


Property no mug's game when planning to secure retirement

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Like many investment professionals I was uncomfortable reading a recent article in these pages — “Why property is a mug's game” (The Weekend Australian, February 22).

I agree anyone who invests in investment-grade residential property primarily for income to fund their retirement is likely to be disappointed with the results.

But that doesn't mean people shouldn't invest in residential property to fund retirement. In fact, it is a very effective asset class when used correctly.

It is true that investment-grade property generates lower income. Most of my clients are achieving an income yield of about 2 per cent after all expenses (excluding loan interest) for apartments and just over 1 per cent for houses.

However, when you consider the capital growth rate, the overall investment returns begin to look more acceptable.

According to data published by the Real Estate Institute of Australia, the median compounding annual growth rate for houses in Melbourne and Sydney was 7.6 per cent between January 1980 and September 2019. Investment-grade property has generated higher growth rates than this.

The main advantage of residential property is that it delivers the vast majority of its total return in the form of capital growth (and consequently, less income).

This is particularly tax-effective while an investor is working, as capital growth is not taxed until the investor sells the asset. This means all capital growth is automatically reinvested, which generates higher compounding returns. Conversely, investment income is taxed each year, leaving

less to be reinvested. Mathematically, during an investor's accumulation phase, the more capital growth you can achieve from an asset in exchange for a lower amount of income, the more wealth you will accumulate in the long run.

Adopting this approach means that an investor in their 30s, 40s or 50s can acquire one or two investment-grade properties with a plan to retain them until they are well into their 70s. This long ownership period is sufficient for them to enjoy the wonderful benefits of compounding capital growth.

They should amass a substantial amount of equity in property, thereby crystallising a large cash injection when they eventually dispose of the properties. Approaching property investment in this way also guards against longevity risk — the risk that you outlive your financial resources. Holding investment assets that provide substantial compounding gains greatly mitigates this risk.

This highlights the importance of having a holistic investment strategy. If you know your strategy includes divesting of at least one investment property in the future, you can structure the ownership of that asset accordingly. For example, holding an asset in a family trust or super fund may allow you to minimise capital gains tax liabilities.

If you find yourself in the situation of being asset-rich but income-poor, it's likely you will need to divest some property and reinvest this money in a more appropriate asset class. This situation can be avoided through undertaking some financial planning well before retirement. The fact of the matter is that we cannot take our properties with us when we die. So, they will need to be sold at some point (or bequeathed). But that is the reason we bought them in the first place — to generate wealth (equity in property) we can use to fund living expenses in retirement.

The role of investment-grade property is not to generate passive income, it is to build our asset base. Once we have accumulated a large enough asset base, we must tilt our asset allocation to higher-income asset classes.

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