expenses – including mortgage repayments, rates, property management fees, etc – come to approximately \$50,000 pa. That leaves a loss of \$29,200 which, of course, can be used as a tax deduction against the property owner's PAYE income.

Let's assume the best case scenario and apply the highest tax rate for this example. This means that the couple would receive 40 cents in the dollar, equating to \$11,680 back in the form of a tax return benefit. This leaves them out of pocket \$17,520 pa. When you convert this into a weekly expense, the investment property is costing them \$336 per week.

To add salt to their wounds, they also have their own mortgage of \$36,000 per year plus rates and maintenance, etc. Their mortgage alone would cost them \$692 per week. Hence they're out of pocket each week by approximately \$1,028 – totalling over \$53,000 pa.

<b>Combined salary: \$120,000 pa</b>	<b>Investment property</b>
<b>Family home</b>	<b>Purchase price: \$500,000</b>
<b>Value: \$800,000</b>	<b>Mortgage repayment: \$45,000 pa</b>
<b>Mortgage: \$400,000</b>	<b>Income from rent: \$20,800 pa</b>
<b>Mortgage repayment: \$36,000 pa</b>	<b>Total expenses: \$50,000 pa</b>
	<b>Loss: \$29,200 pa</b>
<b>Assuming: 40% tax rate</b>	
<b>Tax deduction: \$11,680 pa (\$29,200 x 40%)</b>	
<b>Out-of-pocket cost: \$17,520 pa</b>	
<b>Cost of keeping the family home:</b>	
\$36,000 per year divided by 52 weeks = \$692 per week	
<b>Cost of keeping the investment property:</b>	
\$29,200 divided by 52 weeks = \$336 per week	

Total out-of-pocket expenses are: \$1,028 per week (\$336 + \$692) or \$53,456 pa. I haven't taken into account their living expenses, credit cards, personal loans or car leases. Their gross income of \$120,000 pa is reduced to around \$90,000 after tax, so if mortgages are costing them over \$53,000 the couple will only be left with \$37,000 per year to cover all of their other living expenses. What about holidays, trips overseas, special occasions, dinners out, new clothes, etc? What about children, and their expenses and school fees?

Can you see how quickly you can come from a situation of relative comfort to one of struggling from week to week? I call this 'living off baked beans while trying to get rich'. It's no fun, and I certainly don't recommend buying investment or owner-occupied properties without working out a strategy first.

If the same couple were to rent their own home out and then find a rental property to live in themselves, the scenario would be totally different.

While interest rates are high, your strategy might be to lower your LVR by keeping a bit more equity in the property. This will act as a buffer for the inevitable 'rainy day' and reduce the out-of-pocket cost of owning a negatively geared property



### Case for expanding your portfolio now

#### 1 Great deals available from distressed sellers

It's been widely reported that buyers have been able to achieve discounts of up to 20% on distressed housing sales. The Victorian government is endeavouring to legislate against this practice, but until this happens the discounts will continue. Investors should take advantage of this now.

#### 2 Fewer buyers because of high interest rates

This scenario gives you a better bargaining position when negotiating to buy a property. If auction clearance rates drop below 50%, then it means that there are only one or two serious buyers at each auction. Sellers are already committed to selling and it's possible to negotiate good discounts in this scenario.

#### 3 Better yields because of short housing supply

Supply isn't expected to meet demand for at least another three years; therefore yields will increase even

more because of the big influx of migrants. This will also help to offset the increases in interest rates.

#### 4 Lower house prices

Lower house prices have been caused by high interest rates, which are reducing affordability for many first homebuyers. Prices will skyrocket as we come out of this economic downturn.

This is an opportunity that investors should take advantage of by buying property now before house prices increase again. Predictions are that we'll come out of the downturn early next year, so if you wait too long you'll miss the boat.

History shows that house prices that have dropped from the long-term growth trend curve during an economic downturn often return to the trend curve rapidly at the end of the downturn. There's no reason to suggest that the same won't happen again.

#### 5 Strong fundamentals

Economists report that the fundamentals of the Australian

economy are strong: strong growth fuelled by the resources boom in Queensland, NSW and Western Australia; a low unemployment rate; population growth of 178,000 last year; skills shortages; and massive capital expansion in the mining and related industries.

The impact of the US sub-prime and credit crisis is and will continue to be felt in Australia, but we are, to a large extent, being buffeted from its effect because of our strong association in the Asian region, particularly China and India.

#### 6 Property prices have bottomed out

Areas have already bottomed out, or have never gone backwards and are still increasing in value.

While interest rates are high, your strategy might be to lower your LVR by keeping a bit more equity in the property. This will act as a buffer for the inevitable 'rainy day' and reduce the out-of-pocket cost of owning a negatively geared property.

You might also want to consider taking out a P1515 tax benefit so you don't have to wait until the end of the tax year to get your tax back. Ask your accountant whether this option will work for you.

#### Case for contraction in today's market

There is none.

In summary, plan your strategy and buy now. As always, the best strategy to follow is the strategy that gives you peace of mind. In fact, it's difficult to argue or reason with your 'peace of mind'; hence, whichever strategy you choose to adopt, make sure you can sleep at night.

Until next time, happy investing. ■

*Helen Collier-Kogtevs is director of Real Wealth Australia, and author of '47 Biggest Mistakes Made by Property Investors and How To Avoid Them'. For more information, visit [www.realwealthaustralia.com.au](http://www.realwealthaustralia.com.au)*

