Newsletter

March 2017

BRETT GEAPPEN
FINANCIAL SERVICES

Introduction

Welcome to our second newsletter for 2017! This newsletter contains our blog articles from February, plus the all-important market update for the two main investment asset classes: residential property and the Australian share market. As ever, please feel free to send this newsletter to anyone you think would find it useful – and get in touch with us yourself if there is something you would like to discuss.

Did You Know… the month of March

March has been an important month in Australian history.

In 1975 – yes, that's right, 1975 - colour telly was first broadcast on the 1st of March. In March 1911, the city of Darwin changed its name from the city of Palmerston, in honour of Charles Darwin (Lord Palmerston has been the British PM from 1855-1865). In what was probably an unrelated event, in March 1868 the then Duke of Edinburgh, Prince Alfred, was shot in Australia's first attempted political assassination. And in March 1877 the first test cricket match between cricketers from Australia and England was played in Melbourne. 100 years later, Kerry Packer took the opportunity of the best Australian and English cricketers convening for the Centenary Test to poach all the best ones over to play in his World Series Cricket.

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See our property market update – people like to live in cities, and they always have.

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Market Update 1 March 2017

The share market and the residential property market in March 2017

Property Update March 2017

Property price do not always go up…

You will always hear us emphasise the key drivers of house prices: demand and supply. They must never be forgotten. Here's why…

The end of Australia's mining boom (roughly 2002-2012) presents an object lesson in how property prices are set. In many places, prices rose extraordinarily during the height of the boom.

Consider the Queensland town of Moranbah. In 2011, this town was the most expensive place to live in Queensland (Source: ABC online, 27 May 2011). This high cost of living was driven by the town's proximity to various large scale coal mines. Indeed, Australia's largest coal deposits are on its doorstep.

Well, Moranbah ain't the most expensive place to live anymore! Far from it. In December 2016, a 3-bedroom house in Renier St sold for $150,000 – having been listed for sale at $130,000. According to the register of previous sales, whoever sold the house in 2016 had bought it ten years earlier - for $355,000. That is, the house fell in value by almost 60% across the ten-year period.

The same thing has happened all over town. Another property in Flinders Drive has sold three times in the past 11 years. In 2006, it sold for $310,000. Two years later it sold for $345,000. This is a ten percent rise –not huge when you factor in associated costs such as stamp duty and agent's fees. The sellers in 2008 probably got their money back. But the *buyers* in 2008 did very well: in 2012 they sold the property for $787,000 – doubling their money in just four years.

But what about the buyers in 2012? Well, according to the price guide estimator on **domain.com.au**, the property would be likely to sell for $400,000 were it to be on the market today. This means the value has almost halved in just five years. (And we suspect this is a generous estimate).

So, what do we make of all this? Why did prices double in one four-year period and halve in the next five years? How is it that prices fell by 60% across a ten-year period – during which house prices in Brisbane, that state's capital, *rose* by 42% according to the Queensland statistician's office. To put that into perspective, had a purchaser paid $355,000 for a house in Brisbane in 2006, by now it would be expected to fetch a little over $500,000. The same property in Moranbah just sold for $150,000.

It is all to do with supply and demand. And, in particular, what happens when demand suffers some sort of shock (either a positive shock or a negative shock).

Mining booms can create two sets of positive shocks for a property market. The first occurs as the higher prices for mine output leads those mines to expand. This increases the number of people employed by the mines, which brings people to live in towns near those mines. This introduces a general and, shall we say, genuine rise in demand for housing. It takes a long time to build houses,

which means that it is hard for new houses to be quickly built to meet this increased demand. Thus, the supply of housing is unchanged. Demand grows relative to supply - and prices increase.

In the mid 2000s, not everyone who moved to Moranbah wanted to buy a place, though. Some just wanted to rent. This meant that demand for rentals increased as well. Again, supply did not rise. So, rents rose in accordance with the renewed demand. This is a basic market at work.

The ratio of rent to a property's value is known as the *yield*. When the yield exceeds the interest paid on money borrowed to buy a property, a property becomes 'cash flow positive.' Obviously, cash flow positivity is easier to achieve when rents are high, so this encourages people to buy houses that are entirely debt-financed. People start buying homes using 'other people's money.'

Unfortunately, lots of people spruik the benefits of positive cash flow residential property. It all sounds so enticing. Even if you do not have any of your own savings, you can simply borrow at (say) 7% and buy a house which you then rent out at (say) 9%. You make money immediately.

It is all so good that many people think – why not buy two properties, or three? This is all part of the second 'shock' to demand in towns like Moranbah. Speculators looking to make money by owning investment property drive the prices of those properties up.

The problem, of course, is that these investors don't understand what caused the first shock to their market. Everything was predicated on people moving to the town to work in the local mines. But mining booms end. Prices fall. What happens when the work at the mine starts to dry up? The obvious response: people leave town again as they pursue work elsewhere. This lowers demand for housing, which lowers prices. This is the first 'reverse shock' – a natural adjustment to the market.

But the first reverse shock also leads to a second reverse shock. As we say, people leaving town reduces demand. This reduces both the price of property being bought and sold and the rents being paid to landlords. Either way, investment returns start to fall. But interest rates remain unchanged. As a result, a positive cash flow property can quickly become a negative cash flow property – meaning that the landlord has to put extra money in to maintain the investment. This leads people who are relying on cash flow being positive to want to 'get out' of their investment, by selling up. This increases the supply of housing for sale, which combined with low demand pushes prices even further down.

Falling prices are a real problem for people who have borrowed money to buy an investment property – lenders hate it when values drop below the amount of the loan. When this happens, it becomes a situation of 'negative equity.' And the landlords have to put their own money in to make sure that they meet the interest payments. This is really hard… especially if the landlord does not have any spare money. And remember what we said about people not having any savings to fund their investment, and needing to borrow the whole lot. Making the extra repayments is even harder if the landlord owns three or four of this kind of property.

Before too long, landlords miss payments and lenders start to foreclose on properties> This is what has happened in Moranbah, where one real estate agent has stated that 95% of current listings are properties being sold because the owner has defaulted on their mortgage.

Towns like Moranbah are a helpful way for us to demonstrate the absolute importance of supply and demand on house prices. Populations in places like Moranbah are small enough to be absolutely

shocked by something like a mining boom. In 1986, the population of Moranbah was 6,883. By 2001, it had fallen to 6,133. But by 2011 the population had jumped to 8.965 – a rise of more than 46%. The 2016 census results have not been published yet.

It is harder to see the effect of this type of shock on larger property markets. But it can happen. Perth, for example, saw its median price rise from below $200,000 in 2002 to more than $450,000 in 2007 (source: REIWA). This was largely driven by the mining boom, which had a particular impact on the Western Australian economy. Similarly, the drop off in mining activity since around 2011 has seen prices either stagnate or even drop in six of the past ten years - although the 2016 median remained well above $500,000 – still a 150% increase since 2002.

This last point is essentially the point of this whole article. While a city the size of Perth can still be affected by things such as economic cycles, the fact that the economy of Perth is much more diversified than the economy of a small country town like Moranbah provides a level of insulation for prices. That means that taking a long-term view on a property (other than a high rise apartment or anything sold off the plan) in any well-populated area (the major city in each state and many of the larger cities in the more populous states) is likely to turn out well.

Just remember: long-term means 20 years plus! Property is not a good place to make a quick buck. Just ask the heartbroken landlords of Moranbah.

And one other point: if a property is being advertised as cash flow positive, that is because no one else wants to buy it and the price is low relative to its rent. Think about that: if no one wants to buy it now, why would that change in the future? If no one wants to buy it now, you probably shouldn't either.

Share Market Update March 2017

The ASX 200 started February on 5,620 points. It ended February on 5,712. In between those dates it peaked at 5,816 (Feb 16).

So it is not quite right to say that nothing happened during February. But it was a fairly bland month for the market. Not *much* happened.

By the way: bland is good when it comes to share market investment. The long-term trend for the Australian economy is a positive one. This is true of all developed economies, but has been especially true for Australia. Remember, the city of Ballarat was the wealthiest city in the world in the 1880s. In 2016, Credit Suisse announced that its research indicated that per capita wealth in Australia was the second highest of any country in the world, even after our per capita wealth had fallen slightly in that year. (Switzerland is the wealthiest per capita economy).

Australia has kept up a pretty good standard of living for the past 140 years or so. That is why a month of business as usual in the stock market is welcome news for anyone who knows what they are doing by investing into that market. Which is... to buy and hold shares in solid companies that are expected to perform well whenever the economy performs well. Remember, you are buying a very small part of the overall economy – which is why we think it pays to buy a diversified part of the economy.

Homes are the best investments… For you and your kids

(First published February 10 2017)

As financial planners, helping our clients manage their family home is one of the most enjoyable things we do. We love family homes. For a start, we love families – and families live in family homes. What's more, enjoying your home is the easiest way to enjoy life in general. A happy home – and a home you are happy with – is an essential part of a happy life.

But that is not the only reason we love helping people get the best family home they can afford. Family homes are not just great places to live. History shows that family homes are also cracking investments. Over the last 20 years **Australian property has averaged** a return of more than 9.5% a year, including both rents and capital gains. That means that house values doubled every seven or eight years. (Yes, these are average figures across the country and not every market did this well. But all markets did at least quite well over that time period).

Things are even better when gearing is involved. 'Gearing' is a fancy word for borrowing – and most people borrow money to buy their family home. If you start with 20% equity (and borrow the remaining 80% of the purchase price), and the house doubles in value, then the value of your equity increases to 60% of the increased value of the house. The proportion of debt halves when the value of the property doubles.

But that is not all. Even better is the fact that the family home does not attract Capital Gains Tax (CGT). This means that you do not pay tax when selling a home that has increased in value. This is a central plank of Australia's taxation system and it is not going to change any time soon.

Combine this tax treatment with the long-term results that Australia's housing market has achieved, and you find that most Australians are living in tax-free investment machines. For example, if you are in the 45% tax bracket and you own a $1,000,000 property and it goes up in value by just 5%, or $50,000, that's the equivalent of earning an extra $92,500 a year in pre-tax salary. This is because you would have to earn $92,500 and pay tax at 45% to be left with $50,000 in cash. What's more – you can't live in cash. That is why houses are usually better places to hold wealth than cash.

The last 20 years has seen constant growth in the value of Australian homes, with Perth being an exception in the last few years (having grown by more than the national average prior to the tailing off of the mining boom). This has a lot to do with our constantly growing economy (we have not had a recession for 25 years now). In addition, immigration has been a particularly important driver of the national economy. And guess what? People still want to come to live in Australia. That won't change any time soon.

The Australian obsession with home ownership is likely to continue. It makes sense to invest wisely in the home. We strongly encourage home ownership strategies, and their close cousin, debt management strategies, whenever we meet with a client. Even if the rate of growth slows (or we get a negative year or two), long term the right housing purchase turns out well. What's more, this 'investment' gives you a place to live as well.

(One word of clarification: when we say housing we do not mean high rise apartments. Their economic future is very different to homes and units in small blocks).

And our advice is not just about homes for clients. We also help with homes for the children of clients and even sometimes the grandchildren of clients. Indeed, it is these adult 'kids' that our clients tend most to worry about. "How will our kids ever afford their own home?" is one of the most common things we are asked. In our blogs and ebooks for this month and next, we will discuss various ways to make buying and holding property as easy as possible. And we will not just focus on your home. We will look at ways to help other people – typically your kids – own their homes as well.

But there is no need to wait for your next email from us. Feel free to contact us right now and we can talk you through ways that make home ownership much more achievable for you and the people you care about.

A home for every child…

(First published 24 February 2017)

If you already own a home, then the last 20 years have been wonderful. For you. But what about your kids? Around Australia, house prices have risen by more than 500% in the last 20 years. How will your kids be able to buy their home?

The world of work is changing, and it’s not a good idea to assume your children will enjoy safe employment with just one or two employers during their working lives.

More probably, as the sociologists tell us, they will have a “patchwork” of part-time and casual engagements, with nothing like the secure tenure that typified their fathers’ and mothers’ employment experiences.

I am sure your kids are bright, and bright people tend to do well financially. But it is still not a safe bet that they will blitz their way in and out of university or trade school and then into the top echelons of the work-force. The competition is tough, and is going to get tougher.

What’s more, the competition is not just here in Australia. The global economy means our kids are competing against the brightest minds from anywhere in the world.

Given all this, you can understand why children stay home well into their mid-twenties. They have no choice: they cannot afford to leave. The entry price in the most popular suburbs in all our major cities is becoming too high for most people under age 40. And even then, you would be amazed how

often the new home is only afforded with a bit of discrete help from grandma and grandpa. It's just not possible otherwise, particular if there are kids in the kitchen or on the horizon.

What can you do to help? Here is one simple solution. "Buy" your child a home now. It does not have to be something they will live in when they are 50. But it should be in a part of the world that has good growth prospects. Buying another home in effect insulates your family against future home price increases – and helps to protect the next generation against the risk of home prices running away even further.

If your own home is paid off or nearly paid off, and you are still earning at a reasonable clip, most of the banks will lend you a similar amount at home loan rates without too much fuss or bother. Make sure the interest rate is the same as the home loan rate: the banks will often try to squeeze an extra percentage point or two here, and have been known to tell clients that they have no choice but to charge that bit extra. "It's the 'investment loan rate,'" they say.

Space does not allow us to explain the tax maths of all this. But we will explain it in our next ebook The User's Guide to Negative Gearing, which will be published in March. The ebook will show that a relatively small after tax cost to mum and dad in the early years spares your child a large before tax cost in the later years. This gives your child a real economic head start in life and, with a bit of luck, the child's own efforts will amplify this head start many times over.

The bottom line is that, for higher income earners, it's almost cash-flow neutral to 100% gear a rental property if the interest rate is 5%, the rental yield is 3.5% and depreciation can be thrown in as well. The tenant (with a little help from the tax office) basically pays the place off for you.

Sometimes, the second and subsequent homes are owned through a family trust and the children just live in them later on while saving for their own homes and investments. This has the added advantage of protecting the children against the risk of losing assets in divorce or a bad business experience. Residential property can be a great investment for a trust (and everyone else for that matter).

This strategy works with one, two or even three children. Maybe the maths become a bit daunting with four or more children, but the idea can of course be modified by buying the homes a few years apart or buying lower priced homes and letting the children up-grade them later under their own steam.

Or maybe just aim for half a home for each child.

Call us old-fashioned, but we think this concept is even more important for your daughters. It might be 100 years since the suffragettes, but women still do not have equal incomes or workplace opportunities. Most women have less than $40,000 in superannuation when they retire. That won't go far.

Virginia Woolf thought it took a room of one's own to achieve gender equality. We'd change that to a home of her own – for each of your daughters.

There is a saying in business that the best time to plant a tree was always ten years ago. But there is an even better saying in philosophy: the meaning of life is to plant trees that someone else will sit under in the future.

These sayings are relevant here. This strategy was a great one to implement ten years ago. The return on residential property was 8% per year for the ten years to December 2015 (source: ASX/Russell Long Term Investing Report. You can read this report here).

An investment returning 8% per annum for ten years provides a total return of 116% for the period. A $400,000 home purchased in 2005 was worth $864,000 in 2015 (including the rent received). If only you had read this in 2007, you would now be sitting pretty!

But ten years ago was ten years ago. The key is to not be having the same regret in 2027. So, get in touch with us now and let us talk you through how you too can help your kids have a home of their own.

The Legal Stuff

General Advice and Tax Warning

The above information is general in nature and does not take into account your personal situation. You should consider whether the information is appropriate to your needs, and where necessary, seek professional advice from a financial adviser.

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