Managing the Risk of Investing

Many people feel that it's the act of buying an investment property that's risky; I largely disagree.

Sure, if you're crazy enough to buy real estate without having completed the proper due diligence (i.e. a review of the numbers, the property and the tenant), then you're setting yourself up for a potential disaster… but it's not until you are the owner that the real investment risk materalises.

If there's a weakness to my book, *From 0 to 130 Properties in 3.5 Years*, it's that I did not have the opportunity to properly outline how to effectively manage and mitigate some of the risks associated with owning property.

Well, in an effort to correct that problem, in this bonus chapter I've outlined three potential property pitfalls, in addition to discussing ways that you can reduce your exposure to these risks.

RISK #1: STRUCTURAL DEFECTS

Cosmetic challenges can usually be overcome with minor repairs and a small budget. Structural problems on the other hand are totally different matter.

A few years back Dave and I bought a property with the assurance from the sales agent that the house had been recently partially restumped. Taking the agent at face value and not seeing any obvious problems, we happily went ahead with the purchase, comfortable with the knowledge that we had a client wanting to buy the property immediately from us under a wrap strategy.

When selling the property using a vendor's terms contract, I made mention to our client that the property had been restumped. Being a little more savvy then us, our wrap client made it a condition of the contract that the necessary paperwork proving the satisfactory completion of the restumping be provided within 30 days of taking possession.

Hmmmm – it should have been easy enough, yet in the end it was a humungous nightmare! It turned out that the property *might* have been restumped but no-one could locate any supporting evidence, and to organise to have the council come to inspect and then sign off on any work was a savage exercise in form filling and struggling through red tape.

To even lodge a request I had to draw up a floorplan of where the stumps were and dig 15 centimetres around each stump to indicate that each went to the required depth. This meant that I had to crawl around under the house in dust and dog poo! In the end I just offered my wrap client a discount on his purchase price as an incentive to forget about the problem, which he happily did.

What this experience taught me was:

- Be very careful when you make promises to potential purchasers, especially when the representations you make are later written as terms in a contract.
- When it comes to structural issues, it's better to avoid them entirely than it is to just assume that everything will be OK. Be wary of the cost of anything that has a 're' in front of it – eg. re-wiring, re-stumping, re-plumbing, re-pairs!

Steve's Investing Tip

Be wary of the cost of anything with a 're' in front of it – e.g. re-stumping, re-wiring, re-plumbing and re-pairs. They might look like small problems, but they are almost always expensive to fix.

Remember that it's often what you *can't* see that will cost you the most money to fix and plaster or paint can be used to hide a lot of nasty defects.

Epilogue: I went back to my sales agent and asked him about his restumping assurance but all he said was "Oh, that's what the seller told me and I never bothered to check it out – I thought that was the sort of thing *you* did. Sorry."

Avoiding Structural Defects

I strongly recommend you always pay for a builder to inspect potential property purchases and to provide a written report. If you're going to spend $100,000 plus buying a property then you'd be crazy not to spend the $200, or so, having a qualified builder check it out for you.

Additional Note: When you buy cheaper houses (say, up to $60,000) there may be a tendency for you to gloss over structural issues given that the purchase price is so low. This would be a large mistake because you must remember that your financier will usually only lend on the contract price, not the contract price plus the odd but expensive structural repair.

Buying low and then shelling out substantial amounts to have the property 're-anythinged' will have devastating consequences for your cash on cash return. Be very, very careful.

RISK #2: VACANCIES

In one of my free newsletters (which you can access by joining my mailing list at www.PropertyInvesting.com/newsletter) I made the comment that vacancies are the silent killer of financial independence. This is because a vacant property generates no ongoing cashflow. In fact, a vacant property costs you money as you must pay the loan costs (if any) in addition the ownership expenses (such as rates and insurance).

Steve's Investing Tip

Vacancies are the silent killer of financial independence because an empty property delivers no positive cashflow.

If you plan to live off the passive income that a property can provide then it's critical that you do everything you can to secure the longevity of your income stream.

Avoiding Vacancies

There are only two reasons why a tenant moves on:

1. A change in circumstance:

There is precious little you can do about this. When a tenant needs to move because of a new job etc. then you just need to grin and bear it. Still, you can try to make the best of the situation by asking your vacating tenant (if you think he or she was a good client) for the name of a friend who might be interested in moving into the property.

For example, my wife and I will soon be leaving our rental unit in favour of buying our first home (until now we have always rented). Our first child is not far away and it's time to set down some permanent roots. While we like where we live now, with the pitter-patter of little feet (and lots of screaming and crying I'm told!) on the way, it'll be too small in the near future. Our change of lifestyle has necessitated that we find a new home and there is little that our landlord can do about it.

Our neighbours and friends from across the road (Don and Helen) look after out pet budgies whenever we are away. Recently, while we were on a trip back to visit the in-laws in Queensland, Helen came over to feed the birds with a friend. Her friend really liked our unit and said that if we ever moved out then she'd love to move in.

Should the landlord ask us then I'd have no problem passing on Helen's friend's details (I might do it regardless), which would mean there would be no vacancy between tenants and a win-win outcome for everyone involved.

Just be careful that you complete the proper due diligence, even when you have a tenant recommended to you. For example, just yesterday I received this incredible note from one of my rental managers:

> *"Just a quick email to bring you up to date with goings on. The tenants that were put in there by the previous owner have turned out to be no good. I sent them a notice last week for their arrears, they came in on Friday with a promise of paying all up today.*
>
> *They have just been in and they tell me that they are leaving today as the local gang are after them and have threatened to smash up the house. Rather than have that happen, they are just going to pack up and shoot through, they are signing their bond over to me and are going to pay $20 per week to pay for the three weeks notice and the outstanding week in rent.*

I will go around and visit the president of the local gang and see if I can talk to him to find out what is going on. I have been around to the property and it seems to be okay. I will keep going around just to check on things, and try to get a tenant in ASAP. ”

2. A bad landlord:

All a reasonable tenant ever asks for is a level playing field in the sense that they want a neat and tidy property and then, provided the rent is paid on time, they want to be left alone to enjoy it.

As a tenant I can tell you that the things that really upset me were:

- When the landlord or rental manager unnecessarily hassles me – this happens almost weekly in the office we rent. Our landlord is retired and I'm sure that his new favourite hobby is contacting us several times a week!
- An unfair increase in the rent. Never raise the rent just because you can or else you'll risk losing the tenant altogether! When I raise the rent I seek to be positive and add value rather than risk being seen to be greedy. I try to be practical and to always explain the reasons for the increase rather than just whacking the price up without any courtesy whatsoever.

While there's not a lot you can do about a change in a tenant's circumstance, there is plenty you can do to ensure you don't become an unreasonable landlord. Just be fair and expect fairness in return. I encourage you to revise my thoughts about tenants (i.e. seeing them as partners in wealth) which I outlined in Chapter 12.

Steve's Investing Tip

Always explain the reason for the rent increase rather than just jacking it up just because you can.

It's also wise to remember that you must always retain control of your investment. If a tenant doesn't come to you, then you need to be proactive and go find a tenant! Run a classified ad offering an incentive such as free movie tickets or offer to pay the moving costs. Talk about offering a secure (long-term) tenancy. Focus on the benefits in your advertising (a big backyard where the kids can play) rather than just the features (a big backyard). Generally, the more you can make the property feel like a home the better your chances of finding a long-term tenant.

Only in the worst of worst-case scenarios should you offer a below-market rent, and if you do, it must only be for a short period of time. You must protect your long-term cashflow at all times!

In summary, you can reduce the risk of vacancies by:

- Acting like a reasonable landlord (so you don't create a reason for the tenant to move out)
- Asking for a referral if your tenant does move out or, even better, keeping a database of potential tenants in advance of a vacancy and then find appropriate properties for good tenants to live in (they must be positive cashflow)
- Being proactive rather than reactive by assuming control of your investment when needed as opposed to relying on a rental manager. It's your money and your credit rating on the line; don't let your success be a matter of chance – make it a matter of choice.

RISK #3: A RISE IN INTEREST RATES

Let me be clear – the low interest rates that we're experiencing at the time of writing are not going to last forever.

Steve's Investing Tip

Interest rates will eventually rise – the secret is to not pretend they won't or avoid thinking about it altogether.

Rigjht now – with interest rates at 30-year lows – is a great time to invest, but only if you have a plan to mitigate the risk when interest rates do eventually rise.

Of course, I could be wrong. Maybe, against all the odds, interest rates will stay low forever. However, if you believe this then you're arguing against the boom-bust cycles that have occurred since the dawn of time.

When interest rates rise there will be a profound impact on residential property because higher interest rates mean bigger loan repayments, especially for those that are highly geared (and effectively borrowed too much).

For example, the interest component on a $500,000 loan at 6% interest-only is $30,000. When interest rates rise to 7% the same property will attract $35,000 interest. "What's $5,000?" you might ask. Well, perhaps not a lot if you only own one property. But if you own ten such properties then $5,000 quickly turns into $50,000 and this amounts to a huge potential headache if you don't have the cash to cover the extra interest cost.

There are three ways you can deal with the possibility of an interest rate rise:

1. You can stick your head in the ground and ignore the weight of history's evidence, proclaiming that this time things are different and interest rates will be low forever.
2. You can act ignorantly, knowing that rates will rise but not knowing how they will impact your business.
3. You can be proactive and manage the risk.

An impending increase in interest rates is not a reason to stop or defer investing. Right now, while interest rates are low, is the time to be actively buying property that can help you reach your long-term goals. I can almost guarantee that in ten years time we will look back at the conditions present as I write this chapter and wonder why we didn't do more to take advantage of them!

Managing Interest Rate Risk

Despite its appeal, a low interest rate environment also means that you must exercise caution with what you buy and definitely have a plan to manage your debt.

The plan that we use has the following components:

- **Plan to repay the debt:** Except for the commercial property that we own, all the other dwellings in our portfolio are on principal and interest repayment terms. This is because the act of repaying debt works to minimise our risk as interest rates rise. It follows that the less you owe the lower the potential impact of a rise in interest rates, so I encourage you to develop a plan to repay your debt. Avoid leveraging too highly in terms of borrowing against your equity to fund negative or neutral cashflow property.

- **A mixture of loans:** We use a combination of fixed and variable-term loans. The aim here is to secure a portion of our cashflow profits via the use of fixed-term loans.

  Fixed-interest loans usually attract a higher interest charge, but the premium is worth it, in my opinion, for the security of knowing that some of our cashflow lifeblood cannot be ripped away by a sudden increase in interest rates.

  I don't think that there is a hard and fast rule about the mix between fixed and variable loans. In the end it depends on your circumstances and your risk profile.

- **Manage your margin:** It's always a good idea to look at the amount of positive cashflow that you earn and then translate that back to an interest rate comfort buffer.

  For example, if you had a property with a loan of $100,000 on an interest rate of 6% which provided a positive net cashflow of $30 per week ($1,560 per annum), then interest rates would have to rise to 8.05% before your positive cashflow was wiped out (assuming you didn't have a rise or fall in rent or ownership costs).

  Knowing this piece of information is handy because you then need to then keep an eye on both fixed-interest rates (to know when they reach the danger point in which case you need to seriously think about locking in) and variable rates (to keep track of the general market sentiment).

- **Keep a cash float:** I strongly recommend that you keep enough cash in your business (either in the form of savings or mortgage offset accounts) to repay three months of repayments. Call this your comfort zone, but having the resources to make repayments irrespective of what is happening to your income reduces your dependency and just makes sound business sense.

  As you own more property you must also increase your portion of cash reserves. If, at any time, you find that you're eating into your cash comfort zone, pull back for a while and reconsider your approach. It may be that you are adopting unnecessary risk.

- **Keep your greed gland under control:** The biggest risk in your investing system is you! Things may be going well until you decide to tweak your system and start to take risks because all you see are the huge dollar signs flashing before your eyes.

  Greed is not good. It causes a loss of objectivity and rationalism and needs to be guarded against. Always do your due diligence as the more you leave to chance the greater chance there is that something could go can terribly wrong.

- **Don't bet your entire home:** While it may be prudent to use part of your home equity to fund further property acquisitions, it is equally important to understand your risk profile and to, perhaps, take a cautious approach to just how much home equity you will leverage.

  Understand that if you use your home as security then it will be sold from under you in the event that you can't pay your debts. Personally, as a general rule, I wouldn't leverage against any more than, say, 40% of the value of my home. And anything that I did buy with that equity would have to provide a return far in excess of the cost of my funds. Even then I'd be looking to repay my equity drawdown as soon as possible to mitigate the risk of any rise in interest rates.

The bottom line is that you don't want to be gambling with your family home as security in the event that things go wrong.

SOMETHING TO THINK ABOUT

Anyone who tells you that the act of investing in property isn't risky is a fool. Like any other investment, there is always risk – including the risk that you could lose money. With careful management and lateral thinking this risk can be minimised, but it can never eliminated.

You must appreciate that you need to be the one to re-establish control when things seem like they are starting to go wrong as, at the end of the day, it's your money, your home and your financial wellbeing that's on the line.

Seek passive income, but always remain an active investor who manages your property portfolio to maximise your cashflow returns.