VALANA

TUTORIAL

Module 7 ► **The property investment myths**

► Introduction

To make it easier for our busy readers to scroll directly to the items they are interested in without having to read through all the material, we list the issues covered in this module:

- **THE THREE GREATEST MYTHS SURROUNDING PROPERTY INVESTMENTS**
- **BUYING A PHYSICAL PROPERTY, USUALLY FOR THE PURPOSE OF LETTING**
- **BUYING LISTED PROPERTY STOCK ON THE STOCK MARKET**
- **BUYING INTO SELECTED PROPERTY SYNDICATES**
- **A MORE PROFITABLE ALTERNATIVE FOR INVESTMENT**
- **SOME CONCLUSIONS MADE**

If you are interested in accumulating useful information about stock market investments you may want to copy this module and add it to the others published in order to build your own manual of useful tips to assist you with successful investments in the equity markets.

The statistics and historic performance used in the examples are based on historic averages and we attempted to be as accurate and fair as possible in each scenario or illustration.

■ The three greatest myths surrounding property investments

☼ *It will be very difficult to beat a fixed property investment over the long-term*

☼ *The best investment you can ever make is a property "buy for let" investment*

☼ *You can get someone else to pay all your bond instalments on a property bought*

After the examples with verified facts used in this module to test the above beliefs you can be the judge as to whether these beliefs are true or just myths.

The probable reason why many investors favour property as an investment is the fact that most South Africans traditionally deem physical property to reflect a person's wealth and/or standing in the community.

It is also a tangible and visible asset that may be used and enjoyed whilst owning it.

It could be effectively used as counter security for loans if needed.

However, if you ask most people who had a house "owner built" or who let a property to tenants, they will most likely say that these ventures are all you need in your life to totally

... ***lose all your faith in humanity.***

■ Buying a physical property, usually for the purpose of letting

Example (A) ► Property bought cash (no bond) for letting purposes

If you bought a property in **1978** for **R60,000** with no mortgage bond applicable and you successfully let it over the next 30 years, to good tenants, where you wisely made use of a standard rent management agreement, the situation 30 years later would have been approximately as follows:

- Property would have been worth **± R2,000,000** in 2008.
- Gross return on the property appreciation itself would have been **12.5%** per annum.
- Average gross rental would have been **± 6%** per annum (based on value each year).
- Net rental as a percentage of your investment after tax, fees, levies, rates, insurance, maintenance, etc would have been **less than 3%** per annum.
- The rental income monthly also probably would not have been reinvested in the property scheme and the actual net rentals received over the 30-year term would have been worth **± R540,000.**
- Your end value (sales commission excluded) would have been **± R2,540,000.**
- This scenario would, therefore, have given you a net average return of **13.3%** per annum.

Example (B) ► Property bought with a maximum bond for letting purposes.

- If you bought a property in **1978** for **R60,000** with a maximum bond at 12% per annum, applicable for the full term, and you successfully let it for the 30-year term, the situation in 2008 would have been as follows:
- Physical property would also have been worth **± R2,000,000** in 2008.
- Total bond payments would have been **± R241,000** (30 x R8,036 per annum).
- Total net pre-tax rentals over the period would have been **± R214,000.**
- Total net tax paid on rentals would have been **± R28,400.**
- No tax will be payable on rental income whilst the interest component is higher than the rentals received (applicable for first 15 years or so in example used).
- The compound effect of annual eroded invested amounts, due to the bond repayments, deducted from the ongoing value and the other maintenance costs and expenses will leave a real return over the 30 years of only **8.8%.**
- Therefore, the actual real value in 2008 would only have amounted to **± R763,200.**

A higher bond rate or abnormal upkeep and/or problems with rent collections during the term, of course, would have worsened the situation in this scenario considerably.

It may be of interest to know that if one rather invested the bond payment of R8,036 paid each year above, in the first Allan Gray Equity Collective Fund, your investment after 30 years with Allan Gray would have been more than R4,000,000 in 2008.

If one deducts the rentals received above (R214,000) the latter option would still have given you **R3,000,000** more than the property investment and you would have been free of all the hassles usually involved with property letting.

■ Buying listed property stock on the Securities Exchange

Buying listed property stocks on the JSE is not the same as buying physical property and the returns with these listed property stocks are considerably better than the returns you can hope to get with physical property (real estate) investments.

In fact, during the past 15 years or so, listed property stocks were amongst the best performing asset class investments available as shown in the table below.

Asset Class		Yield %
Equity Investments	►	15.6%
Gilts & Bonds	►	12.9%
Money Markets	►	10.8%
Listed Property Investments	►	21.3%

Example ► Investing R500,000 for a 10-year period in listed property stocks on the JSE

(*Shorter term used as not many listed property stocks has been listed for a long period on the JSE*)

Although listed property stocks have not been around that long, one can still compare its performance with normal fixed property investments over a lesser 10-year term.

If you started a portfolio of listed property stocks in **1998** and bought into the five best rated property stocks at the time, such as Growthpoint, Hyprop, Octodec, Premium and Sycom with equal investments of **R100,000** each (total R500,000) the situation in 2008 would have been as follows:

- The average capital growth of these stocks would have been **513%** over the term
- The value of these stocks, after ten years, would have been **R3,065,000**
- The net pre-tax value if sold, would have been around **R3,034,350** (costs ±1%)
- The total dividend/interest you would have received would have been ± **R470,365**

If you bought a house for **R500,000** in a middle class area in **1998** and let it successfully for the 10-year period, the situation in 2008 would have been as follows:

- The average capital growth of the property would have been **300%** over the same term.
- The gross value of the property would have been around **R2,000,000.**
- The net pre-tax value if sold would have been around **R1,840,000** (costs ±8%).
- The total net rentals you would have received would have been **± R218,681.**

Therefore, if you bought the physical property and you had good tenants who looked after your property you would have ended up with approximately R2,060,000.

If you bought listed property stock and just sat back and enjoyed this hassle-free investment with a certain annual income stream, you would have ended up with approximately R3,500,000 which is R1,440,000 more than the physical property scenario, or ±70% better.

■ Buying into selected property syndicates

Property Syndicates come in many formats, such as:

- Golf Estates
- Game Farms
- Security Complexes
- Apartment Blocks
- Holiday Flats
- Industrial and/or Commercial Facilities, etc.

One still finds many investors who favour investing money into small and even obscure property syndicates who sometimes promise very exciting and tempting returns.

These property syndicates are mostly not well regulated and we found it quite difficult to obtain reliable performance data for a big enough sample group to fairly assess their performance over an extended period of time.

We also could not find a single big fund manager who invested in these syndicate schemes and it would therefore be unfair for us to judge whether these syndicate schemes (on average) deliver a good return or not.

We however, list some of the concerns that investors should address and consider before blindly investing in these schemes:

¤ Can you reliably verify the high returns often claimed?
¤ How diversified are the holdings in the scheme?
¤ Are there sufficient properties involved or will all the eggs be in one basket?
¤ Is there sufficient performance history to assess the sustainability of the scheme?
¤ How much expertise do they have in property lease management and development?
¤ How much access do they have to funds if required for maintenance, repairs, etc?
¤ How easy will it be for the investors to sell their shareholding in the scheme?
¤ How do the acquisition or other fees/commissions compare with other instruments?
¤ Why don't they borrow the money much cheaper and buy all the shares themselves?

If you are satisfied that all the above concerns are in order then such syndicates may contain investment opportunities for investors with a fairly high appetite for risk.

■ A much more reliable alternative

Example ► Starting a share portfolio with R60,000 for a 30-year period

If you started a share portfolio in **1978** and only achieved an average yield of **15%**, which is 2% points less than the 17.4% average yield obtained by the JSE All Share Index over the past 45 years and you earned an average tax-free dividend of only 3% each year, your situation 30 years later in 2008 would have been as follows:

- Your share portfolio in 2008 would have been worth **R6,988,000.**
- The tax-free dividends earned during the period would have been **R679,300**.
- The real return on this investment would have been **17.2%** per annum.

*One should realise that if a stock market investor used a valid stock selection strategy or process, such as offered by **Valana.co.za** the yield obtained will almost certainly be considerably better than the conservative 15% used in the example above.*

There is also the option to invest in ***participating bond instruments*** which some may confuse with property investments.

These instruments are really in first mortgage bond financial instruments and not in property as such and therefore should be seen as belonging to the money and capital market asset classes rather than the property asset class.

Someone in the upper tax brackets who are looking for a good income stream investment may find this type of investment quite attractive as it compares more than favourably with most other money market or capital market investment instruments.

Whilst it is almost as safe as those other instruments, it has the added advantage of greater tax benefits.

Depending on the participant's age, amounts higher than R1m may be invested tax-free in such schemes and if one considers the competitive returns from these investments, such investments may be a worthwhile option to consider.

On the lighter side - *you know you are in a property bubble when the following happens:*

- Your 22-year old hair stylist advises you on which areas are next to explode in value.
- Estate agents immediately return your calls, sounding slightly breathless.
- Your builder wears more jewellery than Liberace and Edith Venter combined.
- You have to wait almost a year to discuss your building plans with a contractor.
- The plumber drives a car worth more than the house you want to build.
- People who could not make ends meet now own more houses than Mugabe's cabinet.

Something to think about

According to research done by Kruger International, a high profile financial consultancy firm, it appears that over the past forty years domestic physical property investments would have given one approximately the same average real return as the modest performing money markets.

■ The conclusions made

Why would anyone make physical property (real estate) their investment of choice?

- When the real returns are considerably lower than alternative equity orientated asset class investments?

- When the hassles and problems with tenants, upkeep, authorities and general maintenance may drive you round the bend?
- When rising interest rates could make the wheels come off your investment to such an extent that it may even become beneficial to just give the property back to the mortgagor and walk away from it?

Module 7
20 February 2010