

## **PROPERTY**

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## **Introduction**

### **By Adrian Vorbach**

Denise Brailey, Special Projects Manager, IMF, highlights the very real dangers of investing in property development schemes in contrast to buying investment properties. The collapse of Fincorp is just the latest example of investors losing their money in such schemes falsely marketed as low risk "securities" when in fact they are high risk financial products.

Phil Anderson, Managing Director, Economic Indicator Services (EIS) shows that boom and bust cycles are common in real estate investing - usually every 18-20 years.

David Rees, Research Director, Mirvac states that residential real estate affordability is currently at historical lows but rents in Australian cities are steadily rising. Dwelling construction is at cyclical lows - not helped by increasing government fees, charges, levies and delays in planning approval etc.

ASX research shows that the top three performing investments over the last ten years in order have been 1.Aust LPTs, 2.Global LPTs and 3.Australian shares respectively. Remember that past performance is no guarantee of future performance!

*Adrian Vorbach is a Councillor of the AIA based in Adelaide.*

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# Assessment of Property Schemes

By Denise Brailey

Investing in property schemes in today's market can be as dangerous as gambling the family home on the roulette wheel at your local Casino. Purchasing property for investment purposes has proven to be a vastly different proposition than investing with companies who claim to be property developers and/or fund managers.

During the past decade, thousands of Mum and Dad investors in Australia have been lured into high risk financial products, marketed as low risk "securities." In light of the latest collapse of Fincorp Investments Limited, where up to \$200 million appears to have vanished, consumers are once again reminded of the inherent dangers of being unfamiliar with hybrid financial products on offer.

My own research since the mid nineties, has led me to conclude the worst is yet to come. In 2004, the Australian Securities and Investment Commission ("ASIC") suggested that at least 22 companies were under scrutiny, running similar property development schemes to the Fincorp Group of Companies. The products on offer were debentures, unit trusts and so called mezzanine investments. Intermediate investors therefore, need to understand the proliferation of these schemes and to become more vigilant in conducting their own research into company background and reliability of information presented to the public. Simply studying the prospectus is clearly an inefficient way of deciding upon which investment is right for you.

My advice would be to read the entire website of the company that you are considering appointing as the holder and manager of your funds. It may have taken you forty years to accumulate your portfolio of investments. Take at least forty days to reach a well researched decision.

## These tips may assist you when making those decisions:-

1. Study the last few years' balance sheets.
2. Search Google, or your favourite search engine, as to previous articles on the company making the offer.
3. Search the land titles of the properties purported to be part of the development portfolio.
4. If seeking first mortgage security, understand that if banks or non-banks have taken first ranking, then security for you is immediately diminished.
5. Ask your accountant to check your preferences – not the one who recommended the product.
6. Ask an independent lawyer to check the fine print of the contracts presented and,
7. If the investment relates to value of property, ask for advice from an independent valuer.
8. Check with ASIC's website as to "Stop Order" registers.

If you have no idea how to read these web-sites, or understand the implications, then you need independent expert advice.

Ross Greenwood recently suggested an amazingly simple remedy for the Federal Regulator to adopt which may assist consumers in making an informed decision. If the Federal Regulator were to categorize each investment offered to the market, by way of ranking of "**low, medium, or high**" risk, then investors would be less likely to be deceived as to the information contained in the promotional material offered by certain fund managers.

I have seen material suggesting the client has specifically requested "medium" investment, yet fine print from the developer reveals the definition of "medium risk" as being 50% of

capital. Advice is therefore delivered amidst neatly hidden clauses and the adoption of highly deceptive conduct. Novice investors specifically asked for low risk but were hoodwinked by promoter/advisers into believing that “medium” translated as 10% risk. In each case, Mums and Dads stated from the outset, they could not afford to lose one dollar of their investment / superannuation funds.

Intermediate investors who are more experienced in market fluctuations and hidden traps, have cause to take a cautious and structured approach when dealing with property investment schemes, due to the extraordinarily low standard of policing in the corporate sector.

Property markets do have stretches of volatility. However, the recent spate of collapses occurred in boom times. In truth, investors believed slick promotional material, suggesting that the products on offer were “safe and secure” and “capital guarantees” could be relied upon. Consumers were comforted by the fact that prospectuses were registered with ASIC and that parent companies enjoyed the benefit of an AFS licence, all of which added to a false sense of over-confidence.

In light of the latest losses, investors ought to be alert to the fact that similar companies are still in existence. Up to \$5 Billion could be involved according to the ASIC. Capital has vanished, yet income is still being paid. Further capital raisings continue to be advertised.

If the regulator set the standard, then novice and intermediate investors would have a better opportunity to explore all the options and products on offer. A benchmark ought to be established to ensure a fair-go for consumers of financial products and services.

Needless to say, given the astounding rash of current collapses and lost funds, Greenwood’s simple suggestion ought to be implemented as a matter of some urgency.

*Denise Brailey is the Special Projects Manager with IMF, Perth.*

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## **What’s Happening With Real Estate?**

**By Phil Anderson**

What's happening with real estate? Just about everyone seems to have an opinion, an opinion that never seems to work out, and is probably more like guesswork. Does anyone really seem to know? Can the market actually be forecast?

The first thing to know about real estate is to study the correct data. And the correct data is land price, land / house sales, and then know the complete history of the market, not just a few years back-data as every other forecaster seems to have. When you do this, a very clear 18 to 20-year cycle of boom and bust is evident for real estate, in every country in which the land rent has been enclosed and privatised, then bought and sold as a commodity, which it isn't.

Anyway, since Economic Indicator Services (EIS) expects the US to lead the world into its next real estate induced recession, we will examine the US market first. The US Federal government began selling off the nation's real estate, officially and under a set legal structure, on May 10th, 1800. After that, here is what happened:

1818, a peak in land sales, followed by a downturn. 1836, a peak in land sales, followed by economic depression. 1854, a peak in land sales, followed by depression. 1869, a peak in land sales (Chicago peak, 1872), followed by depression. 1888, a peak in land sales (1890 was the count off 1800, if we were to mark each 18<sup>th</sup> year from 1800), followed by depression. 1908, a peak in land sales, the following downturn cut short by world war. 1926, a peak in real estate speculation, followed five years later by the world's worst ever depression. (It was the collapse of real estate, not the collapse of the stock market that caused this terrible depression.) 1944, a peak in real estate construction (government

financed mainly in this cycle), then a probable downturn eliminated by rebuilding from war's destruction. In other words, for the first 144 years of real estate enclosure in the US, land sales and / or real estate construction peaked almost consistently, every 18 years.

Since the Second World War and once the US economy finally shrugged off the distorting affects of dislocation wrought by the war, the average 18-year cycle reasserted itself with some vigour.

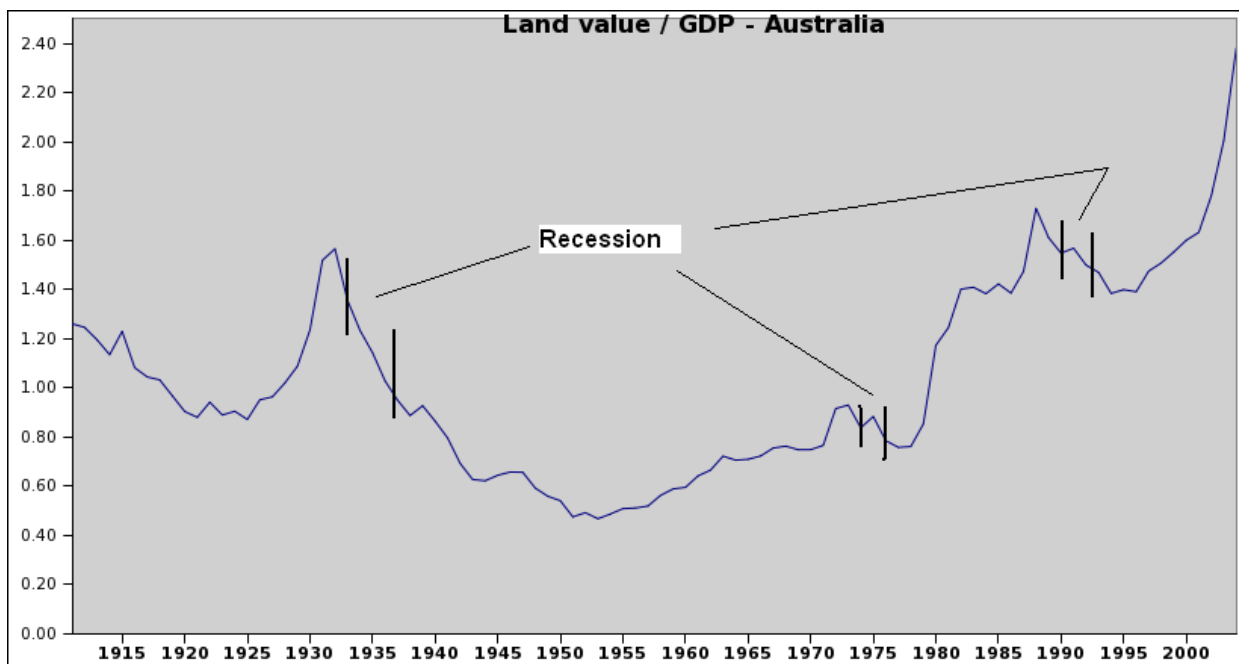
Actually though, as history also clearly reveals, the average 18-year cycle is more a cycle of 14 years of stable or rising prices, followed by four years of, at first a plateau, then recession. The US real estate market last bottomed in 1992; the current sub-prime mortgage debacle the US is experiencing is, therefore, right on time. And as could be forecast. It is just history repeating.

Australian real estate prices can be expected to peak around 2008, fourteen years from the previous recessionary low of 1994 or so. This is not something EIS started forecasting yesterday.

As my co-director in London, Fred Harrison, so eloquently puts it, the real estate cycle tends to work on the basis of 18-year periods determined by the dynamics of the land market. The major event that precedes the recessions of modern history – back 300 years for the United Kingdom – is the rise in the share of national income paid to the owners of land. Because land is in fixed supply, and people need it for both living and working, the share of national income going to its owners must increase relative to wages and profits.

EIS measures this by comparing a nation's land value to its GDP. We can't do this for the US, since no organisation in the US, including the Federal Reserve, considers land important enough to permit accurate data collection. We do however have the data for Australia. When land price relative to a nations' GDP becomes unaffordable, a recession is not far away.

History teaches us that the individuals who will suffer most in the next real estate induced downturn will be those who have over-borrowed in the final two to three years of this current cycle, when land prices were at their highest and unaffordability at its lowest: first home buyers on low-doc loans, others with little or no equity in their property, and the rest with little cash flow to cover the bad times that will inevitably follow the good times. And also those first to be made unemployed in the downturn. (Something business will find far easy to do under the new industrial relations laws.)



Sharp increases in house prices (read land prices) are generally celebrated as great news for the economy. If you have studied history, you will know it is all just part of the cycle, no more, no less.

*Phil Anderson is Managing Director of Economic Indicator Services, the world's foremost authority in business, real estate and commodity cycles. The EIS website can be found at <http://www.businesscycles.biz/>.*

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## Residential Property

**By David Rees**

Residential property closely resembles professional sport. Firstly, both sectors of the economy are guaranteed daily media coverage, typically in their own dedicated pages of the newspaper, but frequently breaking out onto the front page. Secondly, everybody has some experience as a participant and as a spectator in both sectors, and can therefore lay claim to knowledge and expertise at least equal to that of any industry professional. Strongly held opinions, often based on limited experience, proliferate in both spheres of activity. Thirdly, sport and residential property are a source of endless attention intervention by market regulators and politicians who seek to associate themselves with, manage and ultimately manipulate both sectors. And, fourthly, of course, substantial sums of money are at stake for all participants.

Against this background, it is not surprising that recent trends in Australia's housing market should be the subject of considerable debate. Affordability, variously defined as the ratio of average wages to the mortgage repayments on a typical house, hovers around historical lows in all capital cities around Australia. At the same time, the national vacancy rate, currently 1.36 percent according to the Australian Bureau of Statistics, is the lowest since records commenced in 1969. Rents are rising, rapidly in cities such as Perth and Brisbane, more slowly but nevertheless persistently, in Melbourne. Even in Sydney, which currently qualifies as Australia's weakest housing market by almost any indicator you care to select, rents are on the increase.

In a typical housing cycle, a tight rental market portends a rise in the demand by new owner-occupiers, rising house prices and ultimately resurgent construction activity. This time, however, tight rental markets are coinciding with levels of house affordability already near historical lows. Therefore there appears to be limited scope for the rise in house prices necessary to stimulate the next wave of construction. The level of dwelling construction itself, with 144,000 completions recorded during 2006, is running well below the estimated level of underlying demand, which is variously estimated at between 160,000 and 170,000.

The normal gyroscopic mechanism that keeps the housing market in a state of stable equilibrium seems to have gone awry. In the absence of a recovery in dwelling construction, record low vacancy rates in the rental market are likely to put the squeeze on tenants in most capital cities.

What has gone wrong? Strongly held, if contrary, opinions abound. To break away from the clatter it's helpful to apply the tools of orthodox economics.

Economics 101 says that rising prices in any market can be explained by an increase in demand or by a fall in supply. In the case of the housing market, demand has historically been the place to look for explanations of price fluctuations. Changes in mortgage rates, unemployment rates, inter-state migration, as well as well-intentioned, if flawed, policy interventions such as the First Home Owners' Grant (FHOG) all act on the demand side of the market. Supply, in contrast, is relatively stable. Currently there are around 8 million dwellings in Australia, and this number changes little from year to year. With new construction averaging around 150,000 to 160,000 per year, less demolitions whose total number is unknown but probably averages about 22,000 dwellings per year, supply rises at a

modest rate of about 2 percent per annum. Even a bonanza construction year, such as 1994, when 173,000 dwellings were completed, only increases the total supply of dwellings by 2¼ percent.

So with supply relatively constant, it's on the demand side where all the action is – or has been, historically. For example, the big run up in house prices between 1990 and 2004 can be explained, largely, by the fall in the mortgage rate from 17 percent in 1990 to around 8 percent currently. This amounted to an approximate halving in monthly mortgage payments or a doubling in borrowing capacity by first home buyers. Given increased firepower, new home buyers moved into the market, driving house and land prices up. Usually this mechanism should stimulate a rise in construction: but not, apparently, at this time.

With dwelling construction at a cyclical low – and in New South Wales, at a 20-year low – the spotlight is increasingly focused on the supply side of the housing market. A slump in supply might perhaps be the result of low house prices reflecting weak demand for accommodation. But the tight rental market and low levels of affordability challenge this explanation. A tight rental market combined with low levels of supply is best explained by constraints on the supply side.

Analysis by the Property Council of Australia helps to explain why supply has been so weak. Government fees, charges, infrastructure levies, delays in planning approvals and other up-front costs have been rising steadily over a number of years, driving up the cost of new dwelling construction and therefore the entry cost for new home buyers. Adding to cost pressures for developers is the enthusiasm of urban planners for increased dwelling concentration in existing urban areas. Concentrating more people per square meter inevitably drives up the price of land per square meter. Limitations on supply, either in the form of restricted releases of residential land or a tax on supply is entirely consistent with low levels of housing construction and rising prices. Even an undergraduate student of economics would have difficulty in avoiding the obvious here.

To focus on constraints on the supply of new homes as the primary explanation for low levels of housing affordability and the looming crunch in rental availability does not argue that these are the only factors at work in the housing market. High levels of international migration, for example, are expanding the demand for rental accommodation in many metropolitan areas. Declining household sizes, a strong sharemarket and rising balances in superannuation funds are all contributing to an increased appetite for more, and better appointed, houses.

Economics provides a set of tools for analysing current house price trends, and offers a range of suggested policies to address the problem of low affordability. These matters can be discussed dispassionately. Less helpful to the debate are participants who choose to occupy the high moral ground and who complain that home owners for having the wrong tastes, live selfishly in the wrong areas and have over-ambitious requirements for increased living space. Campaigns to improve on human nature make for a satisfying moral crusade. But they are generally very poor economic analysis.

*David Rees is the Research Director, Mirvac.*

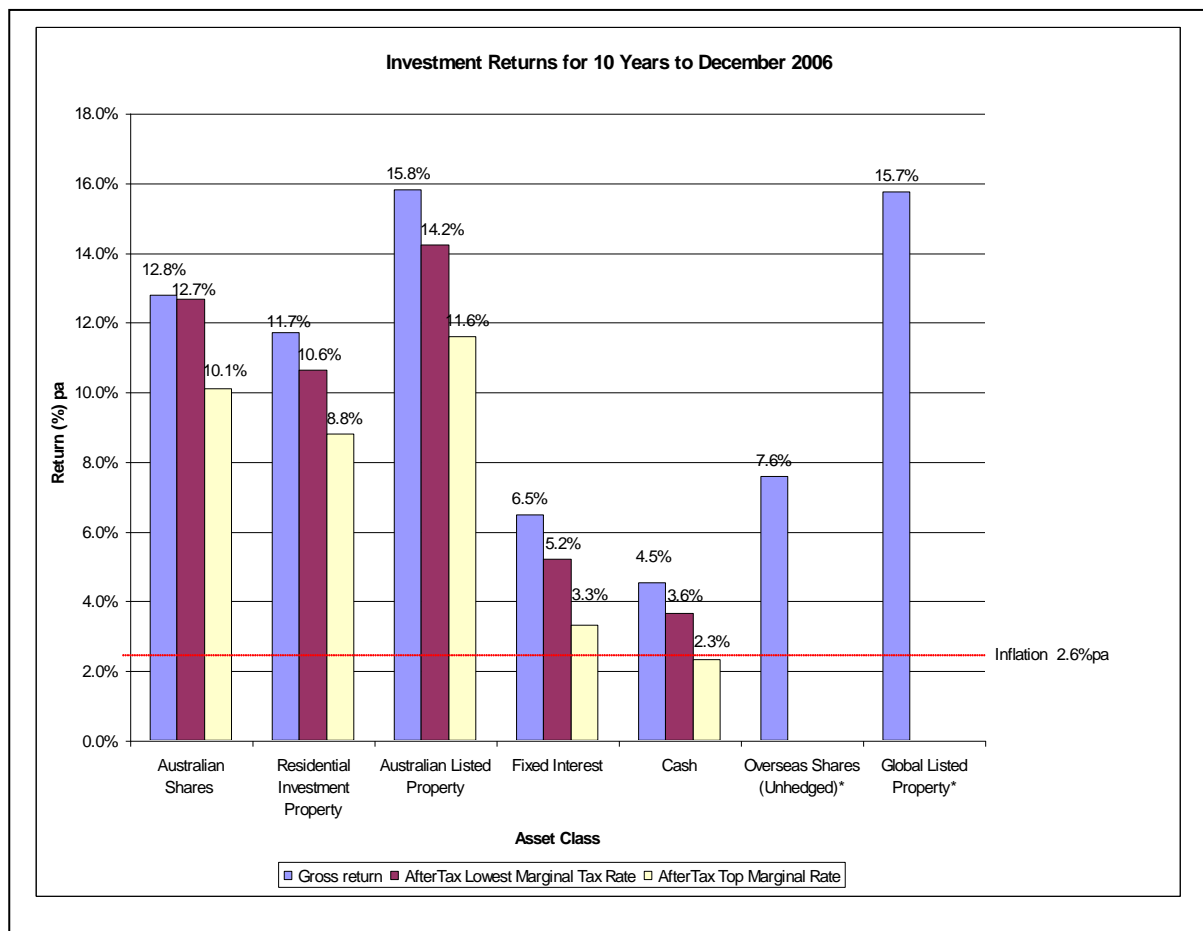
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# Long-Term Investing – Asset Class performance comparisons

## Provided by the ASX

Have you ever thought about how different asset classes perform over the medium to long-term period?

For the past ten years the Australian Securities Exchange (ASX) has produced a yearly report which does just that – compares the performance of a range of different investments. In conjunction with the Russell Investment Group, ASX has released the latest ASX/Russell Long-Term Investing Report, which compares the 10 and 20 year performance of various investments to December 2006.



This report aims to assist individual investors make informed investment decisions primarily those who invest for the medium and longer term. At the same time, the ASX/Russell Long-Term Investing Report provides a reasonable comparison between investment sectors by taking real world factors such as tax and gearing into account.

Overall the study found that the three top performing investments over the 10 year period were all ASX-listed investments - Australian listed property, Global listed property and Australian shares. The returns on each of these three investment types were at least three times the rate of inflation. All three sectors performed better than residential investment property over this period.

Interestingly, over this period, Australian listed property and Australian shares were attractive investment options at both the lowest and top marginal tax rates.

### Some of the key highlights include:

- Before-tax but after-costs, the Australian Listed Property sector achieved the highest returns of 15.8% p.a. for the 10 year period and 13.2% p.a. for the 20 year period. After-tax and after-costs, this sector outperformed all other asset classes at both the lowest and highest marginal tax rates for both time periods.
- For the 10 year period, before-tax but after-costs global listed property came a close second to Australian Listed Property, with a return of 15.7% p.a.
- For the 10 year period, Australian shares achieved a before tax return of 12.8% and after tax returns of 12.7% (at the lowest marginal tax rate) and 10.1% (at the highest marginal rates). Overseas shares (unhedged) underperformed Australian shares by 5.2% p.a.
- Cash achieved the lowest return of any asset class over both the 10 and 20 year periods.

### **Taxation impacts:**

The results of this study also show that personal tax makes a significant difference to the end outcome for various investments. The impact of personal taxation on Australian share returns has been less significant, due to franking credits. At the lowest marginal tax rate, the tax credits from dividend imputation resulted in the after-tax return being slightly greater (11.3%) than the before-tax return (11.1%) for the twenty year period.

### **Impact of Leverage:**

Borrowing money to invest (i.e leverage) over the past ten years has effectively increased the after tax return of both Australian shares and residential investment property. The increase in performance of the two asset classes has more than offset the borrowing costs over the ten year period. For example, assuming 50% gearing on the initial investment of Australian shares, the after tax lowest marginal tax rate returns were 15.5%, compared to 12.7% when no gearing was involved.

While the performance of these ASX-listed investments has been strong, all potential investors would be aware that past performance is no guarantee of future performance and that they should obtain independent advice before making any investment and/or financial decisions.

To find out more about ASX/Russell Long-Term Investing Report 2006, visit [www.asx.com.au](http://www.asx.com.au) or [www.russell.com.au](http://www.russell.com.au).

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