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Time is right for positive gearing a property portfolio

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What is negative gearing

It's a lot like monopoly…sort of

Australians' obsession with property investment is about to be tested.

Flat property prices, the likelihood of higher mortgage repayments and questions over the future of tax breaks are putting at risk the strategy of "negative gearing".

But there is another model for property investors to follow – positive gearing.

Nyomie, a nurse, and Mark, a teacher, have about half-a-dozen investment properties. Their aim is to have a decent standard of living when they eventually retire. *Photo: Peter Gleeson*

This is where the rent covers the costs and the property actually produces an income.

It's the strategy used by Nyomie and Mark Johnson from Port Macquarie on the mid-north coast of NSW. Nyomie, 46, is a nurse and Mark, 53, is a high school teacher.

The Johnsons own six investment properties that are all cash-flow positive. They started investing in property two years ago and Nyomie says it's their intention to hold onto the properties and generate income in their retirement.

The original reason for property investment was to produce an income, just like in a game of Monopoly. *Photo: Alamy*

"We also want to help our kids as we did not have much to leave [to them]," Nyomie says. "We want to be able to leave our kids in a situation where they do not have to worry either."

Nyomie and Mark downsized their family home when their children left home and used the money they freed up to start their portfolio, which includes a combination of villas and apartments mostly in regional NSW.

They talked to several property experts before deciding to follow the advice of Kevin Lee of Smart Property Adviser to buy in regional centres with good growth prospects.

They have been able to find properties where the rent is higher than the costs, something that is difficult to achieve in the more expensive capital cities where prices are high compared with rents.

Nyomie and Mark had previously tried negative gearing – where rental income doesn't cover expenses and the landlord has to subsidise the investment from personal income.

With negative gearing, you can claim a tax deduction for the losses, but it still costs you real money, typically thousands of dollars a year. The strategy works if property prices go up enough to compensate for the losses.

"We did have negatively geared property years ago and it impacted on our personal finances and we decided not to go down that path again," Nyomie says

Many property investors are relying on big capital gains when the property is sold to more than make up for the losses along the way. In the current climate, investors need to rethink how they are going to make it pay.

Some experts suggesting positive gearing is the way to go, regardless of what the government of the day decides to do with negative gearing tax breaks.

Peace of mind

Laura Menschik, a financial planner and director of WLM Financial Services, says she has seen some "disastrous results with buying property, whether it's geared or not".

While Menschik is definitely not against property investment, the risks should be clearly understood, particularly when using a negative gearing strategy.

"The risks include that investors lose their jobs or there is a marriage break-up," she says.

Investors never want to be in the position where they are forced to sell, she adds.

The shorter the time between buying and selling a property the more likely there will be a loss.

That is because of insufficient time to amortise the very significant costs of acquiring property, such as stamp duty and the legal costs.

Some property experts recommend a lower-risk strategy, called "positive" gearing, where rent covers the costs from day one.

The risks are lower. The property is cash-flow positive and self funding and success of the strategy does not rely on big capital gains down the track.

A big attraction of negative gearing to a lot of investors is that they are able to offset the losses on the property against their other income, usually salaries, and reduce the amount of income tax they pay.

The tax savings do reduce the losses on the investment that still have to be funded from other income, but it remains a loss-making investment.

Many higher-income earners are attracted by the tax deductions because they have the biggest tax savings.

However, tax considerations too often override the fundamentals in people's investment decisions, says Peter Bembrick, a tax partner with Sydney accountants and advisers HLB Mann Judd.

"Tax should never be the driver of investment decisions," Bembrick says. "It's the long-term merits of the investment rather than the tax savings that are most important."

Lower risk

There is no rule that says an investor has to be positively geared from day one.

An investor may start off "neutrally geared", where the costs equal the rent, or even negatively geared with the investment eventually becoming cash-flow positive as the mortgage is paid down and rents rise.

Positive gearing also mitigates the risk that the generosity of the tax breaks, when negative gearing, could be curbed or limited.

Pressure is building to curb the tax effectiveness of negative gearing as it costs the federal budget about $4 billion in forgone tax revenue each year.

While the Turnbull government is likely to leave the rules unchanged, Labor says if it wins the election the tax breaks on negative gearing will cease for existing properties and be allowed on new properties only.

Existing investors would be unaffected.

Some experts, including Lee of Smart Property Adviser, think that the best is past for negatively gearing into capital city property.

Prices are already very high for properties in the big cities after the strong gains of recent years.

Indications are that price rises in Sydney and Melbourne have stalled. While interest rates are likely to remain at historic lows for some time, the next move is more likely to be up than down.

That will translate into higher interest rates on mortgages and higher interest costs for investors.

Regions a better bet

Lee says investors need to look further afield, outside of the capital cities.

"Over the past few years we've concentrated entirely on regional cities and larger towns," he says.

Probably 60 per cent of the properties purchased by Lee's clients are houses in the regions, with the remainder consisting of two-bedroom units and two or three-bedroom villas or townhouses.

Lee says "absentee" owners, such as those from Sydney and Melbourne, tend to favour the lower-maintenance properties such as strata-titled investment properties over freestanding houses.

He says the best regional cities and towns for property investment are those with diverse economic drivers, or reliable economic drivers like hosting educational institutions, as well as low unemployment.

"We've never recommended our clients invest in a one-horse mining town," Lee says.

He is referring to towns in Western Australian such as Karratha and Port Hedland.

Demand for property in these towns was red hot during the mining boom. Now, with the mining sector contracting, jobs and workers in these towns have reduced with a consequent fall in rents and property prices.

Louis Christopher, the managing director of specialist property researcher SQM Research, says to break even on an investment property, where the costs equal the rent, probably requires a gross rental yield of at least 6 per cent.

And that is assuming the investor has one of the lower mortgage interest rates in the market, in the low 4 per cent.

That is not going to be achieved in Sydney or Melbourne, Christopher says.

As far as relatively large cities go, there is only Hobart and the Gold Coast where that sort of yield is available, he says.

However, both of these centres have had bad property downturns in the past, particularly the Gold Coast. "And both cities have narrow economies."

Our Port Macquarie couple Nyomie and Mark are achieving a gross rental yield across their regional property portfolio of 7.4 per cent. And the holding costs, such as rates, are typically less than in metropolitan areas.

While there are no cash losses that can be offset against their other income, such as salary, they are able to claim tax-deductible depreciation allowances as stipulated by the Tax Office.

Generally, the newer the property, the higher the depreciation levels which varies for fittings and fixtures.

For Lee, the best strategy is to keep it as simple as possible with the fewer things that could go wrong the better.

For example, he does not like "newer-build" apartments with gyms or swimming pools and their high strata fees. In Lee's opinion, with these apartments, the landlords are subsidising their tenants' lifestyles.

He prefers units in the lower price range as they tend to pay the highest rental yields.

And, if not cash-flow positive immediately, they can quickly turn cash-flow positive.

Lee avoids apartments in buildings of more than three storeys and those with lifts, as they require constant maintenance and repairs.

He also discards apartments in past buildings with visible structural faults or poor strata reports.

How the numbers stack-up

Money asked Lee to provide an example of a positively geared investment and how the numbers would look.

His example assumes a three-year fixed rate mortgage with an interest rate of 4.19 per cent for a property with a purchase price of $220,000.

It assumes a loan-to-valuation ratio of 90 per cent, meaning the investor puts down a deposit of $22,000.

Assuming the mortgage interest rate is constant over a 25-year loan term, the monthly principal and interest repayment is $1066, of which $375 is repayment of principal.

Lee is assuming a weekly rent of $290 a week, or $1257 a month, which makes it likely the investment – even after insurance, council rates, water and strata levies and real estate agent fees – is cash-flow positive from day one.

What is gearing?

The formula to create wealth from property used by most investors is simple.

First, borrow the maximum to buy the investment property with as small a deposit as possible.

The portion of borrowed money to the purchase price is called the "gearing" level.

Just as gearing magnifies capital gains, it also magnifies capital losses.

If the rent from the property does not cover the costs, the largest of which is likely to be the mortgage interest costs, there is a loss on the property that has to be funded from other income.

In that case the property is said to be negatively geared and investors can offset the losses against their other income, such as salary, and reduce their income tax bill.

The higher the investor's income, the greater the tax savings.

The success of the negative gearing strategy depends on the property being sold for sufficient capital gains to more than make up for the losses along the way.

Some investors who start cash-flow negative have a different aim.

They hold onto the property for long enough that the size of the mortgage reduces and rents rise. With time, it becomes cash-flow positive.

They may have bought the investment with a view to moving into the property when they retire or as source of income in retirement.

With positive gearing, the rent more than covers the costs and the investment pays for itself from day one.

An investment can be neutrally geared, where the income from the investment matches the costs.