Is residential property the right investment for you?

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In recent years, Australians have developed a love affair with property investing. The concept of investing in houses and units is easier to understand than many other forms of investments, and the investment returns provided in recent years has strengthened its appeal as a method of creating wealth among many investors. Although, long run capital growth estimates for property may be exaggerated by quality improvements over time and so the return in property as an investment can often look better than it really is.

While the performance of residential property has been strong in recent years, latest available data show it lagging other growth assets, and this is before costs and fees are taken into consideration.

In this article, we outline some of the pros and cons of owning an investment property, and the hidden costs that should be taken into account.

Over the past ten years, Australian residential property has delivered lower returns than shares

Past performance is not a reliable indicator of future performance. Source: Bloomberg, Real Estate Institute of Australia AMP Capital, Year to date to December, 2013. Australian shares: S&P/ASX 200 Accumulation Index, Australian listed property: S&P/ASX 200 A-REIT Accumulation Index, Australian residential property: RP Data Property Price Index and REIA Indices.

Pros	Cons
› Generally, you can borrow up to 80% of the property's value (without incurring lenders mortgage insurance), and use equity as security for another investment property[1] › You may be able to earn rental income and benefit from capital growth › Interest on property investment loans is tax deductible › You are investing in something you can see and touch	› There are very high entry and exit costs › High ongoing costs and taxes can significantly dampen capital growth › It can be time consuming dealing with tenancy administration, maintenance and repair work › Unlike shares, property is an illiquid asset that is not quickly sold without a substantial loss in value › A jump in interest rates will increase your interest costs and decrease your disposable income › There may be periods of time where you don't have a tenant and where you will have to cover all costs yourself › If your property is your major investment and you also own your own home, you will have little or no diversification

[1] The maximum you can borrow without having to pay lenders mortgage insurance can vary depending on the financial institution

Understand the true costs involved

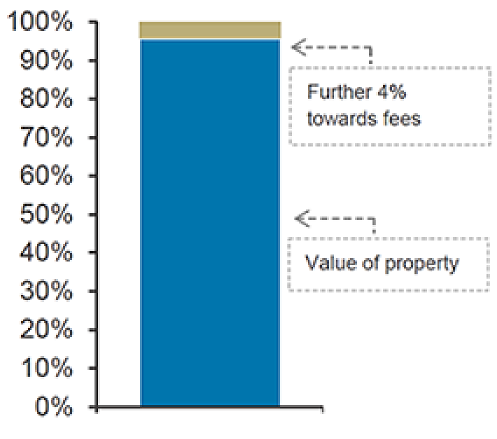
Buying, selling and managing an investment property can be costly and will impact your net return. When you buy a property, you will have to pay for lots of extras on top of the purchase price. Costs may include stamp duty, conveyance fees, legal charges, search fees, and pest and building reports. When you come to sell the property, you will have to pay agent's fees, advertising costs and legal fees. You may also have to pay capital gains tax.

Residential property is notorious for its high entry and exit fees

John and Mary are interested in buying an investment property in Sydney to increase their wealth over time. They have $150,000 in savings, and spot a unit that ticks all the right boxes. The property is priced at $750,000.

They had originally intended to borrow $600,000, however after considering other costs involved, they realise they will need to borrow extra to complete the purchase:

- Stamp duty on the property and mortgage: >$30,000
- Legal and bank fees: >$2,000
- Pest and building inspection: $500



Source: AMP Capital, for illustrative purposes only.

After adding up all these costs, they decide they need to **borrow an extra $33,000**, taking their total loan to $633,000.

If you decide you want to buy an investment property, you'll need to work out how much money you can potentially earn from your investment. To do this, you'll need to consider the ongoing costs that you, as the owner, are responsible for. These may include council rates, water rates, land tax2, insurance, body corporate fees (or strata levies) and property management fees. Don't forget interest repayments and possibly tax to be paid on your rental income, as well as maintenance costs.

Ongoing costs for residential property can affect your investment return

Having purchased a unit as an investment property, John and Mary are able to secure a tenancy which generates an annual income of $29,000 after management fees. After taking into account all other outgoings, they are left with a **shortfall of more than $18,000 per annum**[3] which they will be required to subsidise through alternative income sources.

Annual income	
Gross rental income	31,200
Income less management fee	**29,000**
Annual outgoings	
Water rates	692
Council rates	936
Insurance	1,000
Body corporate fees	5,200
Interest on loan	34,812
Budget for repairs / maintenance	5,000
Total outgoings	**47,640**
Shortfall per annum	**18,640**

Conclusion

When considering if a property investment is right for you, it's important to do your research and seek professional advice if you're unsure about anything.

[2] Land tax is an annual tax levied on owners of taxable land. Exemptions and thresholds apply, check with your office of state revenue for more information.
[3] Some of this shortfall will be tax deductable, that is, you may be eligible to claim this loss back at your marginal tax rate. Please consult your accountant for more information.

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