CASE STUDY

First step as an investor

A young property owner is keen to put his modest savings to good use despite still having a big mortgage

NAME: Andrew Ko
STATUS: Aged 31; bought a home two years ago.
QUESTIONS: What is the best investment for my money? What is the best way to leverage off my two-bedroom unit?
ANSWERS: Pay off your mortgage, so you have a buffer for when rates rise. If you add $3000 a year extra to super, you will save $1000 in tax. Once you have a good chunk paid off your mortgage, invest in a range of Vanguard's diversified, low-cost exchange traded funds (ETFs). You could afford an investment property worth $290,000 and – if you make some changes – up to $420,000. Consider the benefits of "rentvesting", where you rent your home and live somewhere else. Make sure your renovations are covered by at least an equal rise in the property's value.

Andrew Ko took the plunge and bought into the rising Sydney property market over two years ago. Happily, the value of his two-bedroom apartment in a block of 12 has jumped. While that makes him feel more confident about buying another property, he still has a big mortgage and has to renovate the 46-year-old apartment.

Andrew has refinanced his two-year fixed home loan to get a better variable rate of 3.53% using a redraw account with Pacific Mortgage Group.

Andrew's savings are slim. He has started to improve the apartment with small DIY jobs, such as painting, installing LED light fittings and re-tiling the balcony. But the bathroom needs an overhaul. He has set a budget of $15,000 including fittings, fixtures and labour.

While Andrew wants to pay down his mortgage, he would also like to start investing. As well as the apartment, he has a car, savings and superannuation with


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REST but no other investments. His main question is, what should he do with the savings in his redraw account?

Andrew has about $20,000 to invest, after factoring in renovation costs and money for emergencies.

He is an avid *Money* reader and thinks the options include:

- Continue to put money into the redraw account until equity in the home is 50% and then think about investing;
- Salary sacrifice into superannuation, but he wonders if he is too young;
- Buy direct shares or ETFs;
- Leverage off his existing property and buy an investment property.

"Some experts recommend getting a loan and negatively gearing into shares and then claiming the interest payments as a deduction. Then other experts recommend investing in another property and borrowing 100% of its value using the equity in your existing property," he says.

Andrew is open to investing in shares if that will offer the best return. However, he knows very little about them. He says he is OK with risk but obviously wants to avoid a negative return.

What is the best way to leverage off his unit? He has read recommendations about renting out your own property and living or renting somewhere else. **SUSAN HELY**

'Rentvest' and live in luxury

CHRIS GRAY

Chris Gray is the CEO of Your Empire, a buyer's agency that builds property portfolios for time-poor professionals, searching, negotiating, renovating and managing on their behalf. Visit yourempire.com.au for a free copy of his book *The Effortless Empire*.

Most people who buy into median-priced secondhand property in the inner suburbs of a major capital city make money, especially when they invest over the long term.

Based on the information you have given and some basic assumptions, I consulted an experienced broker and he said you may find it difficult to buy an extra investment property in your current situation due to serviceability issues. This depends on your precise situation and when you apply for the mortgage, so take these as rough numbers.

You could potentially buy a $290,000 property, assuming you get $300 a week rent from it.

Suggestions for increasing your borrowing capacity:

- Move your current loan to interest-only as this will cut repayments to $1600 a month.
- This will improve your borrowing capacity to $400,000 assuming $350pw in rent.
- Halve your credit card limit to $3000 to increase your borrowing to $420,000.
- Are you prepared to get a second or third job in the short term to achieve your goals?
- Consider a partner to come in on a deal, for example a relative, friend or investor.

It's a good idea to diversify into other asset classes but it's very hard to be an expert in multiple areas. People often like either property or shares. If you love what you do then you'll make it work, so go with your passion. Property offers you more leverage (5%-20% deposit) compared with shares (often 50% max) and generally has more stability if you follow some simple rules, buying median-priced property in the inner city and paying only a bank valuation price.

Renting your property and living elsewhere is what I do and it's great because:

- Most people can't afford to buy where they want to live.
- You can invest where you get the highest return and live where you want to be emotionally – it's called "rentvesting".
- My investments rent out at a 3.5%-4.5% yield and all my debt and other costs are deductible.
- I then rent luxury properties to live in at 1%-2% yield and so I get to live somewhere two or three times better than where I can afford to buy.

Simple, cheap renovation jobs often add the most value, so well done there – it's the first impression that counts. Whenever I do a renovation I always ensure that for every dollar I spend, the extra rent will cover the extra mortgage and my equity will increase more than it has cost me. So before going ahead, get an assessment from your sales agent or valuer and property manager as to the current value and possible rent now, and then their estimated values post renovation.

I would then speak to your bank or mortgage broker to make sure that they are happy to refinance the equity back out of the property post renovation: that is, if you put in $15,000 and it increases the property value by $25,000, then at 80% refinance can you increase your redraw by $20,000? That way the renovation hasn't actually cost you any money – it has put money in your pocket.

Clarify goals before going any further

JASON PETERSEN

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When it comes to investing, the hardest part can be deciding to start. Many people delay acting, trying to get the timing just right. But, often, how long you are in the market is more important than trying to time your entry. As such, it's wonderful to see that Andrew has already made a start.

But before considering his next steps, however, it's important for Andrew to clarify his goals.

Paying off the mortgage is an excellent risk management tool that will help reduce the impact when interest rates rise. Andrew has secured a low variable rate but setting some of his mortgage at a fixed rate should further reduce interest rate risk. Creating a large buffer to ensure he is prepared for a rate rise is also important, otherwise his lifestyle could be affected dramatically.

Renting out your own home and renting elsewhere may be a good strategy, particularly when your mortgage is large and interest rates are higher. Rental yields in metropolitan areas run at around 4%, so when interest rates are at or below that level there is negligible difference, unless you have significant depreciation benefits. In Andrew's case with an older property, this is less likely.

When interest rates rise, it's difficult for landlords to increase rent at the same rate. Owner-occupiers, however, feel the full extent of an interest rate rise. If you are negatively geared, at least some of the rate increase and costs can be dampened by tax deductibility. Based on Andrew's tax rate, he would feel only around 70% of the interest rate increase.

Although some may consider Andrew too young to salary sacrifice to superannuation, to retire on a comfortable $60,000 income in today's dollars at 65 he needs to contribute $12,000pa, including the super guarantee, meaning an additional $3000pa. By salary sacrificing this amount, Andrew saves around $1000pa in tax and gains the peace of mind of knowing his retirement is taken care of.

Once Andrew has a buffer on the mortgage enabling him to comfortably meet any future rate rises, he can focus on investing. An offset account would be a smarter option than the redraw for future tax purposes and flexibility.

Andrew owns his $24,000 car and could consider creating a novated lease through a sale and leaseback arrangement, using the $24,000 to pay down the mortgage and creating tax-effective debt and running costs for the car.

Key to this strategy is to diversify and keep costs to a minimum. This is where exchange traded funds (ETFs) come into their own, enabling broad diversification at a low cost.

A regular investment strategy using surplus cash would enable Andrew to build a solid, highly diversified and highly liquid portfolio. A portfolio using a range of Vanguard ETFs, for example, would cost less than 0.2% to manage and give exposure to a range of markets including Australian shares, international shares and property.