Investments

03

PROPERTY GROUP
maple

LET'S START WITH SOME BASICS.

Investing has become a particularly loose term in the 21st century, with strange financial instruments being drummed up by various financial institutions, new products such as cryptocurrencies and binary options being subject to network marketing groups and complex legal structures designed to confuse.

With this new age of information sharing, questions arise - what should I invest in? How do investments work? Why should I invest at all?

The purpose of investing is to ensure that your money can grow faster than inflation (basically, the increase in the cost of living). As an example, you could imagine $100 in your bank account, with 2% inflation in one year, is reduced by $2 in that year in terms of its ability to purchase goods or services. If that some $100 was invested in, for example, shares, it would have increased in purchasing power. As an example, the same $100 invested in shares with a 10% return would be worth $110 (and of course, inflation will still take it's share as well). Fairly basic right?

But why do we care what inflation does to our $100 you might ask? After all, I earn $80,000 per annum - won't that increase with inflation? Well let's say, for argument's sake, that it does. As long as you keep showing up to work, you should be fine. But what happens if you hope to stop working at some stage? What happens if you become unable to work? Well, you're going to need to replace that income somehow. This is where investments step in. Most investments should provide some form of income (property has rental income, shares have dividends, bonds pay coupons - you get the point).

Given this, the first thing you need to think about is "how much income do I need if I stopped working?". The next question should be "how much do I need invested to produce that income?".

LET'S USE AN EXAMPLE:

- Scott currently earns $80,000 per annum and decides that, if his mortgage were paid off, he would probably need around $60,000 per annum to be comfortable (new car every 5-10 years, medical expenses, general living expenses and a holiday once per year)

- Scott also owns an investment property worth $350,000 - and it's completely paid off! This investment property is rented at $340 per week (or

$17,680 per year) which means it has a rental yield of around 5% - pretty typical for this type of investment.

Assuming Scott continue to get investments that produced about 5% yield, he would need $1,200,000 to get his retirement income of $60,000 per annum.

Hopefully this can act as a guide into figuring out your own retirement needs. Obviously, these are just examples, income from investments can vary but we believe 5% is a pretty good place to start.

Now that you've figured out how much you're going to need saved up, I'm sure you're wondering "how do I save my way to that number!?".

EXACTLY - YOU DON'T.

Investment income is only half of the picture. The other half is growth, possibly the most important part of your investment criteria. Investing your money now, allows you to utilise time in the market to increase the value of your overall portfolio. More than this it allows you to take advantage of a number of tools which will help you grow faster than trying to save and outpace inflation. For example, you can utilise leverage to take control over a larger asset, take advantage of compounding interest by starting sooner than later and reinvest income from an asset to grow your portfolio.

Investing also allows you to reach other goals faster as well. Saving for children's education, leaving an inheritance, purchasing your dream home? All of these can be achieved in a more timely manner through investing.

SO WHAT'S THE DOWNSIDE? TO PUT IT SIMPLY - RISK.

Risks are abundant in the world of investing - losing your hard earned capital, investing in scams, market crashes, foregoing short term pleasures, the list goes on. But perhaps the most common risk of all is where people get their advice from. How many times have your friends told you about a mining share that you should have brought, or tips on which property market is about to boom? Unsolicited advice based on no criteria or statistical analysis can be seriously damaging to an investors portfolio.

People also invest to take advantage of using their tax dollars for their future.

Now that you know WHY, let's take a closer look at HOW.

SHARES

The concept of investing into shares (also known as equities) is really quite simple - you purchase a share (equity) in the company's ownership! A company worth $100 with 100 shares would sell shares at $1 each. Companies that list on a stock exchange are what is known as publicly listed companies and these are the shares that can be bought and sold between members of the public.

The biggest question investors have with shares is "which shares do I invest in?".

First and foremost, it is important to ensure that you diversify into shares. This is no simple feat however it is important to recognise that there are some major factors:

> **Countries or markets** (e.g. Australian shares, US shares, Japanese shares)
> **Industries** (Medical, financial, minerals etc.)
> **Companies** (for example, which companies in a particular industry in a particular country?)

Thankfully technology has simplified this process through the introduction of instruments such as index funds and exchange traded funds (ETFs).

An **Index Fund** is similar to a managed fund (someone else does the investing and you buy into a share of that investment) however instead of trying to beat the market and charging abhorrent fees, an index fund manager invests into a particular stock market (such as the Australian Stock Exchange) and purchases a proportionate amount of each of those companies. For example, let's say the Australian Stock Exchange is made up of the following companies in the following shares:

> A = 10%
> B = 20%
> C = 20%
> D = 30%
> E = 20%
> Total = 100%

Now, there is an Australian Index Fund created, it invests in all the above companies. Let's say the fund is worth $1000. The index fund holdings would be:

> A = $100
> B = $200
> C = $200
> D = $300
> E = $200
> Total = $1000

The final part of this is example involves you, the investor. Let's say you have $100 you wish to invest. You decide to invest into the Australian

Index Fund. Your $100 would be spread according to the following:

> A = $10
> B = $20
> C = $20
> D = $30
> E = $20
> Total = $100

Pretty simple right? The beauty of this is that the Australian Stock Exchange as a whole is a pretty safe bet, as opposed to the 'trying to pick a winner' approach which, unless well versed in equities analysis, is really like gambling.

An **Exchange Traded Fund** acts in a similar fashion however the ETF itself is actually traded on the stock exchange just like a normal share - much as the name suggests. Moreover, the ETF's purpose isn't necessarily to represent an entire market. There are ETFs that invest in a variety of different areas. For example, you can trade ETFs that specialise in gold, property, bonds, cash, different industries and even cryptocurrencies! The important thing to consider is whether or not you are getting exposure to enough asset classes, in enough markets, across enough industries and in a variety of companies.

Another important consideration of shares is the fact that they are a particularly volatile investment. What this means is that the price of the asset can vary considerably over short periods of time. The share price that is currently available at any given time is how much the particular share was last traded at (i.e. Party A purchased the stock for $2.71 from Party B so therefore it appears as $2.71), and given how much volume is in the market, this changes from second to second in most cases. The share market is particularly susceptible to large movement because of how easy it is to trade in or out of shares (liquidity). Therefore, if a natural disaster occurs in, for example, Japan, traders might decide that this will negatively impact that economy and so start selling shares from that market, which will have a negative impact on the share price. If this happens enough the price will 'crash' so to speak.

Finally, it is worth considering, in line with the above, how 'liquid' shares are as an asset. Liquidity is the ability to transfer an asset into cash. For example, if you have a property, it would be considered to have low liquidity as there are barriers to selling the asset for cash. Shares on the other hand are incredibly liquid thanks to the advancement of technology allowing traders to buy and sell almost immediately.

This can be a good and a bad thing. On the one hand, liquidity means that they can be accessed in the event of an emergency.

However, on the other hand, this can mean temptation for some people. In a lot of instances, having your money tied up in an investment that can't be immediately sold can result in better decision making for the long term.

PROPERTY

Investing in property is something that most Australians are fairly familiar with, whether it be themselves, a family member or a friend. The concept of owning a property that someone else lives in and pays rent is pretty straight forward - figuring out which property to buy, when and where, and a multitude of other factors are often overlooked during the purchase process and are responsible for some of the 'horror' stories you might hear.

Everyone has heard of the investment property destroyed by bad tenants, or the negative equity situations in rural Queensland and Western Australia after the mining boom slowed and destroyed single economy towns. So how can this be avoided, if at all?

The answer is not so simple, and no one can ever know exactly what is going to happen. You just need to follow some basic steps to give yourself the best chance:

> **Get educated** about what makes and breaks an investment property;
> **Use this education** to create or follow a selection criteria;
> **Invest with numbers and logic**, not emotion and hearsay; and
> **Find a team** who work harder to get a positive outcome.

With this in mind, let's cover some of the basics.

RESIDENTIAL VS. COMMERCIAL

Again, these concepts are fairly straight forward, residential properties are for people to live in, commercial properties are places where business is carried on. Deciding whether to invest in residential or commercial is probably the first step so let's take a closer look at both.

Residential properties can include apartments, units, townhouses and standard property formats, each carrying advantages and disadvantages specific to themselves. Choosing which style of residential property depends upon your specific preferences, your goals, your attitude towards risk as well as your time frame.

Residential properties typically have lower vacancy rates than commercial properties and as such, usually have lower rental yields (4-5% is a healthy number). This can prove to not be true in certain circumstances and often rental yield will correspond with either the vacancy rate or the likelihood of growth in a particular region i.e. if the likelihood of growth is low then rental yield will typically be higher.

A number of factors influence this including how many people want to live in the area, the price of the asset itself, how many properties are available in the area and various other factors.As an example, a property may rent in a rural region for a rental yield above 10% as there are renters in that market, with not many places for rent as it is mainly retirees who own properties in the region and not many properties available for rent. For obvious reasons you can imagine this would have a negative impact on the rate of growth of these properties. Conversely, a property in inner city Melbourne, an area that has seen particularly high growth, would see properties selling at over $1,000,000 however with a rental yield of perhaps 2-3%. This occurs as typically, people who are renting are not willing to pay a premium for a $1,000,000 property. It is worth considering that a similar property, further from the city might not be valued at $1,000,000 and so the rental yield would become closer to 4-5% without any change in rent.

Commercial property is influenced by a multitude of factors. Often macroeconomic (national) factors will have more impact on the yield and growth of a commercial property. Things such as legislative changes in parliament can even affect commercial property. Wage growth, employment rates, inflation, interest rates, international trade and more, all affect commercial property. It is worth noting that commercial property tends to have higher vacancy rates than residential and as such have correspondingly higher rental yields (typically). Higher rental yields can be a good thing for income however, if borrowing to invest, the lower vacancy rates can cause cash flow and repayment issues, ultimately becoming a burden on the investor.

It is also worth considering the flexibility of borrowing to invest. To begin with, an investor can typically borrow anywhere from 80-95% of the value of a residential property (depending on the bank, the investors position, and a number of other factors) whereas lenders will usually limit this to around 60% in commercial property, meaning the investor must have a much larger deposit. Further to this, the lender will regularly revalue the commercial property to make sure the investor is still within this 60% restriction. Lenders tend to see commercial property as a riskier asset and as such will continue to revalue the property to make sure the value doesn’t drop too much.

If the value drops the loan becomes worth more than 60% of the value of the property, the lender will actually ask the investor to come up with the funds (cash) to reduce the margin back to 60%. Given this, commercial property tends to be more suitable for investors who are looking to make a cash purchase and are happy to brave the lower vacancy rates.

One of the great benefits of investing in shares is the ability to leverage (borrow to invest) a much higher amount than you can in shares. Let's use an example of an investor who has $100,000 available to invest:

Cash Invested	**Shares (leveraged)**	**Property (leveraged)**
No leveraging	LVR Max 60%	LVR Max 80% (90% possible but incurs Lenders Mortgage Insurance)
Total value = $100,000	Total value = $250,000	Total value = $500,000
Growth of 5% = $5,000	Growth of 5% = $12,500	Growth of 5% = $25,000
Income of 5% = $5,000	Income of 5% = $12,500	Income of 5% = $25,000
Gross return = $10,000	**Gross return = $25,000**	**Gross return = $50,000**
No loan	Loan interest rate = 7%	Loan interest rate = 4.5%
Costs = $0	Cost of interest = $10,500	Cost of interest = $18,000
Net return = $10,000	**Net return = $14,500**	**Net return = $32,000**

The above table illustrates how leveraging into property allows you to take advantage of growth and income over a larger asset with a better cost ratio. It is worth noting that if the property is residential, it is not subject to a margin call which the shares would be.

What this means is that if, at some point during the year the shares drop suddenly in value (even if they recover), you might be asked to top up the loan with your own cash to ensure that the loan remains at 60% LVR. This would not occur in a residential investment property.

COMPOUNDING INTEREST

Finally, let's take a quick look at why it's so important to begin investing as soon as possible and figure out how much each wasted year is costing.

The idea of compounding interest is really quite simple. Let's imagine the rate of return is stable each year at 10%. Each year the 10% is calculated on a higher amount than it was the year before (because you've had growth).

For example:

> $100,000 invested @ 10% = $10,000 return in year 1
> Portfolio is now worth $110,000 @ 10% = $11,000 return in year 2
> Portfolio is now worth $121,000 @ 10% = $12,100 return in year 3

Each year this becomes more and more powerful. If we take a look at longer returns this will become clear. How would $250 a week invested at 10% look if you kept going until age 60?

LET'S COMPARE:

Starting at age 25	Starting at age 30	Starting at 40
$1,278,512 by age 50; or	$744,575 by age 50; or	$207,187 by age 50; or
$3,523,317 by age 60	$2,138,422 by age 60	$744,575 by age 60
Difference at 60	**-$1,384,895**	**-$2,778,742**
Retirement income = $176,165 pa	**Retirement income = $106,921 pa**	**Retirement income = $37,228 pa**

As we can see, even just 5 years can make your retirement look incredibly different. We can also see that starting later can severely impact your ability to actually retire and have the lifestyle you want. Obviously you can try and save more or retire at a later stage, however starting today is the strongest investment tool that you have.

CONCLUSION

In this publication we discussed reasons why you might invest and how to figure out how much you will need in the long term. We also discussed the importance of starting sooner rather than later to take advantage of compounding interest and ensure you have enough time to generate the level of wealth required to achieve your personal and lifestyle goals - even if it's just to leave something for the kids!

Hopefully this publication has helped you to understand the basics of investing, but more importantly how many considerations there are. The pitfalls of investing usually come from people taking unnecessary risks, receiving (and acting upon) advice from people such as friends or colleagues and by overestimating their own ability to see the whole picture. Investing should be about numbers and logic, not emotions. It's important to understand how investing works but it is almost always beneficial to work with experts when it comes to securing your financial future.