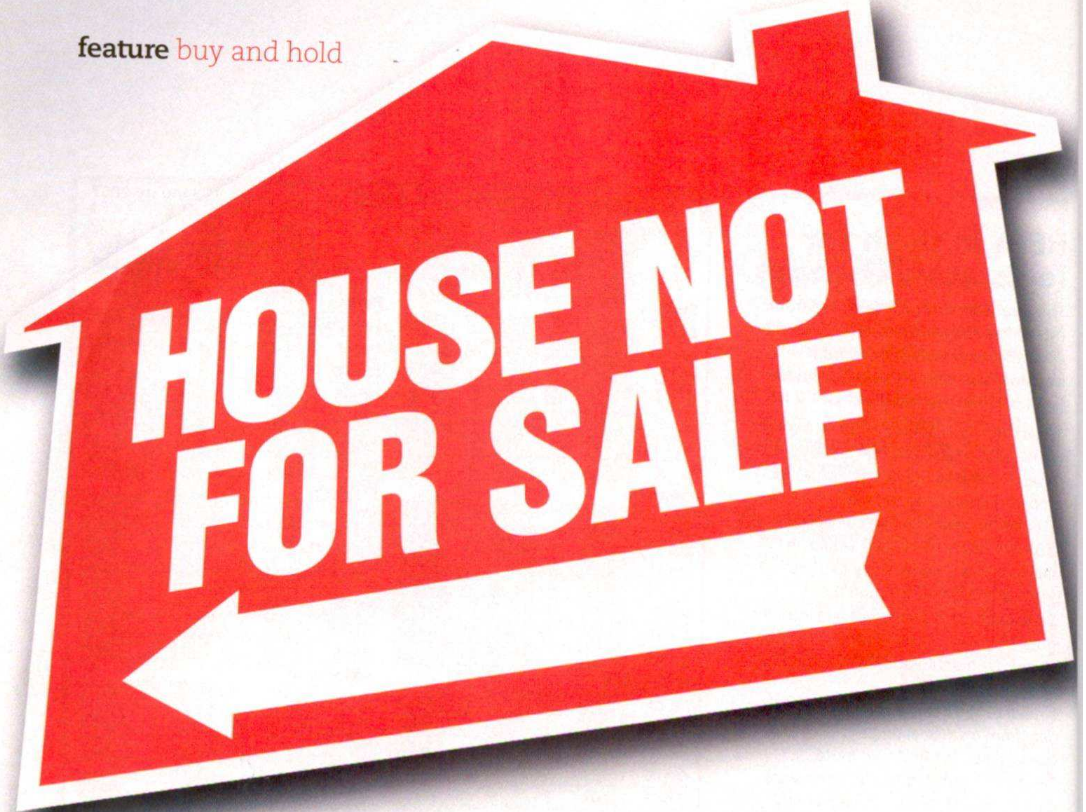

Should you sell?

Some investors try to trade their way to real estate riches but is buying and selling really the best investment strategy? **Terry Ryder**

EVER driven past a house you owned 15 years ago, knowing you sold for $150,000 and it's now worth $500,000?

If you have, you've experienced one of the reasons most property analysts agree that if you own good real estate, you should never sell.

There are other strong reasons to reject the trading method of wealth creation. The high cost of selling and buying is one of them. So too is the power of equity in creating a real estate portfolio.

Sydney buyers agent Patrick Bright applies the philosophy of American share market legend Warren Buffett to real estate investing.

"Buffett's approach is to buy something he would be happy to own forever. His fundamental question is, 'if you could never sell it, would you be happy to own it forever?'

"That's become my focus with real estate. If you follow that approach, you'll make sure you do proper research and look at areas with future prospects."

Many property analysts agree. Monique Wakelin of Wakelin Property Advisory in Melbourne says: "Trading is absolutely not the way to go."

And Perth analyst Gavin Hegney of Hegney Property Group says: "If you've done your research and bought the right property, you should never sell."

Impatience and imprudent decisions

Gold Coast solicitor Rob Balanda of MBA Lawyers sees many investors make mistakes with their assets because they get bored with them. They sell assets they should keep because they lack long-term vision.

"Patience isn't a virtue many investors have," he says. "But it's a virtue investors need to have to be successful and create wealth."

Balanda says some residential property investors get too caught up in problems with tenants. They make the mistake of trying to manage the property themselves.

Hegney says too many investors

apply a 'get rich quick' mentality and lack a long-term outlook.

He says, "People buy a property, it goes up in value by $50,000 or $100,000 and they think: that's my vision, I'll sell and take my profit. And typically they spend it on a car or an overseas trip.

"People don't see investments as businesses. They see them with a terminal life: making a certain amount and then spending it. A good investment is like a business. If it's a good business and continues to create wealth, why would you sell it?"

Hegney says some sell too soon because they don't understand the impact of compound interest.

"If you have a million-dollar asset and it grows 10 per cent, its value is $1.1 million after one year. When it rises another 10 per cent, that's 10 per cent on $1.1 million, not on the original price. By the time you get to year 10, it's $2.6 million. It's that compounding effect that creates the wealth.

"The same thing happens with the rental return. With the current rates of growth, within five to ten years your rents are well and truly servicing your repayments for a high-growth asset.

"In 90 per cent of cases, the most an investment property will cost you is in the first couple of years. After that, your costs should decrease as your rents increase."

Hegney says in an ideal investment world the only asset people should trade is their principal place of residence. As they create wealth, they can buy a bigger and better home and not be liable for capital gains tax.

"But all other property assets you hold forever – unless some drastic change comes to your life."

Brisbane buyers agent Scott McGeever agrees that the only time you should trade in real estate is to upgrade the family home.

"You do that to give yourself a better standard of living and it's a tax-free ride," he says.

Investment advisor and author Margaret Lomas says a lot of people trade property assets because they believe it's the way to get ahead.

"But I haven't seen anyone make a lot of money doing that," she adds. "And if you do it too often, the Taxation Office will conclude that your business is property trading, which has many implications.

"I knew people who used to do that. After doing it for 15 years, they weren't very far ahead. All they had was a pretty good house in a good suburb but they hadn't built up a great amount of equity. They would admit, I think, that it didn't work for them."

Value growth does the work for you

Imagine if you'd bought the average Melbourne house in 1990 – and did nothing since. You would have paid around $150,000 for the property and by 2005 it would have been worth around $365,000 – providing enough equity to finance you into several investment properties (depending on your ability to service the loans).

On the other hand, imagine if you'd sold it in 1992 for the then-average price of $144,000 because the market was taking a caning and values had fallen in the wake of the bust which followed the boom of the late 1980s. You'd cry every time you drove past it, wouldn't you?

Why hand your gains to the government?

Selling an investment property before buying another means you're handing a big chunk of your capital gain to government, the legal profession and lenders. Taxes and fees eat a big share of the profits.

Bright says buying costs are about 5 per cent of the price – and selling costs include 3 per cent to the marketing agents, 1 per cent in marketing costs, solicitors' fees and mortgage discharge costs, as well as stamp duty and capital gains tax.

"If you sell and buy again you'll blow around 9 or 10 per cent on costs," Bright says. "You're just wasting money. It doesn't make sense when you can save that money and borrow against the property you have to buy a second property. Rather than trading up, you're better off having multiple properties."

Lomas says an investor who's made $300,000 in value growth is looking at $80,000 in capital gains tax if they sell.

And Wakelin says: "The bottom line is that property isn't an inexpensive asset class to get into and out of. So it requires a long-term strategy. It's important to buy the best quality assets you can and hold them long term.

"When you buy and sell, you're up for very hefty costs, not the least of which are stamp duty and capital gains tax. Why line someone's pocket? Line your own."

You don't need to sell to access your gains

Lomas says people think they have to sell to release the capital gains they've made.

"But your unrealised gains are worth just as much – probably more, because you don't have to pay CGT (capital gains tax)," she says. "The gains are there for you to leverage against. You don't have to realise the gains to leverage into more property or another kind of investment. If people are thinking of selling because they want cash for something, they would be better to get that cash by borrowing against their equity – although it depends on many variables."

A comparison of two hypothetical scenarios shows how equity is more powerful in creating wealth if good property is retained rather than traded. Take two investors who buy similar investment properties for $300,000, one

> "A good investment is like a business. If it's a good business and continues to create wealth, why would you sell it?"

HOUSE NOT FOR SALE

who plans to use the equity build-up to buy more properties, the other seeking to trade. For the purposes of the exercise, let's assume values rise 10 per cent a year and ignore buying costs (identical for both investors).

After two years both investors buy again. Investor A has $63,000 equity and uses that as leverage to buy a second property for $400,000. Investor B realises his $63,000 equity build-up by selling (and paying around $25,000 in fees and taxes) before buying a better property for $400,000.

After another two years, both buy again using their respective strategies.

Compare their situations after another two years (i.e. six years after each made the initial purchase):

- Investor A owns three investment properties worth around $1.72 million, with total equity of $521,000. Investor A is well-positioned to buy more property.
- Investor B has one property worth $605,000, with equity of $105,000. Along the way, Investor B has paid out $60,000 in fees and taxes by selling and is about to lose more, because the strategy calls for Investor B to sell and buy again.

Plan and be patient

Perth real estate agent Bernie Kroczek says building wealth through property investment requires a long-term goal, developing a strategy and being disciplined enough to follow the plan without over-extending.

"Assuming you've done your homework and purchased wisely within your financial capabilities, holding a property over the long-term (minimum of 10 years) virtually guarantees success – without taking unnecessary risks or trying to pick the market," Kroczek says.

"It's really quite simple and doesn't require tricks, elaborate schemes or superior knowledge – which many people pay thousands of dollars for, attending one seminar after another looking for the magic bullet."

Bright tells all his investor clients they should look at a five-year buy-and-hold as a minimum – but preferably they should never sell.

"They should be happy to own the property if the market shut tomorrow and never reopened," he says.

Balanda says he helps many wealthy people with lots of assets prepare their wills; invariably they're people who've bought and held shares and property.

"Very few people create wealth through trading, but I see a lot who create wealth through buying and holding good assets," he says.

Wakelin advises investors to hang on to their tax-free profits and use them to leverage into other assets.

"Hold on to good quality assets and use the equity build-up as your notional deposit to buy the next property. It's incredibly simple. The real take-home message is that there's no need to line anybody else's pocket. Hang on to your profits."

Wakelin says investors should base property-buying decisions on the potential to double in value every seven to ten years.

"You only need to build up $50,000 to $60,000 in equity. You can unlock a good proportion of that and use it to springboard into the next asset."

Hegney buys with a long-term view and never sells (these days) because he wants to avoid capital gains tax.

"I've bought and sold 10 or 12 properties and the wealth I've created out of that hasn't been as high as buying and holding five good properties – because a lot of my growth has gone in fees and taxes.

"By the time you sell, pay fees and pay capital gains tax, the next investment you buy has to work that much harder to make up for that."

Lomas owns more than 30 properties and has only once sold a property.

"You might get good growth in the first year or it might be the ninth or tenth year, but you need to hold for ten years to make it work for you. If you're buying to trade, you probably won't give it that much time."

> Lomas says trying to trade your way to wealth is a mistake but it's also a mistake to hang on to property that doesn't perform.

Of course, there are exceptions...

Mortgage broker Tricia Green of Home Loans Now is an experienced investor who sometimes sells assets. She says it depends on her initial objective in buying a particular property.

"Sometimes I buy with the intention of making improvements to achieve capital gains and then on-selling," she says. "But if it's negatively geared for tax benefits I wouldn't want to sell. It depends on what you're buying it for."

Green bought a block of units with friends who planned to renovate and sell the improved product.

"Our objective is to hold the property for a year to reduce the capital gains tax impact – and as the units become vacant we'll renovate them and sell."

Green says people who retain properties and build their equity so they can borrow against it to buy more need to be aware of the commitments they're taking on.

"That's fine providing it's not going to create hardship in meeting repayments," she says. "You have to service the loans and if the repayments are much higher than the income, it might work against you.

"But I agree, why sell if you're comfortable with the commitment, because the capital gains will still be there for you to use. If you're investing for your retirement, just keep them and build up a property portfolio."

Wakelin says there's a danger in the buy-and-hold strategy for people to over-commit and become too gung-ho.

"There have been lots of so-called gurus urging people to be highly speculative," she says. "It's better to buy a good tenantable property, be patient and let it do its work to allow the equity to build."

Hegney says many buyers in the recent boom market in Perth have made the mistake of buying with short-term vision.

"People have bought assets that have been fantastic performers over one or three years, but they're not long-term performers," he says. "If the market goes into reverse, they're the assets you'd want to get rid of.

"I would say to people – all those properties you bought in the cheaper areas that aren't long-term high-growth areas, I would sell them now. They've had their run."

Lomas says trying to trade your way to wealth is a mistake but it's also a mistake to hang on to property that doesn't perform.

"In those circumstances, you have to cut your losses and get out when you can," she says.

"I always say you should never sell but sometimes you need to. I discourage people from hanging on to something that's a bad investment which is soaking up money and preventing them from buying more property. You might need to get rid of it to allow you to do something else."

A client of McGeever's provides a striking example. The investor paid $120,000 for a small suburban unit in 1992 and found it was worth only $95,000 10 years later. He had to decide whether to persevere with it or cut his losses. He decided to sell and used the proceeds to buy a small retail property for $365,000, yielding 9.5 per cent.

McGeever says with rental increases and firming yields, that property is now worth $645,000. ■

Terry Ryder is the creator of hotspotting.com.au and author of four real estate books.