Property or shares.

Where should you invest?

2016

stockspot

Contents

1: Introduction

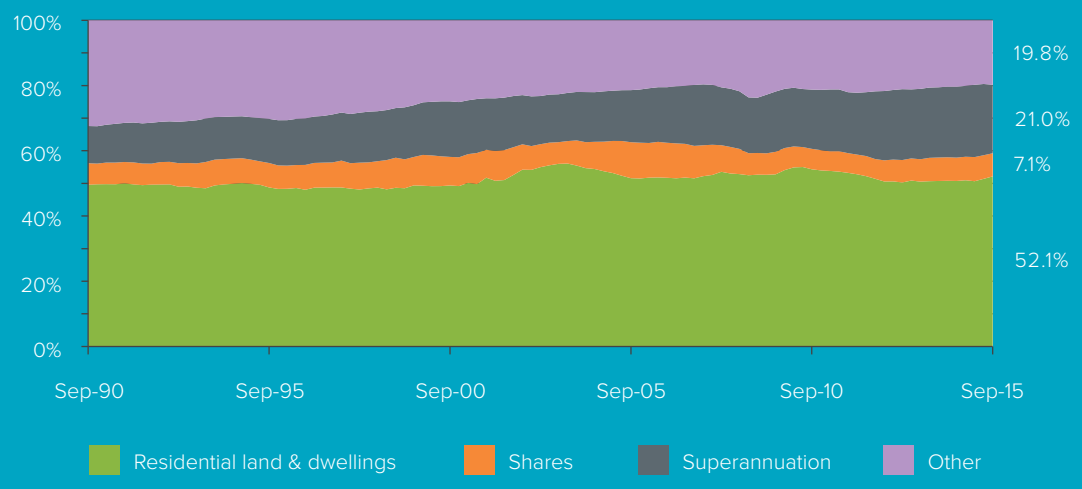
Investing in property or shares are the two most common ways of building wealth in Australia outside of superannuation.

The topic of whether to invest in property, shares (or both) often leads to heated debates, as the 67% of Australians who own the house they live in feel passionately about their investment decision.

These two asset classes are rarely out of the news, with weekly predictions about booms and busts fuelling speculation and creating confusion for the majority of investors. Against this tide of information overload, it is important to remember that there are costs and benefits associated with both property and share ownership.

This short whitepaper will look into the most common pros and cons of both investments. Please keep in mind that this whitepaper provides general advice only and doesn't consider your personal circumstances. You should seek advice specific to your personal situation before making any financial investment decision.

DISTRIBUTION OF HOUSEHOLD WEALTH IN AUSTRALIA



From Corelogic, Housing Market and Economic Update March 2016 p. 4

2: Property ownership

Historically there has been a belief in Australian culture that home ownership leads to an improvement in living standards, representing a symbol of success and security.

Since 1961, home ownership has been relatively stable at around 70%, with a decline in recent years to 67% due to stretched affordability. Home ownership tends to increase with age, alongside general increases in wealth.

Despite weakness in many overseas property markets, the Australian residential property market overcame the downturn of the Global Financial Crisis and has continued to strengthen. In addition to their family home, a growing number of Australians now own an investment property. The 2011 Census showed that 7.9% of Australians own at least one investment property. On the other hand, recent analysis has shown a rise in the proportion of renters, as buying a home become less affordable due to rapidly increasing prices.

The future of residential property in Australia will be affected by a range of factors including demographic shifts, migration and overseas investment. General population growth, infrastructure expansion, costs issues and government responses will also shape the state of the housing market.

RESIDENTIAL REAL ESTATE UNDERPINS AUSTRALIA'S WEALTH

Residential real estate
$6.5 Trillion

Australian superannuation
$2.3 Trillion

Australian listed shares
$1.6 Trillion

Commercial real estate
$0.7 Trillion

As at the end of February 2016

From Corelogic, Housing Market and Economic Update March 2016 p. 3

3: Share ownership

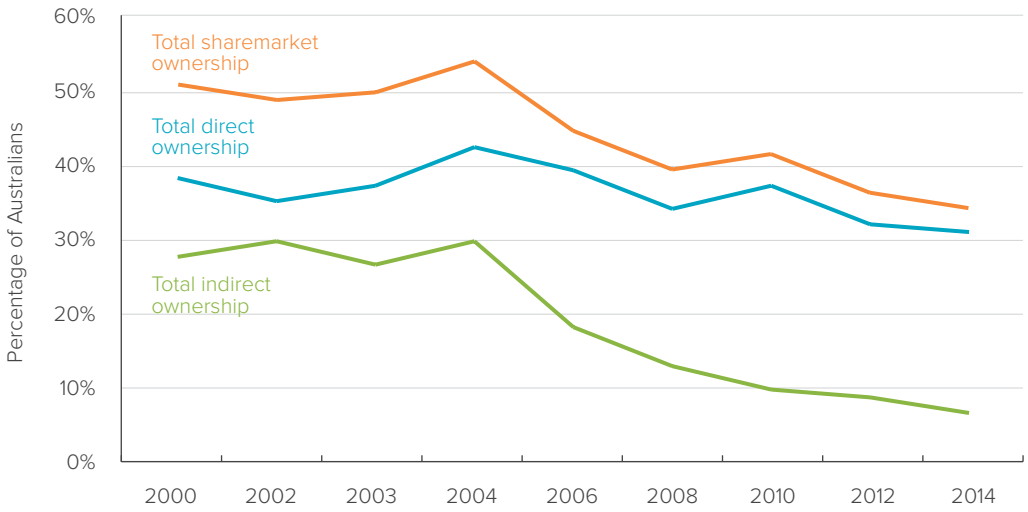
Australia has one of the world's highest share ownership rates, with around 36% of adults owning shares outside of their superannuation.

Owning shares doesn't typically bring same level of personal attachment when compared to property, since the part-ownership of a business is less tangible than that of a physical house. Notwithstanding, shares have generated reliable income and returns for Australians over the long-run.

Over the 30 years to 2015, Australian shares have generated an average return of 10.8% per year including dividends. Despite the Australian share market's consistent growth over the past three decades, the percentage of share ownership has actually declined over the past 15 years. Shares have fallen out of popularity due to the market volatility that occurred around the Tech Crash of 2000 and Global Financial Crisis of 2008.

Over the past 5 years, Australians investing in shares have increasingly turned to diversified products such as Exchange Traded Funds (ETFs) to reduce the risk of investing in single shares and provide access to international markets.

PROPORTION OF AUSTRALIANS INVESTING IN THE SHAREMARKET



Source: ASX - The Australian Share Ownership Study 2014, p.10, fig.3

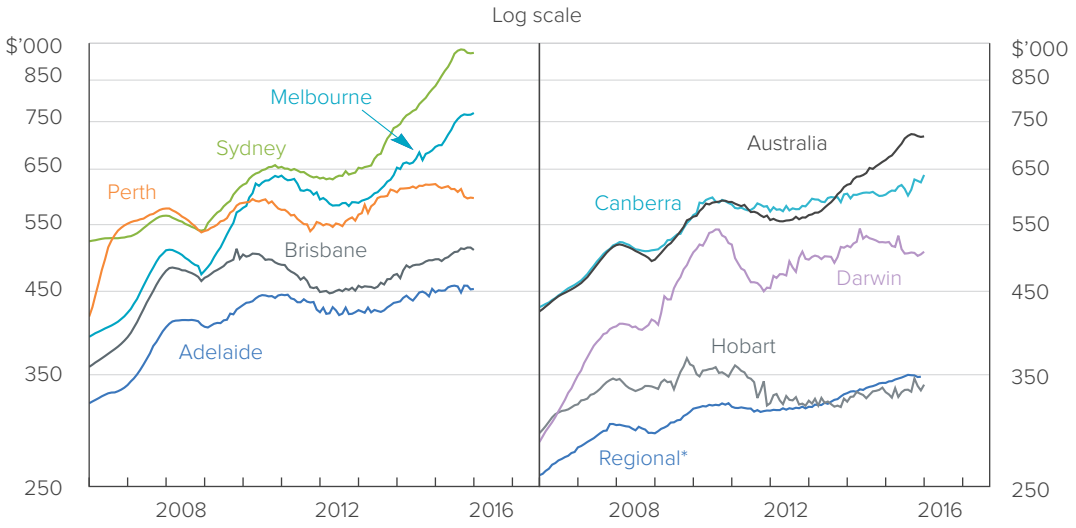
4: Benefits of property

Rising house prices

Decades of rising home values have helped generations of Australians to build wealth. Nevertheless, the general upward trend is neither guaranteed nor without periods of decline.

The movements in prices are connected to wider economic conditions and the average values represent an index of thousands of properties – not a single house. The divergent movements between states and even suburbs within major cities show that location and other factors do matter when it comes to the price of a single house. History suggests that no investment asset can enjoy perpetual growth without some set-backs along the way. For homeowners, the dangers of falling house prices come largely from leverage and any inability to service the mortgage debt.

AVERAGE HOUSE PRICES IN MAJOR AUSTRALIAN CITIES



*Excludes apartments; measured as areas outside of capital cities in mainland states

Sources: CoreLogic RPData; RBA

Leveraged return potential

Property is often perceived as a less volatile investment compared to shares, so banks are willing to lend high percentage of the total house value to individuals.

For instance, it's typical to contribute a 20% deposit and the bank mortgage covers the remaining 80%, or an 80% Loan to Value Ratio (LVR). Let's say you buy a property for $500,000 with a deposit of $100,000 and borrow the remaining $400,000. If you sell the property a year later for $550,000, the property itself has risen 10% in value but your return on investment is 50% since you have made $50,000 profit on a $100,000 investment (i.e. the original deposit). That's 5x leverage because you earned a 5x 10% return. It should be noted that after transaction costs, interest and principal repayments, the actual return is likely to be lower. Also, the opposite would be true if the house price fell from $500,000 to $450,000. Your profit would be -50% or worse after repayments and costs are accounted for.

Peace of mind

Owning a house can provide intangible benefits such as security and peace of mind.

When you own the property you live in there are no worries about the inconvenience of moving after lease expiration or restrictions on renovating. Property investment is also seen to be a hedge against inflation due to its relationship with inflation and population growth over the long-term. This helps to protect your wealth over your lifetime from the gradual increase in prices of all goods.

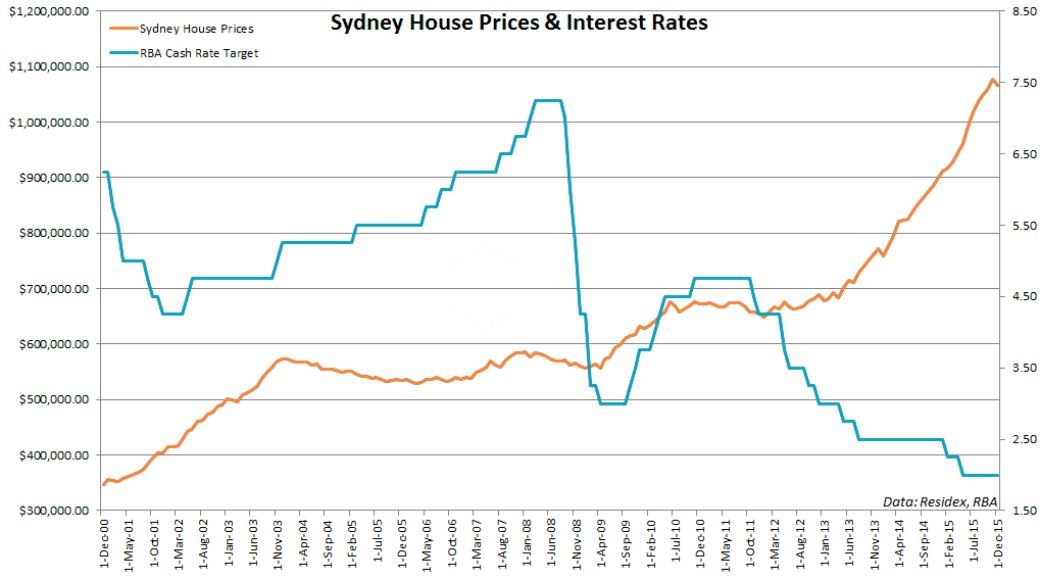
5: Risks of property

Loan servicing (interest)

Property is often correlated with defensive assets like bonds because like bonds, house prices can fall when interest rates rise. This is because the cost of servicing mortgage debt can rise significantly when interest rates are raised from low levels.

Low interest rates tend to be supportive of rising house prices, as they enable buyers to afford larger loans. However as interest rates rise, higher repayments need to be factored into the household budget. In this situation, paying the interest can become unaffordable for some families. This can lead to some people becoming forced sellers of their homes due to rising interest rates.

Currently, average variable interest rates are about 4.00% per year, which means that you would pay about $32,000 a year on a $800,000 loan to buy a $1,000,000 house. That's almost the same amount as the $35,000 you would pay to rent a similar value property for a year. As interest rates rise, renting starts to look more attractive because of the rising cost of paying a mortgage.

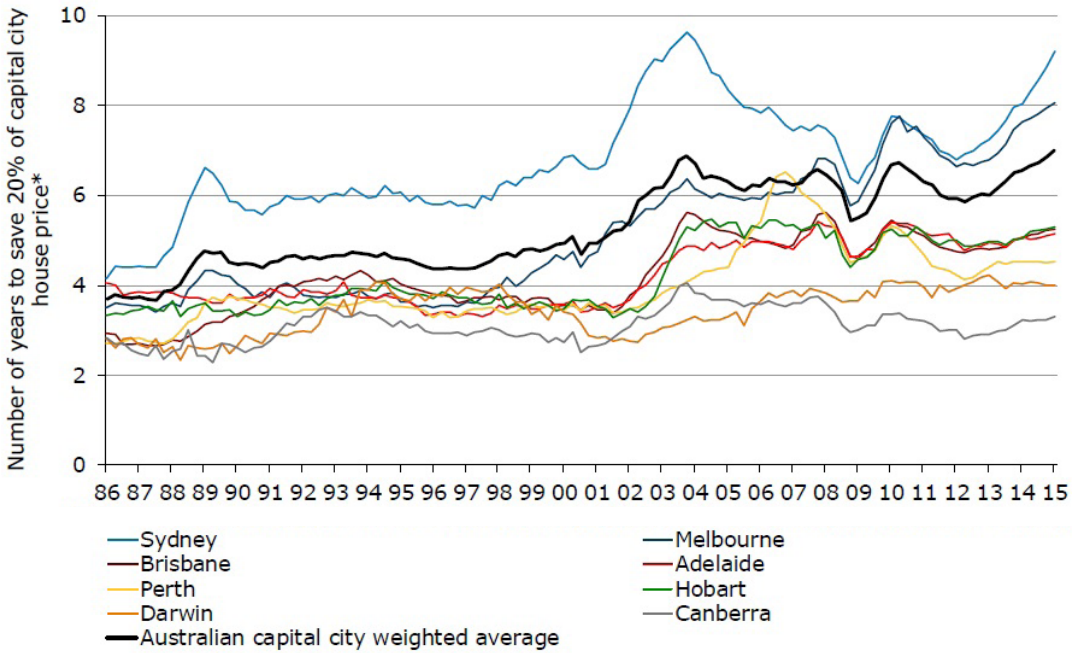


House prices tend to enjoy their best returns during periods when interest rates are low and falling.

Opportunity cost

Due to rising house prices, it is taking Australians longer periods of time to save up for a house deposit compared to previous generations.

It now takes 7 years on average across Australia's major cities to save up a 20% house deposit. This is even higher in Sydney, where it takes over 9 years to afford an average deposit.



* At 15% savings rate on average state/territory household disposable income

Source: ABS, Residex, ANZ Research

Saving up for a deposit and then paying off a mortgage means that your money is tied up for the long-term. There is a significant 'opportunity cost' from not being unable to move your money into other possible investments, while all your spare savings are needed to pay off the mortgage. In addition, mortgage loans in Australia are "recourse loans" which means banks can chase you for any loss they incur when foreclosing your loan if you become a forced seller.

Ownership costs

Despite the focus on saving for the initial deposit, there are many more associated costs of buying and selling a house.

Costs for conveyancing and stamp duty can add up to 4.3% of the total transaction depending on the state, with potential real estate commissions and advertising costs adding up to 3%. Thereby, the total costs for buying and selling a property could account for up to 7.3% of the final transaction value.

After the initial purchase, ongoing extra costs such as strata fees or council rates and utility bills are also required to be paid every year. Choices about home insurance offerings also need to be made in order to mitigate costs from unexpected events. Like most physical assets, real estate suffers from depreciation costs due to required maintenance and potential renovations or repairs. The RBA estimates these ongoing costs to amount to approximately 2.6% of the property's value annually.

Home maintenance should be considered not only in regards to financial costs, but also for the time and effort these activities may require.

Lack of diversification

Whilst property is generally considered to be an asset with low long-term risk, it has a higher level of concentration risk over the short to medium term given its lack of diversification.

Diversification refers to spreading your risk across many investments, however the majority of Australians simply own one house. This means that the majority of their net worth is exposed to a single house in a single suburb, in one city in one country. This is similar to holding a single share, rather than buying a portfolio of many shares or index fund to reduce risk. Investing in a single property could provide excellent or terrible returns depending on market timing, demographic and infrastructure developments, government policy changes and various other factors. Spreading your risk when investing in property is difficult given the cost of houses. This is a major reason why property investing can be much risker than most people think, especially when compounded by the risks leverage and interest rate changes.

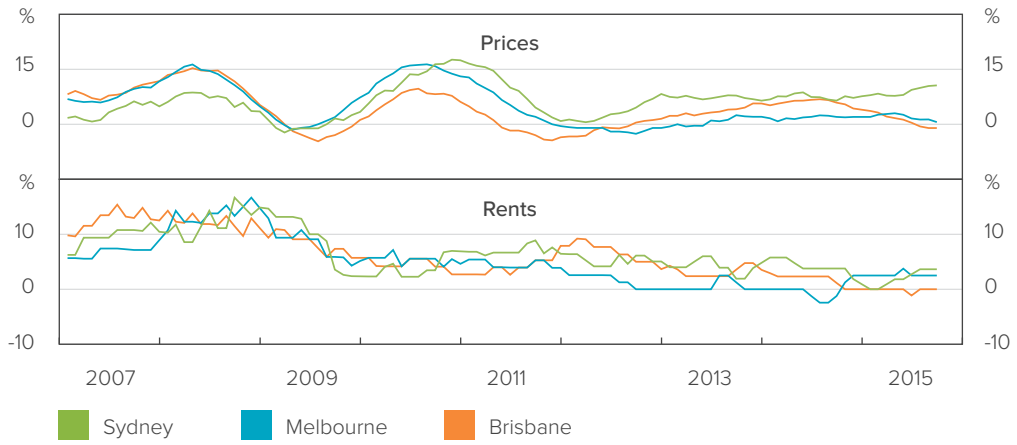
6: Landlord responsibilities

Rather than buying property to live-in, some people buy property as an investment to rent out. This brings another whole other set of potential advantages and disadvantages. Two of the most common are negative gearing and landlord costs.

Negative Gearing

The cost of owning a rental property is often greater than the income it generates. Negative gearing is a unique Australian tax policy that allows the owner of an investment property to offset rental loses against their other income to reduce tax. Negative gearing is a hotly contested political issue and future changes to negative gearing laws are possible. Changes could potentially benefit or disadvantage those who rely on this tax benefit to afford an investment property.

APARTMENT GROWTH



SA4 regions: Sydney – City and Inner South, Melbourne – Inner, and Brisbane – Inner City.
Rolling 12-month average growth rate.
Sources: CoreLogic RP Data, RBA

Landlord costs

As a landlord you will need to ensure your property is rented for as much of the year as possible to avoid periods of vacancy when you are not receiving rent. This may involve the costs of paying a rental agent, as well as ongoing maintenance. You should ensure that you're also accounting for other often forgotten costs, such as utility bills and council rates when planning your budget.

7: Benefits of shares

Flexibility

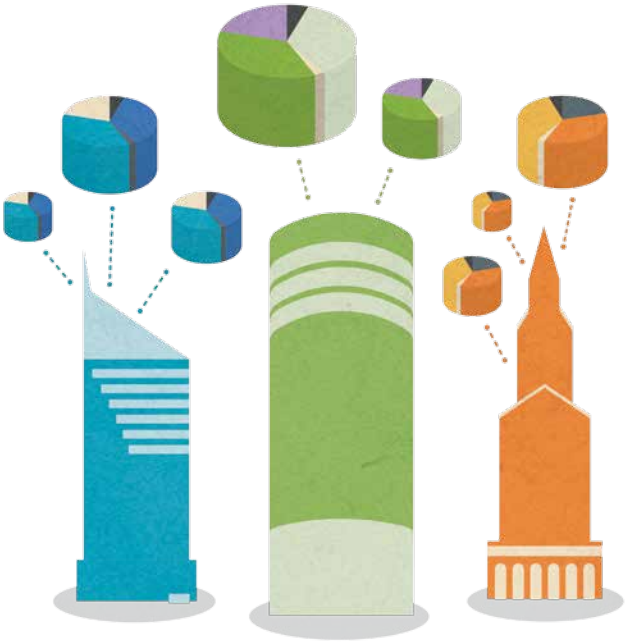
Shares can be easily bought and sold within a short timeframe if required and turned into cash within a few days. When compared to the weeks, if not months it takes to sell a property, shares are much more liquid. Once purchased, shares also require much less time and effort compared to maintaining a home as an owner-occupier or landlord.

Low initial investment

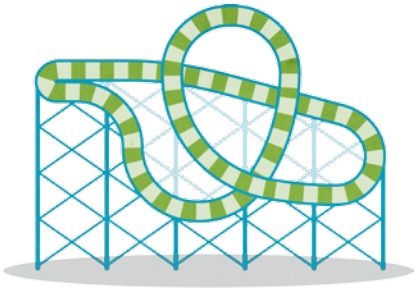
Digital financial service providers have leveraged technology to make investing in shares more accessible than in the past when you needed tens of thousands of dollars to start a diversified portfolio. For example, Stockspot now enables Australians to own a personalised portfolio of shares and bonds with as little as $2,000. Technology will continue to lower the barriers to investing in shares.

Diversification

One of the main benefits of diversification is that risk can be drastically reduced by investing in many businesses. When you invest in shares it's now easy to spread your risk across thousands of different companies at once at a very low cost. This means that you face much less concentration risk - which refers to the risk of having a high portion of your total portfolio invested in a small number of investments. Unlike investing in property, shares can also give you exposure to many sectors of the economy including IT, healthcare, financial services, mining and property.



8: Risks of shares

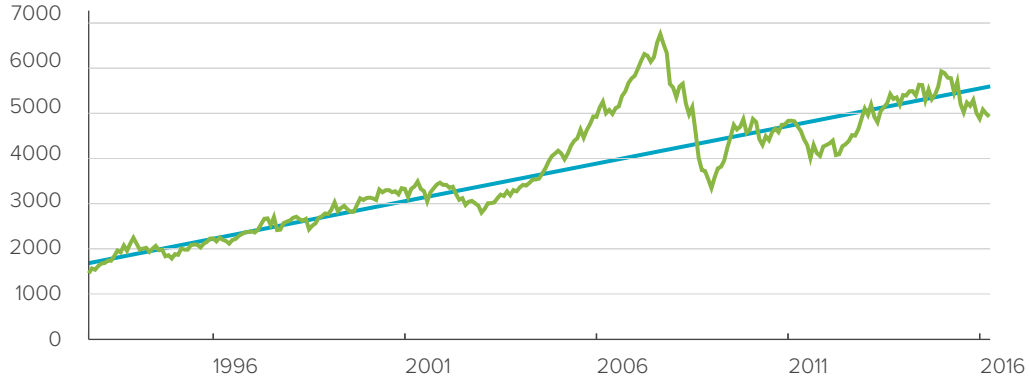


Volatility

Share investing can seem risky compared to investing in property because of the daily publication of prices. It can be tempting to check the value of your share portfolio regularly, however many people make the mistake of fixating on short time periods. Their focus should be on the long-term trend, rather than the shifts in value over a few days, weeks or months. Checking your investments too often can make it tempting to change strategy, especially if profits don't come quickly. However jumping in and out of shares is fraught with danger because you're likely to be buying and selling at exactly the wrong time.

If you look at the performance of Australian shares over the long term you can see that there is an upward trend despite many peaks and troughs along the way.

AUSTRALIAN SHARES - S&P ASX 200 INDEX



Source: ASX

Knowing exactly where the market is tracking compared to the trend-line is difficult to know, which is why it's important to have an appropriate investment horizon to be able to ride the trend. Investing for less than a couple of years is not a sensible strategy since that's not enough time for a fair chance of a positive return.

No forced savings

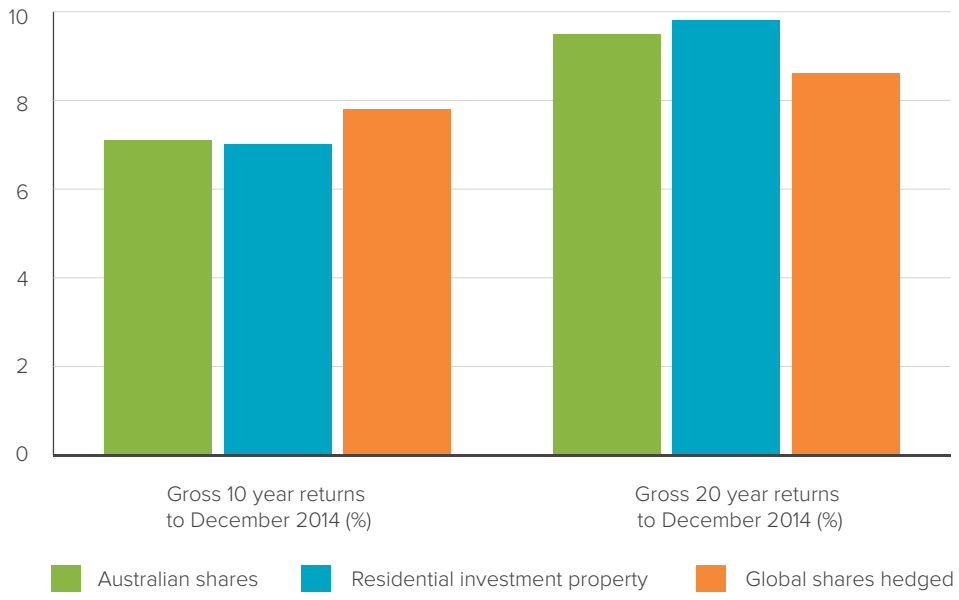
Investing in shares doesn't encourage forced savings, unlike the monthly mortgage payments that are a requirement when buying a property. This can make it tempting for share investors to spend spare cash rather than setting it aside to invest in their portfolio. Nevertheless, technology is making it easier for Australians to regularly invest in a diversified portfolio with regular direct deposits or salary sacrificing practices helping to enforce discipline.

9: Returns of property vs shares

Property and share market returns are both made up of two elements.

Capital returns

The first aspect is the capital return – which refers to prices rising over time. Historically both shares and property have enjoyed rising prices over the long-term although these can vary widely year to year. The second aspect is a dividend or rental yield – which refers to income paid out to the asset owner on a periodic basis. Both rents and dividends can be quite variable since dividends rely on companies making profit, and rents rely on having tenants.



Source: Vanguard

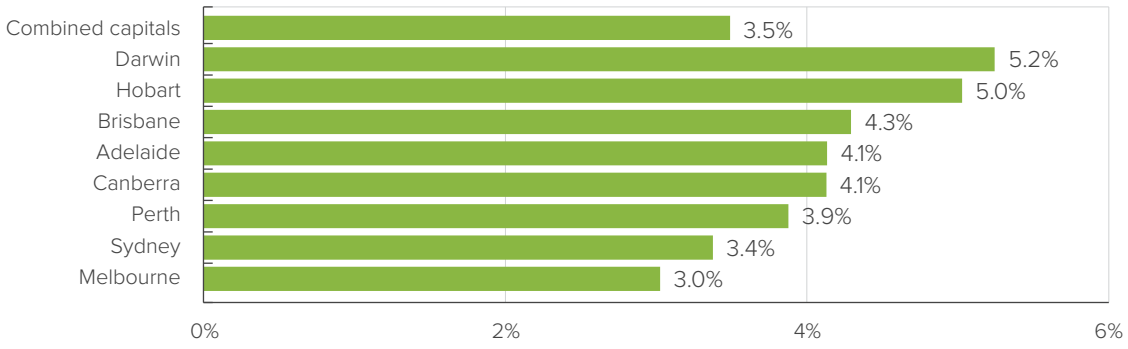
Over 50 years, shares in Australia have generated higher capital returns (9-11% per year) when compared to property (7-9%). However, over the past 10 and 20 years, returns from property and shares have generally been similar.

Dividend and rents

Dividends are payments that companies make to their shareholders (if they choose to) from retained profits and are usually paid once or twice a year around the times when financial results are announced.

Currently the broad Australian share market has a gross dividend yield of approximately 5.1%. This compares to a property gross rental yield across Australian capital cities of approximately 3.5%. Therefore shares currently generate higher dividends when compared to property rents. It should be noted that these figures are historical yields and that future yields will be impacted by future prices, the amount of dividends paid and rents received.

GROSS RENTAL YIELDS

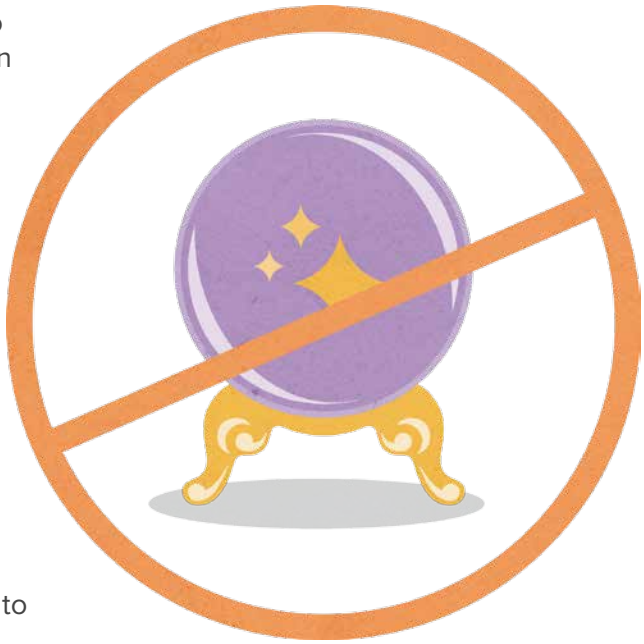


Source: CoreLogic RPData

10: Past performance vs future returns

It's important to remember that past performance is not necessarily a good indicator of future returns and that there's always risk associated with investing in any asset class.

What makes investing even harder is that money tends to chase investments that have performed well recently – which leads to momentum and short-term bubbles when price increases accelerate. Usually these short-term booms are followed by periods of poor performance as prices tend to revert back to their long-term average returns. The best performing investment for one year may be the worst performer of the next, so keeping a long-term perspective is vital.



There is a natural tendency to panic during market dips and buy after markets have risen. However, this means that you may actually end up buying and selling investments at the worst time in the cycle since prices tend to come back to their averages.

Markets can also be 'overvalued' or 'undervalued' for long periods of time so avoiding investing altogether during times when investments seem 'cheap' or 'expensive' can mean missing out on long periods of good returns. Unpopular investments can actually be seen as a positive contrarian indicator since assets tend to perform best after they have been 'unloved' for a period whereas 'hot' assets tend to perform poorly.

PAST PERFORMANCE FOR A RANGE OF INVESTMENTS

	Australian Shares	Global Shares	Australian Property	Cash	Australian Bonds
Average Returns	9.9%	4.6%	7.4%	5.6%	7.5%
1993	45.4%	24.2%	30.1%	5.4%	16.3%
1994	-8.7%	-8.1%	-5.6%	5.4%	-4.7%
1995	20.2%	26.0%	12.7%	8.0%	18.6%
1996	14.6%	6.2%	14.5%	7.6%	11.9%
1997	12.2%	41.6%	20.3%	5.6%	12.2%
1998	11.6%	32.3%	17.9%	5.1%	9.5%
1999	16.1%	17.2%	-5.0%	5.0%	-1.2%
2000	3.6%	2.2%	18.1%	6.3%	12.1%
2001	10.1%	10.0%	14.9%	5.2%	5.5%
2002	-8.5%	-27.4%	12.2%	4.8%	8.8%
2003	16.4%	-0.8%	8.8%	4.9%	3.0%
2004	27.7%	9.9%	32.0%	5.6%	7.0%
2005	21.0%	16.8%	12.5%	5.7%	5.8%
2006	25.0%	11.5%	34.0%	6.0%	3.1%
2007	18.0%	-2.6%	-8.4%	6.8%	3.5%
2008	-40.4%	-24.9%	-54.0%	7.6%	15.0%
2009	39.6%	-0.3%	7.9%	3.5%	1.7%
2010	3.3%	-2.0%	-0.4%	4.7%	6.0%
2011	-11.4%	-5.3%	-1.5%	5.0%	11.4%
2012	18.8%	14.1%	33.0%	4.0%	7.7%

N%	Best Performing Asset	N%	Worst Performing Asset

Often the worst performing asset one year can be the best performing the next.

11: Factors to consider

There are many factors to consider before making a decision on whether to invest in either shares or property (or both).

- Your budget for living and investing has limits. Look at what you can afford and test different interest rate scenarios before making a major financial decision.
- Compare whether you would be better to buy or rent – both have advantages and disadvantages.
- What is your attitude to market movements? Would you have the discipline to stay invested even during periods of market volatility?
- How stable is your income? Would you be able to continue paying a mortgage if something changed to you or your partner's work situation?
- How much of your decision is impacted by tax? Be aware that tax law changes regarding property and shares could occur at any point in time.
- Consider your lifestyle, whether or not you have dependents and the kind of area that would be best to live in. Buying a property in an area with access to desired facilities such as public transport and schools may not always be immediately affordable.
- Can you commit the required time to maintain a property?
- Personal values and situations affect your decisions about opportunity costs and risk appetite for investing decisions. Social pressure can push individuals into making choices that are not best suited for them, even though these choices may have worked out well for others.

12: Conclusion

Investing in property or shares both have their advantages and disadvantages.

This paper has outlined some factors you may want to consider before making a decision to invest in either. Please keep in mind that this whitepaper has provided general advice only and hasn't considered your personal circumstances. You should seek advice specific to your personal situation before making any financial investment decision.

Consider	Property	Shares
General	**Pros:** • Peace of mind and stable place of residence. • Flexibility to renovate. **Cons:** • Lack of liquidity and unable to quickly change mind after the initial commitment.	**Pros:** • Easily bought and sold. • Regular income from dividends. **Cons:** • Not a physical asset. • Generally more volatile in the short-term.
Diversifi-cation	**Pros:** • Lack of correlation with other asset classes and good protection against inflation. **Cons:** • Poor diversification and highly concentrated in a single asset.	**Pros:** • Easy to gain exposure to the entire index of thousands of companies to reduce risk. **Cons:** • The entire market can also have periods of weak performance.
Leverage risk	**Pros:** • Able to borrow more and leverage returns which can be great during times of low interest rates. **Cons:** • Higher repayments if interest rates rise. • Leverage magnifies losses so you can lose more than you invested.	**Pros:** • No leverage means you can't lose more than you invested. • Interest rates typically have less impact on share prices. **Cons:** • No benefits of higher leverage during periods of high growth.
Taxes and transaction costs	**Pros:** • Potential for negative gearing benefits. **Cons:** • Relatively high transaction costs associated with buying, selling and property maintenance.	**Pros:** • Potential for franked dividend benefits. • Transaction costs and fees can be low. • Involves very little ongoing effort after an initial investment. **Cons:** • Capital gains tax when shares are sold.

Low fee, hassle-free investing

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