# Should I invest in residential property?

StatePlus

*Formerly State Super Financial Services*

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*Australians love investing in property. For several generations the great Australian dream has been to own one's own home. However, many Australians also strive to own one or more residential investment properties.*

Property investment is complex. With some rental yields as low as 2% a year, houses and units aren't valued on their investment fundamentals like other assets; they're priced on emotion.

Share market, bond and even commercial property investors recognise that an investment's income stream is important. But it seems that when it comes to residential property, the same rules don't apply. What someone is willing to pay for your property is by definition the market price. And that underpins the difficulty in projecting the outlook for residential property prices.

Measured against average household income Australia has some of the most expensive housing in the world. However does that mean that Australian house prices are in a speculative bubble? Well not necessarily.

Australia is suffering from a chronic housing shortage which will only get worse as demographic demand outstrips supply, particularly in major cities. Continued easy access to debt, combined with historically low interest rates and a generation of first home buyers looking to get into the market, are likely to keep upward pressure on prices.

Buying into an overpriced market is never a good idea from an investment perspective. As we know, the most successful investors buy when the market is down, or depressed, and sell when the market is high. However, if you're seriously considering investing in a residential investment property, the most important thing is that you understand the risks, and how the investment fits in with your financial goals.

## Fundamentals of property investment

Owing to high property prices, most investors purchase their asset with borrowed money. This strategy, known as 'gearing', allows you to increase your investment exposure, gaining access to investments you would not otherwise be able to afford.

It also means that if the property price rises, then you magnify your investment returns. Of course, the flip side to this is that if the property price falls, your losses are magnified, potentially taking you into negative equity, where the debt is larger than the property price.

If you rent the property out to tenants, then the interest you pay on your loan will be tax deductible. At current rental rates, your investment property is only likely to yield 3 – 4% pa, while the interest rate on your loan will be significantly higher. This strategy of ongoing losses is known as 'negative gearing', and a tax deduction is generally available, reducing the tax you pay on other income, like your salary.

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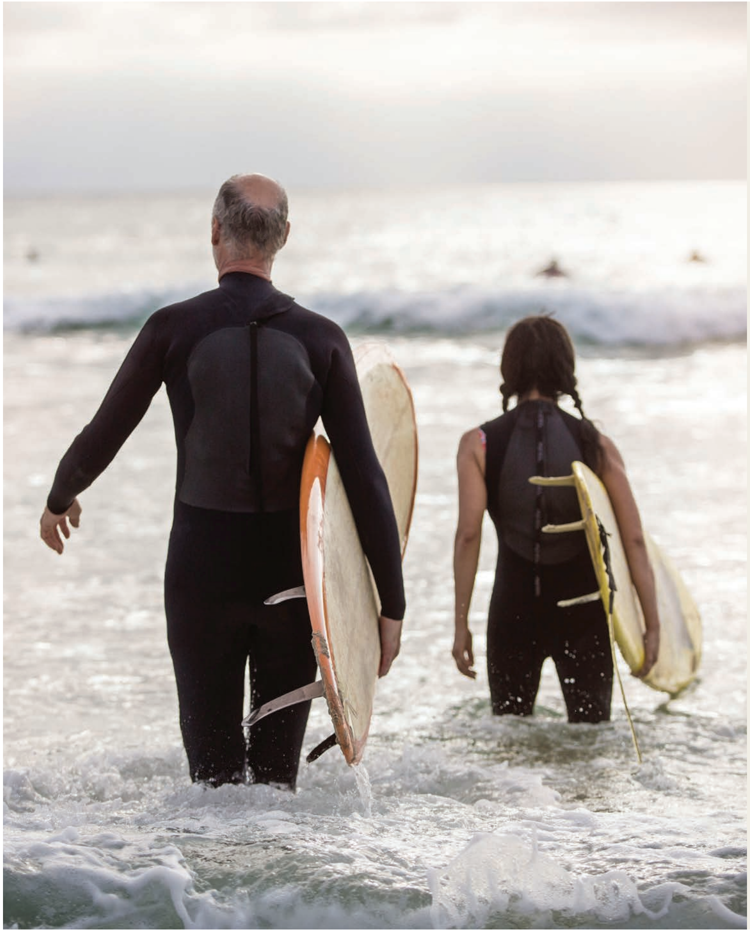

### Property investment and retirement

Generally, an investment in a residential property is better suited to a wealth creation strategy than a retirement portfolio.

Any tax benefit from gearing will usually be wasted in retirement because income from your super is tax free after age 60.

Unless you have a significant investment portfolio, it is likely that your continued ownership of an investment property will limit diversification. This means that you will expose yourself to the risks associated with putting all of your 'eggs in one basket'.

Further, low rental yields may not provide enough income to meet your living expenses in retirement. This is especially important if you choose to hold property as the major, or only, investment in a self-managed super fund (SMSF), as rental yields may be insufficient to meet minimum pension payment requirements. Since most retirees spend more in the early years of retirement, it may be preferable to invest in a portfolio that allows flexibility and easy access to capital.

### Still interested?

Many Australians have built significant wealth through property investment.

If you have your heart set on a residential investment property, then you should ensure that any debt you take on can be serviced should your financial circumstances or economic conditions deteriorate. Make sure you understand the ongoing costs, and be prepared for the possibility that they may not be matched by future capital gains.

A negative gearing strategy is only successful if capital growth outpaces the accumulated losses. So you shouldn't just be concerned with whether the property will lose capital value, but whether it will generate the capital gains necessary to bridge the gap between the rental income you receive and your interest payments.

But it's not just the interest payments you need to cover. As well as the upfront entry costs like legal fees and stamp duty, ongoing costs include maintenance and rates. When it comes time to sell, you will need to pay agent fees and, of course, any capital gains over and above the costs will be subject to capital gains tax.

Property is an illiquid investment which means it cannot readily be converted into cash. It's also indivisible, which means that if you need access to funds, then you'll have Basic Advice Series to sell the whole property. And if you need to sell in a hurry, then it is unlikely that you will optimise the selling price.

To find out more about how we can help you now and in the future call your member service team on 1800 620 305



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