

NZFUNDS

# How property stacks up



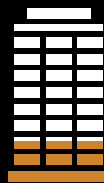
21%

of clients chose a  
flat as an investment



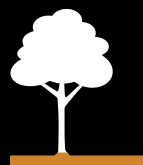
84%

of clients chose a  
house as an investment



23%

of clients chose a commercial  
property as an investment



9%

of clients chose bare  
land as an investment

SOURCE: NZ FUNDS PROPERTY SURVEY, 21 JULY 2014.  
BASED ON 165 RESPONSES.

IMAGE: 'AUCKLAND CITY' PHOTOGRAPHER: CAROLYN ARCHER



Nearly half of the NZ Funds clients surveyed own or have owned a rental property. Of the 52% who have not, about half would consider investing in property in the future.

There is little debate about the merit of owning your own home, but how does property stack up as an investment? To answer this question, we analysed investment property returns over the last 20 years. We also researched your attitude to, and experience with, property investment.

#### HOME OWNERSHIP IS NOT A RENTAL

**68%**  
of New Zealanders own their own home.



Statistics New Zealand



Statistics New Zealand, REINZ



NZ Funds Property Survey, 21 July 2014

SOURCE: NZ FUNDS CALCULATIONS, STATISTICS NEW ZEALAND, NZ FUNDS PROPERTY SURVEY, 21 JULY 2014.

## Home ownership

Most clients' perception of property is gained through the purchase of the family home. Despite being considered one of life's more stressful experiences, home ownership can stack up well. And so it should. As a property investment your home is tenanted for life. Not only that, but the tenant (you) willingly maintains and repairs the property free of charge. Home ownership is also unlikely to be a short-term commitment. The average New Zealander owns their home for 17 years, maximising their potential for a meaningful capital gain. Few of us can afford our first home without the assistance of a mortgage, which we diligently pay off over our working life, turning a highly leveraged investment into a wholly owned asset. By the time we come to sell, it is not unusual to have made a multiple of our initial investment tax free.

## Investment property types

Investing in property can be quite different from home ownership. It is worth briefly outlining the range of property types available to New Zealanders. Each has slightly different attributes.

21% of clients chose a flat as an investment. The principal advantage of flats is that they are, on the whole, cheaper than other forms of property. The rental yield can also be quite attractive: generally up to 10% depending on condition and location. On the downside, there is generally little or no capital gain from land value appreciation, the corporate body fees and obligations can be onerous, and there is no shortage of new supply.

84% of clients chose a house as an investment. An advantage of owning a residential property is that it will be a familiar property type for most New Zealanders. The issues that arise – for example, mowing the lawns, maintaining the hot water cylinder and guttering – are all issues clients are familiar with through home ownership. The downside is that rental yields (rent after tenant and maintenance expenses, relative to the purchase price) are usually low: for example we estimate the current net yield is around 3.1% p.a.<sup>1</sup>









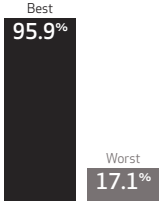






22% of clients chose a commercial property. Commercial property comes in several forms: industrial property (for example a warehouse) retail property (for example a building with a shop front) or office property (a central business district office building). Commercial property generally offers higher rental yields and longer term tenancy agreements than residential. However, the entry price is usually higher than for a flat or house. Commercial property also requires a different set of skills from that used to manage residential property. Agricultural land usually requires specialist knowledge as well, which may be why only 1% of clients held it as an investment.

Finally, 9% of clients chose bare land as an investment. If you decide to invest in land, you do not have the safety net that rental yield provides. The success of your investment depends on the price of the property appreciating over time by more than the cost of the mortgage. Such an investment is speculative in nature and often best suited to those with specialist property knowledge, such as builders and property developers.

Interestingly, between the two residential property types, flats and houses, the majority of clients reported themselves as being happy with their investment experience in a flat, whereas more than half the clients who had invested in a house reported they were either neutral or unhappy. Those who were confident enough to invest in the various types of commercial property reported themselves as being on average happy, with very few reporting they were unhappy. In contrast, the majority of investors in bare land recorded they were unhappy. There appears to be a strong correlation between the property types that offer a higher yield (flats and commercial property) and how investors feel about the investment subsequently.

Also of note is that from 1993 to 2014, Auckland property returns outperformed the rest of the country by 42.8 percentage points. Whether this continues remains to be seen. 40.7% of clients chose to invest in Auckland; 16.0% chose Christchurch; 13.6% Wellington and 44.4% other regions in New Zealand.

## SURVEY RESULTS BY PROPERTY TYPE

	 Flat	 House	 Commercial	 Bare land
Pros	<ul style="list-style-type: none"> <li>• Lower entry price</li> <li>• Higher yield</li> </ul>	<ul style="list-style-type: none"> <li>• Familiar</li> <li>• Comes with land</li> </ul>	<ul style="list-style-type: none"> <li>• Higher yield</li> <li>• Longer term leases</li> </ul>	<ul style="list-style-type: none"> <li>• Wide range of entry prices</li> </ul>
Cons	<ul style="list-style-type: none"> <li>• No land value</li> <li>• New supply</li> </ul>	<ul style="list-style-type: none"> <li>• Higher entry price</li> <li>• Lower yield</li> </ul>	<ul style="list-style-type: none"> <li>• Higher entry price</li> <li>• Specialist knowledge required</li> </ul>	<ul style="list-style-type: none"> <li>• No yield safety net</li> </ul>
Client choice	 20.9%	 83.9%	 23.4%	 8.6%
Average price	\$360,623	\$476,346	> \$1 million	n/a
Estimated yield	3.0%	3.1%	7.8%	0
Best and worst five year periods (March 1994 - March 2014)				n/a
Clients' proportion of leverage used	43.8%	51.9%	46.4%	20.9%
Clients' satisfaction level				

SOURCE: NZ FUNDS CALCULATIONS AND ESTIMATES, CORELOGIC, INVESTMENT PROPERTY DATABANK LIMITED; © IPD 2013, STATISTICS NEW ZEALAND, RESERVE BANK OF NEW ZEALAND, NZ FUNDS PROPERTY SURVEY, 21 JULY 2014.

## The risks and rewards of property

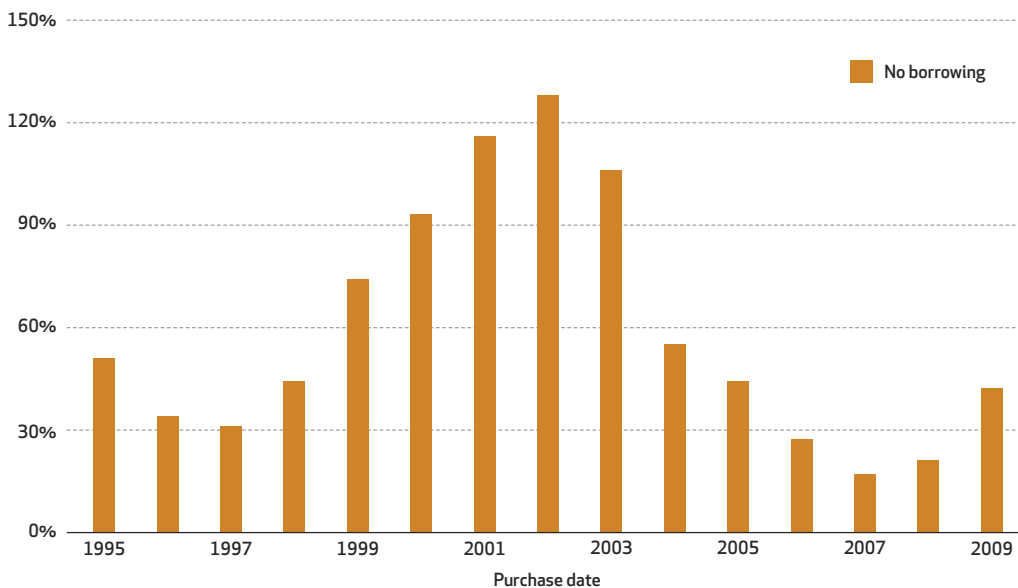
Property offers a number of attributes that can make it a highly attractive investment when managed correctly. It is relatively predictable. As well as generating an income, it offers the potential for capital appreciation. And perhaps most significantly, banks can lend against it, so it can be leveraged.

## Timing the market

Property also comes with a number of risks. As with almost all investment, property is cyclical. That is, despite a long-term upward trend, property prices do rise or fall for a number of years at a time. Ideally, this would be to clients' advantage. Clients could purchase at the bottom of the cycle and sell at the top. Unfortunately, as with all investments, it is extremely difficult to have the conviction to invest in property during a market downturn. It can also be difficult to hold on to an existing property in a downturn as banks change their lending criteria and tenants and landlords alike face financial hardship. In contrast, it is all too easy to buy at the peak with little or no down-payment and the promise that it will be easily rentable later on.

Purchasing near a cyclical high does not necessarily mean all is lost. The long-term stable nature of a high-quality property should see its value recover, eventually. If clients are able to extend their holding period, a respectable increase in value is still salvageable. By way of an example, clients who purchased property around the recent peak in 2007 would have initially lost around 42% of their equity (assuming they borrowed two thirds of the purchase price), but should now be close to recovering their capital. On average, clients held their property investment for seven years. The ability to hold on for longer will often depend on your circumstances and your level of borrowing.

### WHY TIMING MATTERS: FIVE YEAR TOTAL RETURN FROM PURCHASE DATE, ASSUMES NO BORROWING



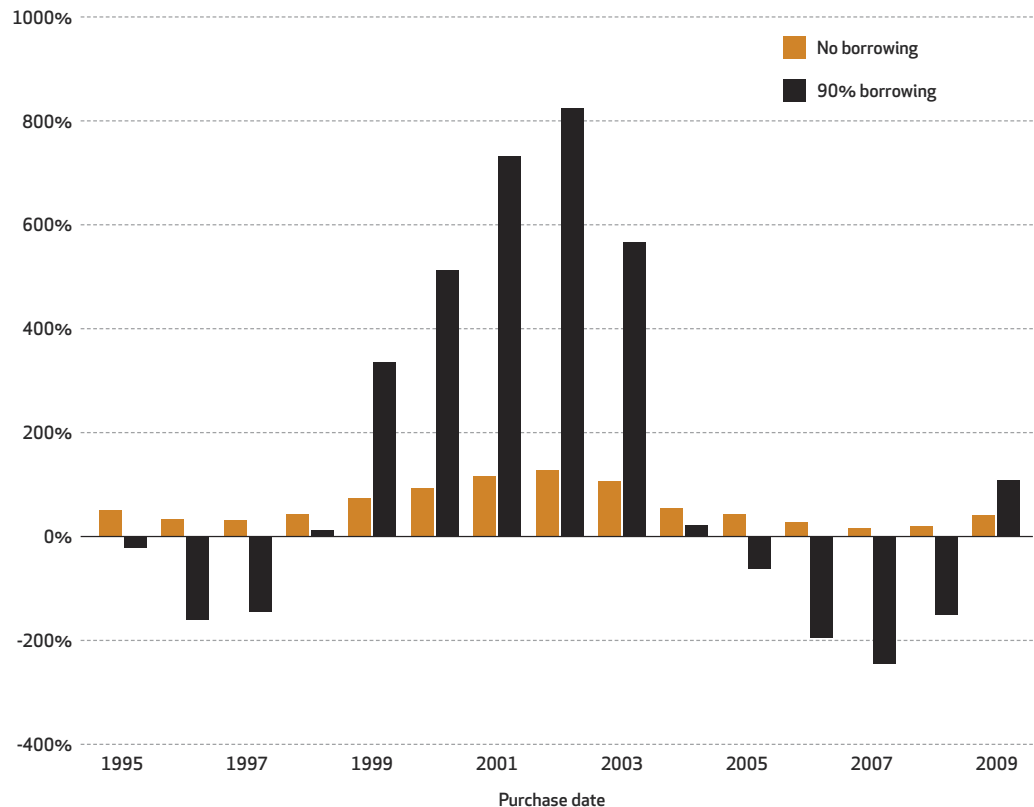
SOURCE: NZ FUNDS CALCULATIONS, CORELOGIC, STATISTICS NEW ZEALAND, RESERVE BANK OF NEW ZEALAND.

## Using leverage

Borrowing, or leverage, is aptly referred to as a two edged sword. A little leverage can significantly enhance your long-term returns, while too much leverage can wipe out your deposit and, in some circumstances, the equity in your home as well.

If clients are able to service their loan safely throughout the cycle, they take the capital gain on the entire property, even though they only "paid" for a portion. Taken to the extreme this can lead to spectacular gains (and losses). Clients on average used leverage to enhance their returns: 31% borrowed between 0% and 20% of the purchase price; 20.2% borrowed between 21% and 50% and 48.8% borrowed between 51% and 100%.

### LEVERAGE IS A TWO EDGED SWORD: FIVE YEAR TOTAL RETURN FROM PURCHASE DATE, ASSUMES NO BORROWING VERSUS BORROWING 90% OF PURCHASE PRICE



SOURCE: NZ FUNDS CALCULATIONS, CORELOGIC, STATISTICS NEW ZEALAND, RESERVE BANK OF NEW ZEALAND.

## Property management

Maximising the probability of a capital gain over time requires work. This is perhaps the most misunderstood aspect of property ownership. A property manager can do some of this work in return for a percentage of the weekly rent, but they will not do all of it. Even with a property manager, you will need to invest your time to purchase the right property, at the right price. You will need to coordinate upkeep and maintenance. You will also need to manage the mortgage and bank relationship. You are responsible for deducting expenses and filing tax returns. And finally, you will also be responsible for managing the sales process to exit your investment.

66% of clients chose to manage their investment, while 33% outsourced various aspects of the relationship. Either way, managing a property from purchase to sale is more like being a small business owner than many clients realise. Making sure, at the outset, you are familiar with your obligations as a lessor and are willing to invest an appropriate amount of time and energy into your investment is essential.

## THE IMPORTANCE OF PROPERTY MANAGEMENT



SOURCE: NZ FUNDS, 30 JULY 2014.

## Property returns relative to alternatives

There is considerable debate about whether shares or properties make better long-term investments. In fact, both stack up well especially when patiently held for long periods of time. Interestingly, the value of a modestly leveraged property (assuming borrowing half the purchase price) does not necessarily rise and fall at the same time as New Zealand shares or international shares. This suggests that property can be a helpful source of diversification for clients. This appears to be how most clients use property. Of those clients who invested in property, 80.9% also held term deposits, 69.7% held shares or bonds; 74.2% held managed portfolios and 86.5% had a KiwiSaver or Superannuation Scheme.

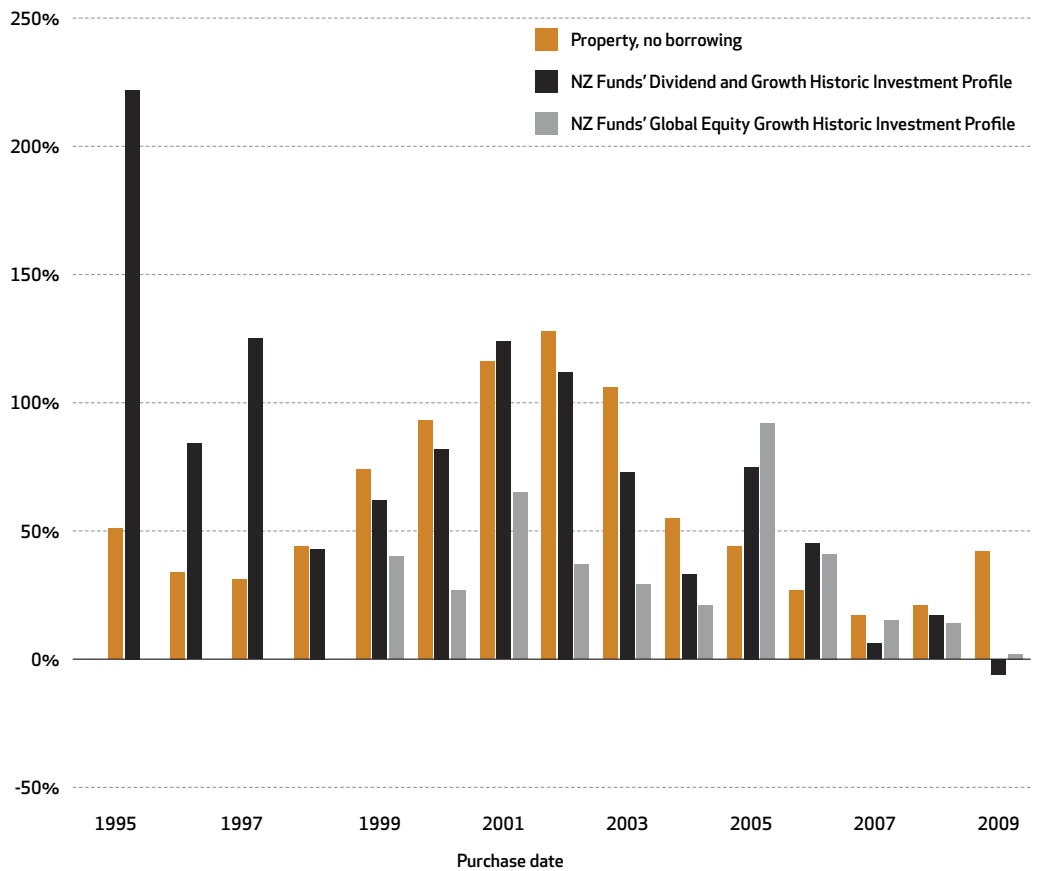
### CHARACTERISTICS OF PROPERTY RELATIVE TO ALTERNATIVES - LAST 20 YEARS

	Cash*	Bonds**	Residential property***	Commercial property****	Shares*****
Average yield p.a.	5.84%	5.94%	3.93%	8.72%	6.41%
Average growth p.a.	n/a	n/a	6.47%	1.59%	1.89%
Average return p.a.	5.84%	5.94%	10.20%	10.03%	8.30%
Largest decline	n/a	n/a	-6.10%	-3.80%	-38.70%
Liquidity	0 to 3 days	0 to 3 days	Estimated 60 to 90 days	Estimated 90 days plus	0 to 3 days
Transaction costs	0%	0%	3.00% to 4.00% (NZ Funds Estimates)	1.50% to 2.50% (NZ Funds Estimates)	0% to 1%
Tax rate	28%	28%	If held personally, marginal tax on yield, personal tax status determines tax on growth	If held in corporate structure, normal corporate tax rate is 28%	0% if dividends imputed

SOURCE: NZ FUNDS CALCULATIONS. \* ANZ CALL INDEX 1994 - 2014. \*\* NEW ZEALAND GOVERNMENT BOND INDEX 1994 - 2003, ANZ CORPORATE BONDS INVESTMENT GRADE INDEX 2003 - 2014. \*\*\* NZ FUNDS CALCULATIONS AND ESTIMATES, CORELOGIC, STATISTICS NEW ZEALAND, RESERVE BANK OF NEW ZEALAND. \*\*\*\* INVESTMENT PROPERTY DATABANK LIMITED; © IPD 2013. \*\*\*\*\* NZX ALL INDEX 1994 - 2014.



**BOTH PROPERTY AND MANAGED PORTFOLIO RETURNS STACK UP WELL: FIVE YEAR TOTAL RETURN FROM PURCHASE DATE, ASSUMES NO BORROWING, VERSUS NZ FUNDS' HISTORIC INVESTMENT PROFILES**



SOURCE: NZ FUNDS HISTORIC INVESTMENT PROFILE CALCULATIONS, CORELOGIC, STATISTICS NEW ZEALAND, RESERVE BANK OF NEW ZEALAND. PLEASE NOTE THE NZ FUNDS HISTORIC INVESTMENT PROFILES DO NOT REPRESENT THE HISTORIC RETURNS OF THE RELEVANT PORTFOLIOS. THEY ILLUSTRATE THE HISTORIC PERFORMANCE OF NZ FUNDS' APPROACH TO MANAGING ASSETS OF THE TYPE HELD WITHIN THE PORTFOLIOS. FOR MORE INFORMATION SEE NZ FUNDS' PORTFOLIO INSIGHTS JULY 2014.

## Checklist for including property in a retirement portfolio

If you are thinking about adding property to your retirement portfolio, you may wish to consider the following:

### **Do I have the time, energy and inclination?**

If you are willing to put the time and energy into property management, the long-term rewards can be substantial. On the other hand, if you have never managed property before or do not work in a property related industry, your lack of practical experience and know-how can leave you vulnerable. If you do proceed, you may wish to start with a smaller property, and a lower level of borrowing. You can always gear it up later on if property investment agrees with you.

### **Does property suit my time frame?**

Because transaction costs are relatively high, and leveraged property prices can fluctuate significantly over the short term, property is usually a ten or more year investment. If you are lucky enough to enjoy a short-term windfall gain, terrific, but it should not be counted on. New Zealanders purchasing a property with less than ten years to go before retirement and little or no alternative sources of savings may therefore be taking a gamble.

### **Does my borrowing match my risk profile?**

If you wish to borrow, ensure your borrowing matches your risk profile and age. A conservative couple in their late fifties may wish to use little or no leverage, or have their mortgage payments fully covered by the rent (after taking rental expenses and tenant vacancy rates into account). In contrast, an individual in their early forties with an aggressive risk profile and a stable income may wish to borrow a higher portion of the purchase price.

### **Are my retirement savings diversified?**

It may be unrealistic to assume the average New Zealand family will accumulate a diversified portfolio of property assets to mitigate the risk of any one property performing poorly; 55.6% of clients held one investment property. In the absence of any other forms of savings, clients' retirements may become dependent on the entry and exit and intermediate fortunes of a single property decision. It should not. There is no reason why all clients' savings should sit in the property basket. As you age, the importance of holding a growing portion of your wealth in easily accessible assets, such as bonds, shares, or a managed portfolio, grows. A useful rule of thumb for less liquid, long-term assets is to ensure that they make up no more than 100% less your age (for example 100 – 60 years old = 40%) of your retirement savings. For 43.3% of clients, property made up between 51% and 100% of their savings; for 21.7% of clients it made up between 21% and 50%, and for 34.9% it accounted for 20% or less.

## Summary

Given that managed portfolios and property are both capable of growing your wealth over time, it is logical to consider whether property should be included in your retirement portfolio. There is even evidence to suggest that adding property to a managed portfolio of growth orientated assets such as shares helps dampen the volatility of returns. There is however nothing to suggest you have to own property to accumulate wealth for your retirement – there are plenty of alternatives available.

Whether property suits you will primarily depend on your personal circumstances and, in particular, whether you have the inclination and skill to be a property manager. If you do invest in property, following the simple checklist above should help you mitigate the risks and maximise the potential rewards.<sup>2</sup>

<sup>1</sup> Source: NZ Funds calculations, Corelogic, Statistics New Zealand, Reserve Bank of New Zealand.

<sup>2</sup> For clients who are considering a property investment we recommend **Property Investment: A Strategy for Success**, Martin Hawes and **The Truth about Property Investment**, Duncan Balmer, as unbiased practical guides to property investing for New Zealanders.



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