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The return of rental property

John Collett
July 8, 2009

An undersupply of housing and weak returns from other assets has put the spotlight on investment property. John Collett talks to the experts.

Advertisement

Following the dismal performance of shares and super funds, many older investors are likely to have a renewed appreciation for the value of a reliable income stream generated by investment properties.

Super funds have posted their worst returns since super was introduced in 1992, with default funds falling, on average, 13 per cent for the year to June 30. More aggressive "growth" funds have lost about 20 per cent.

Baby boomers in particular, hit hard by these losses and the freezing of redemptions on mortgage, property and fixed-income trusts, are likely to be considering the merits of a rental property over which they can exercise their control.

There are signs this group has become disillusioned with the performance of their super funds and managed investments in general, as well as governments' constant tinkering with the super rules.

The Government is increasing the age pension age to 67 and it is likely to put restrictions on access to super lump-sum benefits as Australia's population ages.

Investors are likely to be considering re-weighting their portfolios from shares into property, says an economist for ANZ, Alex Joiner. He says they can buy in an area they know, at a good yield, with vacancy rates often only 1 per cent or 2 per cent.

BIS Shrapnel is a bit more bullish in the prospects for property price growth than many researchers. In a report released last month, Residential Property Prospects 2009 To 2012, the property researcher found although first-home buyer demand is expected to ease after the expiry of the Federal Government's grant scheme at the end of 2009, the baton is expected to pass to upgraders and investors.

An economist at Australian Property Monitors, Matthew Bell, is also positive on property.

"For Sydney and Melbourne, I expect to see the unit median price grow moderately for the remainder of 2009, with stronger growth in 2010," he says.

But the question is whether investors chasing a property bargain are better advised to hold fire until the first-time buyers have had their fill, or take the plunge now.

Some market watchers suspect that first-home buyers may be paying over the odds. The market for units costing less than \$500,000, where first-home buyers are particularly active, has experienced moderate price growth, against generally flatter prices in the middle price ranges.

A property commentator and founder of hotspotting.com.au, Terry Ryder, dismisses the notion that the first-home owners' incentives are creating a bubble in lower-end property. There has been a small rise in prices in first-home owner suburbs, he says. But it has been areas, especially in Sydney, where there has been no growth for five or six years. "It is hardly a cause for concern," he says. Ryder says first-home buyers have been driven more by low interest rates and softer prices in a lot of areas and less so by the first-home owner incentives.

There are recent signs property markets generally have turned the corner, after almost six years of treading water in Sydney (though, upper-end prices have fallen substantially) and two years of mostly flat prices in Melbourne.

Over the past year Melbourne and Sydney property prices are up 3.5 per cent, according to RP Data.

The chief economist at CommSec, Craig James, says the combination of low interest rates, tight rental markets and generous grants to first-home buyers is pushing house prices higher.

"Sydney and Melbourne dwelling prices are back at record highs while other capital city home prices are not far off peak levels," James says.

"It is a simple case of supply and demand. Demand for homes is being spurred by improved affordability, the fastest population growth in 40 years and weak returns on other assets," he says. "At the same time, Australia continues to experience an undersupply of homes through lack of building over recent years. Demand for homes exceeds supply, pushing prices higher."

COST OF FINANCE

But there are more twists and turns for would-be property investors than just what is happening on the prices front. They have to keep a careful eye on the cost of finance.

While interest rates are expected to be on hold for the time being and may go a bit lower during the next 12 months, they will eventually return to normal levels. That will mean variable mortgage rates of 8 per cent or 8.5 per cent rather than the 5.8 per cent now.

Not everyone is convinced on the merits of property investing. The founder of Motivated Money, Peter Thornhill, says the emphasis on owning a roof over our heads, rather than renting, has pushed the prices of houses above what is justified by rents.

"In Australia, there is much emotional overlay with property and the tax system is skewed towards home ownership," he explains.

Thornhill says there are big transaction costs when buying and selling property, such as stamp duty and fees to real estate agents.

He says many investors fail to account for these when assessing the performance of their property investments. "Nor do many investors properly account for the costs of renovation or improvements," he says.

Also, unemployment will increase and that could put pressure on prices at the lower end of the market. It could make it harder for investors to find and keep good tenants. The Federal Government and the Reserve Bank of Australia are expecting unemployment to hit more than 8 per cent by the middle of 2010 from an unemployment rate of about 5.5 per cent now.

Ryder says higher unemployment is unlikely to mean lower prices. When unemployment has risen in the past, prices have continued to rise, he says. That's because the Reserve Bank tends to cut interest rates when unemployment is rising, which helps to support property prices.

Nevertheless, competition from first-home buyers has been so intense since late last year that many investors seem to have stepped back for the moment, the senior corporate affairs manager for Mortgage Choice, Kristy Sheppard, says.

"Property investors have been sitting back and waiting until the first-home owners boost ends [at the end of this year] before they jump into the market because they are facing so much competition from first-home buyers," she says.

OLDER UNITS BEST

Many property investors are attracted to apartments because they are cheaper than houses and easier to maintain.

The managing director of Residex, John Edwards, says investors have greater potential to achieve higher rental returns from units than from houses because units generally produce higher rents in relation to the purchase price.

Apartments also appeal to investors because demand is stronger from tenants for units than for houses, Edwards says.

This gives investors greater power in negotiating rent increases and units are likely to be vacant for shorter periods of time, he says.

While the markets in Sydney and Melbourne, overall, are holding up well given the economic backdrop, the upper-end housing in Sydney and, to a lesser extent, in Melbourne, is under pressure.

"But under \$500,000, investors can pick up surprisingly good deals in the inner areas of Sydney and Melbourne," the managing director of SQM Research, Louis Christopher, says.

These are hard to come by but for patient investors there are one-bedroom apartments in Sydney's Mosman, for example, with views of the harbour for less than \$400,000 (see top picks, page 5).

Christopher says there is good buying potential in the sub-\$500,000 unit market in Melbourne's St Kilda West and Sydney's Potts Point.

These two suburbs are also among the top picks of Cameron Kusher, a senior analyst at RP Data. St Kilda West has a median unit price of \$344,000, which Kusher considers undervalued for a bayfront suburb.

"It has good transport links while being slightly removed from the hustle and bustle of St Kilda," Kusher says. He also likes Footscray in Melbourne. "It has a median unit price of \$240,000. It is dominated by two- and three-storey 'walk ups' with good transport links and ongoing urban renewal of the area should help to increase the prices of all units," he says.

Among Terry Ryder's top-five picks for Sydney and Melbourne, he includes Sydney's Lakemba, which some investors may shy away from. "But for those seeking a cheap property with above-average yields, it's worth considering," he says. "You can buy a two-bedroom unit for under \$200,000 and rent them for between \$230 and \$260 a week."

Ryder also likes Sydney's Chippendale. "It is close enough to the CBD to walk to work, it's right beside universities and it's on the train line."

In Melbourne, Ryder likes Windsor. "It's testimony to the power of the ripple effect," he says. The popularity of South Yarra and Prahran is rippling through to Windsor, he says.

He also likes Melbourne's Carlton. "Carlton has enduring appeal because of its cosmopolitan lifestyle near universities and the CBD," he says.

Student apartments are not for everyone and they have their limitations for investors but they offer low entry prices and above-average yields, though body corporate fees can be higher than normal, he says.

Yield v capital gains

The undersupply of apartments in Sydney and Melbourne is getting worse, says Angie Zigomanis, a senior analyst with BIS Shrapnel. That, combined with lower prices for units and continuing urban consolidation (more people living in units), augurs well for apartment investors. And the yield also tends to be higher for units than for houses.

"Up to \$500,000 price-point, you typically look at yields that are more attractive than \$1 million-plus properties," he says.

For most property investors the rule of thumb is that they should be getting \$500 a week for a property costing \$500,000 - a gross rental yield of 5 per cent.

"I think that yields are a bit better than that for older apartments in some areas, which have been a little bit unloved and are generally cheaper," Zigomanis says. However, detached houses, generally, will experience greater capital gains over the long term than units in the same area, he says.

As to the question of whether investors are better off with an older-style apartment or a relatively new apartment with a gym and a swimming pool, the numbers tend to favour the older apartments.

"The body corporate fees for the facilities in the newer apartments may offset the higher rents and investors may be better off with a unit without those costs," Zigomanis says. "Investors may get a better net rental return on the basis of lower body corporate fees."

Terry Ryder, property commentator and founder of hotspotting.com.au, says he discourages people from buying new real estate because it is expensive, with buyers paying the developers' costs and profits. He says older apartments that have some individuality are best for capital gains.

The managing director of Residex, John Edwards, says the best return, with respect to both rent and capital gain, comes from properties that most people want to buy or rent. That means properties that are affordable for most people. He says most investors would probably be better off with units that are not old but "mature", in those suburbs in which apartment complex development is complete and supply of new apartments is tight.

He says would-be property investors, when doing the numbers on any potential investment, should consider the prospective investment from a total return (capital growth plus rental yield) perspective. The prospects for capital growth from all assets, including property, are likely to be lower than in the past and rental yields will be a much more important consideration for property investors.

A fairly common error is to pay too much for the property.

Analysis by Residex of the prices paid for property shows that in about 15 per cent of property purchases, buyers pay too much.

"I have the philosophy that you make your money when you buy, not when you sell," Ryder says. "Investors should buy well and now is a good time to buy well because investors can negotiate from a position of strength."

FIVE TOP PICKS - UNITS UNDER \$500,000

CAMERON KUSHER

Senior analyst

RP Data

SYDNEY

Potts Point

Stanmore

Crows Nest

Chippendale

Newtown

MELBOURNE

Flemington

Footscray

Coburg

Abbotsford

St Kilda West

TERRY RYDER

Founder

Hotspotting.com.au

SYDNEY

Chippendale

Lakemba

Ryde

Randwick

Dee Why

MELBOURNE

Carlton

Maribyrnong

North Melbourne

St Kilda

Windsor

LOUIS CHRISTOPHER

Managing director

SQM Research

SYDNEY

Potts Point

Mosman

Balmain

Elizabeth Bay

Freshwater

MELBOURNE

Williamstown

Sunshine

Carlton

St Kilda West

Albert Park

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