COMPREHENSIVE EXAM NOTES FOR WEALTH MANAGEMENT (FINS2643)

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1 POTENTIAL ESSAY QUESTIONS

1.1 W5 – HOME OWNERSHIP

When it comes to investing in property, it is generally a huge decision to be made by Australian households. What are the important factors that a person needs to consider before going ahead with such purchase? What are the advantages and disadvantages of investing in property? Despite economic downturn in recent periods, there are various incentives provided by federal and state government in supporting housing property in Australia. Discuss.

Adv/Disadv of home ownership – Adv/Disadv property investment – Incentives provided by federal and state government for housing property

There are different types of property:

- residential property,
- small commercial properties (e.g. shops, service stations),
- large commercial properties (e.g. office buildings, hotels and shopping centres),
- land of various types.

Adv/Disadv of home ownership

Advantages of home ownership

• CGT main residence exemption	⇨ When you sell or otherwise dispose of a dwelling that was your main residence (home), any capital gain is generally exempt from capital gains tax
• Possibility of substantial capital growth	⇨ There will be capital growth as your property increases in value over time
• A form of disciplined savings	⇨ Paying of the mortgage on the home is a form of disciplined savings- the more you pay off the more you will own. This is contrasted to renting, where the excess money you may have from not buying may or may not be put into investments
• High collateral with low finance costs	⇨ You can use your house as collateral to take a loan from the bank. Since this is a secured loan, compared to an unsecured loan such as a personal loan, you will be able to secure a relatively higher amount at a lower cost in terms of interest rates.
• Lifestyle	⇨ A home in a good neighbourhood 'opens social doors', provides stability and security, and freedom to make personal changes to the residence.
• Strategy for client with substantial super	⇨ Further improvements to main residence may act as a strategy for a client with substantial super

Disadvantages of home ownership

• Price risk	⇨ The risk of decline in value of a home. If the property does not increase in value at or above the rate of inflation, then there is a loss of money in real terms.
• Interest rate risk	⇨ Interest rates affect the cost and availability of finance and therefore can affect demand and property prices. Most people borrow to buy property and mortgage payments greatly influence how much a person can afford to borrow and spend.

	⇨ Generally, when interest rates increase, house prices flatted or decrease. When interest rates decrease, house prices increases as affordability improves and demand increases. ⇨ Interest rate volatility can lead to uncertainty and a drop in market activity as buyers and sellers wait for clarity on interest rate direction → Low stable interest rates are ideal
• Liquidity/financial risk	⇨ May take a long time to sell (months) and there are selling costs. Home ownership is not a short term investment.
• Costs	⇨ Interest rate, stamp duty, vendor duty (?), land tax, conveyancing fees, commissions, loan application fees, insurance, rates, maintenance and renovation costs
• *Unlikely to make short-term gains*	⇨ *When factoring the costs associated with selling a house, it is difficult to make short-term gains 'flipping' property*
• *Retirees*	⇨ *Principal residence does not provide retirees with income*

Adv/Disadv of property investment

Advantages of property investment

• Tax deductions	⇨ Tax deductions can be claimed for interest on borrowed funds used to finance the investment and for expenses (e.g. rates, utilities, and depreciation items). Strategy is often used for rental properties where expenses claimed are usually greater than rental income received, resulting in lower tax liability.
• Income stream and capital gain	⇨ Property can provide income stream (e.g. via rent) whilst also achieving steady capital growth
• Relatively stable asset class	⇨ History shows property to be a relatively stable asset class
• Manage risk and return in portfolio	⇨ As part of a portfolio, property investment can help manage risk and return

Disadvantages of property investment

• Government taxes	⇨ Changes to government taxes over the years have made property investment less attractive (e.g. CGT, land tax, stamp duty, GST)
• Costs	⇨ For example: legal fees, conveyancing costs, agents' fees ⇨ Cost of continued maintenance
• Illiquid asset	⇨ A medium to long term investment is required to return a net capital gain
• Commercial property issues	⇨ For example: zoning, planning and complicated lease arrangements
• Knowledge of markets	⇨ Must research and understand the market thoroughly
• Tenants	⇨ Management of tenants may be difficult
• LVRs	⇨ Must maintain loan to value ratios to satisfy financing requirements

Incentives provided by federal and state government for housing property

- Main residence CGT exemption
  - When you sell or otherwise dispose of a dwelling that was your main residence (home), any capital gain is generally exempt from capital gains tax
- CGT 50% discount for holding property > 1 year
  - Individuals and small business can generally discount a capital gain by 50% if they hold the asset for more than one year
- First Home saver accounts
  - the government will make a contribution equal to 17% of your personal contributions for the financial year, up to a maximum (indexed amount)

Explain the key drivers of residential property prices

Factors that affect demand (and price) for residential property – Valuation of property

Factors that affect demand (and price) for residential property

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  - Generally, when interest rates increase, house prices flatted or decrease. When interest rates decrease, house prices increases as affordability improves and demand increases.

  - Interest rate volatility can lead to uncertainty and a drop in market activity as buyers and sellers wait for clarity on interest rate direction → Low stable interest rates are ideal
- Location
  - Amenities and convenience
  - supply of land
- Demographic trends
  - immigration levels – for example an increase in foreign buyers
  - deferring of first home purchases or decrease in family size
  - age composition of the population
  - rate of household formation
- changes to various state and federal taxes and duties
- Social attitudes

Valuation of property

- Recent sales of similar property in the same neighbourhood

- Capitalisation of the future cash flows from the property

$$p = \frac{y}{r - g}$$

- p = property value
- r = discount rate
- g = assumed growth rate income from the property
- r-g = capitalisation rate
- y = annual net income from the property

Indexing methodology

- Median price index:
  - ranks all sales from high to low and plucks out the middle or 50th percentile observation.
- Repeat sales index (e.g. Cash-Shiller Index)
  - looks at the price of the same piece of real estate as it is sold over time.
  - Advantage: calculate changes in price of same property and therefore avoid trying to account for price differences of homes with different characteristics
  - Disadvantage: Don't take into account homes that were sold only once during reported time period which are also meaningful indicators of housing market activity

- Hedonic pricing index
    - the price of a property is determined by the characteristics of the house (size, appearance, features, condition) as well as the characteristics of the surrounding neighbourhood (accessibility to schools and shopping, level of water and air pollution, value of other homes, etc.) The hedonic pricing model is used to estimate the extent to which each factor affects the price.

Explain the process, alternative methods and costs in buying and selling residential property

Methods of buying and selling residential property – Costs of buying and selling residential property

Methods of buying and selling residential property

- Private treaty purchase
    - 10% deposit
    - 5 day cooling-off period after exchange of contract
    - Issues
        - more time to find buyer to pay top dollar
        - more likely to back out
- Auction purchase
    - 10% deposit
    - No cooling off
    - issues
        - competitive (higher price0
        - less chance of buyer dropping out
        - quicker
        - fixed auction fee

Costs of buying and selling residential property

- Purchase price
- Taxes (e.g. stamp duty)
- Council rates
- Maintenance Costs
- Body Corporate/strata management fees
- Insurance
- Conveyancing costs

Most Australian households invest in property through direct investment which is generally illiquid. What are the alternative ways to gain exposures in property?

Forms of property investment

Vehicles: direct investment, listed property trusts (LPTs or A-REITs), unlisted property trusts, syndicates	

Direct investment	• Purchase property directly through a real estate agency or broker (negotiable sale or through the open auction process)
	• 'Off the plan' – when new developments are in planning stage. Allows for price to be locked in, potentially protecting from increases in value during construction and allowing for input regarding features included in property. Also entails risk if the property is not completed on time or in the manner expected.
	• Buying commercial property is more complex with more regulatory requirements
	• Costs of investing in direct property
	    ○ State taxes: stamp duty and land tax
	    ○ Federal taxes: GST and CGT

Listed property trust	Listed property trusts (LPTs) • LPTs are listed on the ASX and invest directly in property • LPTs are known as Australian real estate investment trusts (A-REITs) and work similar to a managed funds in that investors can purchase 'units' in the trust • LPTs are a professionally managed and diversified portfolio that may invest in a variety of asset classes, whilst others may specialise in a particular asset class or location. ○ E.g. Centro Retail Group, Goodman Group, Mirvac Industrial Fund • Advantage: more liquid than property purchased directly and fewer transaction fees. Also more suitable for those who may not have funds or time available to purchase a whole property themselves.
Unlisted property trust	Unlisted property trusts • are managed products that invest only in property • usually have higher entry and exit fees than LPTs • Less volatile than LPTs as they are not as susceptible to daily market fluctuations of traded stock • Choose fund manager with proven track record
Syndicates	• Involve several investors pooling cash to buy asset that investors would not be able to afford on their own • Syndicates are relatively illiquid with a seven-year time frame • Usually run by accountants or financial services groups

Superannuation fund	• A SMSF can be set up to invest in residential property – must comply with the rules
	  ○ Rules: sole purpose test, restrictions of connection of property to related party of a member and members
	• SMSF property sales may have many fees and charges that can add up and reduce super balance
	• Borrowing or gearing your super into property must be done under very strict borrowing conditions → 'limited recourse borrowing arrangement': can only be used to purchase a single asset
	  ○ Before committing to a geared property investment you should assess whether the investment is consistent with the investment strategy and risk profile of the fund.

Compare and contrast between investing in property with respective to other asset classes? What are the tax considerations for cash and fixed interest, property, and shares?

Property investment vs other investments

Diversification benefit of residential property?

How can the family home be used in retirement

Issues – Reverse mortgage – down sizing

- **Age pension**
  - Many retirees will seek to claim benefits under the Centrelink age pension
  - Income and asset tests to determine pension entitlements – if any and how much pension a person or couple are entitled to.
- **Reverse mortgages**
  - Reverse mortgages allow you to borrow money using the equity you have built up in your home.
    - The lender runs a tab: each time a drawdown is made, the debt to the lender increases and interest on the debt is added to the debt account
  - Advantages: