

Investment Concepts – Costs and Risks of Direct Property

Benefits

Owning a property directly (direct property), whether as a home or as an investment, can provide a number of benefits, including:

- Not having to pay rent on a property you live in as your own home.
- Receiving rental income from an investment property.
- The capital value of the property may increase over time.

Historically, in major cities at least, the capital appreciation (or increase in the value) of property over the longer term has generally kept up with or exceeded the rate of inflation. This is not certain and depends on the location and physical condition of the property, as well as the market's supply and demand.

Direct property assets include the following:

- Residential: house, townhouse, unit or apartment
- Commercial: retail or office
- Industrial: workshop or factory
- Rural: farm

You may purchase an established property, purchase land and build (privately or a 'house and land package' through a developer) or purchase a property 'off-the-plan' which means before construction has even commenced.

Considerations

Any decision to purchase, retain, or sell a direct property asset should be carefully considered as there are specific issues, costs and risks associated with this type of asset. Below is a summary of some of the issues, followed by more details on the main costs and risks, relating to direct property assets.

- Large amounts of capital are required and you may need to borrow money.
- There are significant upfront, ongoing and sale costs.
- Direct property assets can be illiquid, making it difficult to access your capital in the future.
- Owning direct property investments may reduce the diversification of your portfolio.

Purchasing direct property

- **Purchase costs:** There are many upfront costs associated with direct property such as:
 - Time and cost of searching for a suitable property
 - Pest and building reports
 - Legal and conveyancing fees
 - Loan establishment costs
 - Stamp duty
- **Location:** The character and location of a property can have a big influence (positive or negative) on the current and future desirability of the property to purchasers and/or

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tenants. It is important to consider potential changes in the suburb that may affect future prices like planned developments or population changes.

- **Timeframe:** Direct property should be viewed as a long-term investment. This is due to the potential short-term volatility that the direct property market (and/or specific locations) may experience. It may also take time to recover the significant initial and ongoing costs related to purchasing a direct property asset.
- **Opportunity cost:** When purchasing direct property, you give up the opportunity to use that money to invest into other assets which may be more appropriate to helping you achieve your financial goals and objectives. You need to consider if a direct property investment will provide you with the best net-return after taking into account all estimated costs, risks and returns.

Owning direct property

- **Risk vs return:** The return on direct property is impacted by various risks which affect income and growth of the property. The rental income you receive will depend on the supply and demand for the type and condition of the property in its location. The capital growth or loss on a property also depends on the location and condition of the property and its desirability for potential purchasers. Other influences also include movement of interest rates that may affect a buyer's affordability.
- **Lack of diversification:** If you invest only in direct property assets, you will have all of your wealth concentrated in the property market. Poor diversification increases your risk since no one type of asset class provides the best performance over all time periods.
- **Lack of liquidity:** Direct property is an inflexible asset. You can't sell off a bedroom if you urgently need access to some cash. If you decide to sell a property, there is usually a lengthy time-delay between making the decision to sell and receiving the sale proceeds.
- **Tenants:** There may be periods of time where you don't have a tenant and will have to cover all costs yourself. Tenants may also damage the property, and may pay the rent late or not at all.
- **Ongoing costs:** There are many ongoing costs associated with direct property, including:
 - Council rates, water rates, insurance, land tax, agent fees and body corporate fees.
 - Loan interest, repayments and fees.
 - Maintenance and repair of existing structures and fittings (both internal and external).
- **Improvements:** Often capital improvements to a property are necessary (for example, the replacement of an oven or air conditioner). Such capital expenses can be costly and unplanned. Other costs may include building or renovation work.
- **Legislative risk:** There is a risk that the capital gains and social security concessions related to certain property assets may be made less favourable.
- **International property:** Where international property is being held or considered, it is important to be aware of any applicable international tax laws, residency issues and currency risks before you proceed with any purchase or sale.

Selling direct property

- **Sale costs:** There are many sale costs associated with direct property. These may include.
 - Time needed to select an agent to manage the sale
 - Time spent preparing and vacating the property for inspections
 - Legal and conveyancing fees
 - Advertising costs

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- Agent fees
- **Capital gains tax (CGT):** Generally, unless the property has always been your home, you may have to pay CGT on some or all of any gain in the value of the property. This could reduce the net sale proceeds available to you once the property is sold.
- **Sale date uncertainty:** Unlike some other asset types, it may take months or even years to sell a direct property. This could be due to the property's location and desirability (or lack of), the asking price, the length of the settlement period and/or the state of the property market. Generally, it takes at least two months from the time you decide to sell until when you receive the sale proceeds.

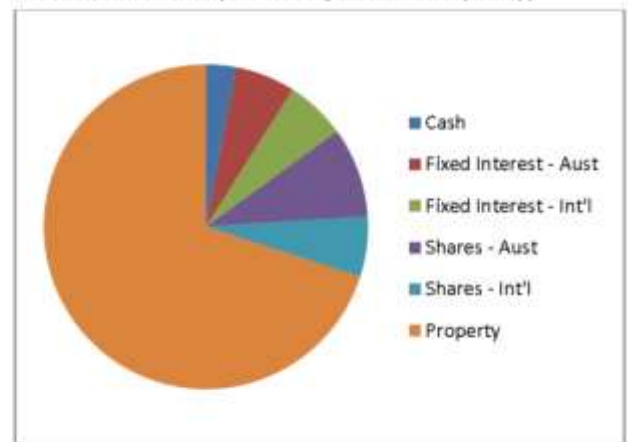
Investment risk profile and asset allocation

- Generally, once your investment risk profile is confirmed with your adviser, it will be used to determine how your portfolio will be invested across the various asset classes. This is known as your target asset allocation. Unless otherwise noted, your investments other than direct property will be invested in line with this target asset allocation.
- When direct property assets are included as part of your overall investment portfolio, this may have a significant impact on your overall asset allocation through reduced diversification. It will increase your exposure to growth assets relative to defensive assets. It will also reduce your exposure to all other asset classes relative to direct property. For example, a client with a 'moderate' risk profile (50% Defensive / 50% Growth) who owns a direct property valued at \$700K and superannuation and other investments valued at \$300k will have the following asset allocation (excluding/including direct property).

Asset Allocation (excluding Direct Property)



Asset Allocation (including Direct Property)



Other property-related professionals & service providers

There are a range of other professionals and service providers that can assist you with different aspects of direct property purchase, ongoing ownership and sale. These are shown in the table below including a description of what they do and where you can go to obtain more information.

Who	What	More information
Valuers / Quantity Surveyor	<p>Valuers can provide comprehensive reports on the current market value of a property.</p> <p>Quantity Surveyors provide depreciation schedules to estimate costs of depreciable items in a property.</p> <ul style="list-style-type: none"> • Site inspections 	<p>The Australian Property Institute www.api.org.au/about-certified-practising-valuers</p> <p>Australian Institute of Quantity</p>

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Who	What	More information
	<ul style="list-style-type: none"> Valuation reports Depreciation schedules Usually charge an agreed fee.	Surveyors www.aiqs.com.au
Real Estate Agent	Specialise in selling property usually for a commission but sometimes for an agreed fee. <ul style="list-style-type: none"> Trends in local property market Market appraisals Negotiating selling of properties 	Real Estate Institute of Australia www.reia.asn.au
Buyers Agent	Assist property purchasers/investors with property selection and negotiation for a fee calculated as a percentage of the purchase price or an agreed fee. <ul style="list-style-type: none"> Selection of investment property Negotiation Purchase 	Real Estate Buyers Agents Association of Australia www.rebaa.com.au
Pest / Property Inspectors	Assesses both the interior and exterior condition of a property for an agreed fee. <ul style="list-style-type: none"> Pest reports Building reports 	Search for Pest and/or Property Inspections on your state or territory website (eg. NSW Fair Trading)
Conveyancer / Solicitor	Provide legal advice and services related to property investments usually for an agreed fee. <ul style="list-style-type: none"> Contract review Local council requirements Stamp duty and land tax Wills & Estates 	Australian Institute of Conveyancers www.aicnational.com.au Look at your state or territory Solicitors – search for ‘Law Society’ in your state or territory
Property Investment Adviser	Work with property investors to build personalised long term property investment plans for an agreed fee or sales commission. <ul style="list-style-type: none"> Risks & benefits Goals & strategies 	Property Investment Professionals of Australia www.pipa.asn.au
Property manager	Look after the management of your rental properties usually for a fee calculated as a percentage of the rental income. <ul style="list-style-type: none"> Managing tenants Conduct regular inspections Maintenance requests 	Real Estate Institute of Australia www.reia.asn.au
Builder / Developer	Specialises in building and developing new properties and makes profits by selling the properties for more than the costs of construction, marketing and sales. <ul style="list-style-type: none"> Apartment complexes House and land estates Off the plan 	Ensure you research the builder(s) and developer(s) you are intending to purchase a new development from Search state of territory website (eg. NSW Fair Trading)
Research Providers / Project Marketers	Market new properties to prospective buyers and usually charge a sales commission. <ul style="list-style-type: none"> Information Marketing Sales 	Ensure you understand who these businesses are representing and how they are getting paid

The Australian Securities and Investment Commission (ASIC) Moneysmart website includes some very useful information to help people make the most of their money – including a specific section on property investment (www.moneySMART.gov.au/investing/property).

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