How do you change your investment strategy to suit your borrowing capacity?

Stuart: Hey, it's Stuart. With the tightening in credit policy, it's going to create a few challenges for some people to implement their original investment strategy. Let me give you a simple example.

Stuart: Let's assume your investment strategy was to acquire or invest in two properties worth around about $750,000 each, so $1.5 million into property spread across two assets. Let's assume that you've already acquired a couple of years ago the first asset, and you're now turning your attention to acquiring that second asset. However, your inquiries have highlighted that now your borrowing capacity only allows you afford to invest $400,000, which is a really common situation these days because of a reduction in borrowing capacity. Whatever plans that we might've formulated two, three, four, five years ago now might be more difficult to implement.

Stuart: So in that situation, what does that investor do? and that's what I'd like to talk about during this video. Well, before I get there, what I'd like to share with you is a very sort of small chart or illustration from my book, Investopoly. Here it is here. Essentially, it's saying that there's three ways to build wealth. That is that you can do it through pure investing, you can do it through running your own business, or you can do it through speculation, so that's really typically the kind of three ways.

Stuart: The challenge, however, is that sometimes these strategies overlap. So sometimes when we might think we're investing, we're probably getting closer to speculation, and in some things look more like a business than they do investing, for example, property development. A small development's probably somewhere in the middle here between investing. Well, to reduce your risk and maximize your returns, I believe you really need to stick out in this pure investment space, which is really employing a fundamental approach by investing in quality assets and holding them for long term. So I just wanted to insert that because that provides a little bit context to my answers shortly.

Stuart: So let's get back to the question. What does the investor do that now has a rather impaired borrowing capacity? Well, I think they've got probably four different options.

Stuart: The first option is that they could reduce the budget and invest $400,000 in a different style property. Secondly, they can go in perhaps a regional area. So instead of being in Melbourne, go out to Dulong, or instead of being in Sydney, go out to Wollongong or something like that, not that I know Wollongong market very well. Thirdly, they could invest in other assets. There are other investments assets other than properties. I'll talk about that. Or, fourthly, they might decide to wait it out to see if borrowing capacity's going to change, if things are going to normalize. So, let's talk about all those four options and the pros and cons of each.

Stuart: The first one is reducing the budget. If your plan was to buy two properties for 750 each, you've got one 750 property and now you can only afford to spend up to 400,000, you are going to buy a comparably lower quality asset. I mean, it stands to reason that if you're investing in investment grade location, that 750 is going to buy you a better quality asset than 400,000 in terms of budget. Quality is really going to dictate the returns that you enjoy or that you might enjoy, and so it stands to reason that a $400,000 property, holding everything else equal, is going to probably deliver lower capital growth than a $750,000 property. And a $400,000 property, therefore, exhibits higher risk than a $750,000 property does.

Stuart: So depending on how much your budget has been reduced, I think that 400 amount's going to be really challenging to buy something, a quality asset. So I probably wouldn't like to do that. If your original budget was a million and now it's 800,000, it's probably okay. It's still a big enough sum where you can invest those monies without necessarily being forced or compromised to reduce on the quality of the asset. So an example I gave, let's ignore option one.

Stuart: Option two is going to a regional location. So instead of being in a capital city, move further out and buy yourself a property. So, perhaps to draw an analogy, a Victorian analogy, instead of investing in Melbourne, you invest in Dulong, and the Sydney one is maybe Sydney versus Wollongong and so forth. You get my drift. Ironically, in my view, if you're going to go to a regional town, we have to understand that the demand, which is really driven mostly by population size and growth, is going to be lower and less sustainable. So we need to sort of make friends with that, and as a result, if I was going to invest in a regional location like that, my view, you've got to really level up in quality.

Stuart: If you're going to go further out, you've then really got to shoot for the lights and get the highest quality asset that you can get. Ironically, I think that actually then means that you need to invest more or spend more in that marketplace. So if I was going to buy something in Dulong, maybe I'd buy a really great parcel of land with a older style house on it in areas like Newtown and [Towollen 00:05:46] and so forth, really established areas that have proven growth prospects. But the problem with that strategy is it's probably cost me a million dollars or more to do that, to execute on that strategy. So, let's probably ignore option two.

Stuart: Option three is invest in other assets, and you know there are other assets out there other than property, and what you possibly do is what I refer to as a regular gearing strategy. What you might be able to do is access equity in your properties, maybe $100,000, for example, and you might draw $1,000 every month from there plus $1,000 of your own cash. So you're sort of putting in 50% of your own cash and 50% in borrowings and investing $2,000 into the share market each month regularly. So you're sort of spreading the time and risk of making those investments, and you can still do that in a really low cost broad-based manner so not suggesting you need to go in peak stocks.

Stuart: Obviously if you follow any of my content, blogs, and podcasts and so forth, you know I don't believe in that. But Vanguard have a few very low cost, very diversified products, plus depending on how much you're investing you can add a little bit more complexity to address some of the risks in the market at the moment. But it's still a very good strategy, and I would argue that, that's a better strategy than buying an average type property asset.

Stuart: Fourthly, your other option is to wait and see what happens. Will this all blow over and will lending go back to normal? Will borrowing capacities return? Of course, no one really knows what the future holds, but I guess what I'm saying, what I'm sort of thinking is, look, it might ease up from here. Perhaps it's a little bit tighter than what it will be in the future, but I'd very much doubt it's going to go back to where it used to be. So maybe waiting, may or may not be depending on how far away from borrowing capacity terms you are, may or may not be a good strategy.

Stuart: I guess the theme of my communication on this particular communication is really two fold. Firstly, just because borrowing capacity is reduced, don't, don't ever compromise on the quality of the investment assets that you put your money into. Don't try and make the strategy fit the execution. If you can't afford to implement on the original strategy, then you need to go back and revisit the strategy. You don't try and squeeze a square peg into a round hole. And secondly, my second theme is really there are other assets, so I would much rather see my clients invest in a really well-thought-out thorough, diversified low cost shared portfolio than buy a secondary asset in a secondary location, which could potentially compromise their whole investment strategy.

Stuart: Anyway, just a little bit of food for thought. There's always going to be changes in the investment markets, and it's our job to help our clients kind of navigate those changes and make sure they don't make any critical mistakes and keep them on the straight and narrow. Anyway, until next time, bye for now.