PropertyInvesting.com 'Insider'

Discover proven tips, strategies and techniques to dramatically increase your property investing profits

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Hi welcome to your June 2003 edition of *'Insider'* - the PropertyInvesting.com e-bulletin for positive cashflow investors seeking a lifetime of passive income through real estate.

Are you receiving this newsletter for the first time? If so then I'd like to extend you a warm welcome on behalf of the entire Property Investing.com community.

The topics for this month's newsletter are:

Let's get started...

Auction Antics

Last weekend I attended an auction to bid on behalf of a friend. The house was a standard three-bedroom weatherboard job, on a reasonably large, but not excessive, parcel of suburban land.

As the bidding got down to the wire, it was a three-way race between two others and myself. I was quite relaxed, as there's a certain amount of peace you receive when you're bidding using other people's money.

Anyway, as the price edged higher and higher in $100 intervals, my friend's self-imposed limit was exceeded and I opted out. It was now a two-horse race. Slowly and steadily the price again rose, in $100 intervals, until the second to last bidder, a young couple, were also out.

The final price at the fall of the hammer $388,700.

Until you understand the consequences of the figure, the price might just appear as black text on your screen, but reality is a very different matter. For example, assuming the purchaser took out a loan for 80% of the purchase price:

- The stamp duty and government charges payable are an additional $21,217.
- The total cash needed for deposits and closing costs would be about $100,000.
- The weekly loan repayment based on an interest rate of 6.5% over 25 years would be $482.03 per week.

Wow - that's a huge commitment! If the family enjoyed a modest combined income of $110,000 per annum (say $70,000 and $40,000), the after-tax amount remainder is $79,680. The mortgage repayments therefore total 31.45% of the after-tax remainder.

Presuming they can afford the repayments, things will be fine until interest rates begin to rise, which will have the following impact:

Interest rate	Weekly Repayment	Percentage of after-tax income
7.5%	$527.47	34.42%
8.5%	$574.66	37.50%
9.5%	$623.43	40.68%
10.5%	$673.63	43.96%
11.5%	$725.10	47.31%
12.5%	$777.70	50.75%

All in all, you could reasonably conclude:

- Buying a house and using debt to fund 80%+ of the purchase price is an enormous financial obligation. With a possible interest rate cut on the horizon, homebuyers might be tempted to ignore the warnings put out by both the Reserve Bank and the Federal Treasurer that the housing market is overheated.
- The reason why the market is overheated is because increases in income or salary have not kept pace with rising home prices. The gap has been funded by debt. While interest rates are low, things look remarkably rosy. But interest rates **must** eventually rise, because that's the way financial markets work! It not a matter of **if** they will rise, only a matter of **when**.
- It's more important than ever to distinguish between an investing decision and a

lifestyle decision. Buying a home is a lifestyle decision that will have a serious impact on your ability to retire when you want from the workforce and on your available cash for investing.

- I firmly believe that for those who can wait, there will be better opportunities for buying a home when interest rates rise. That said, if you want to buy or upgrade your now, then don't be afraid to do so provided you have a long-term outlook and can easily afford the repayments

Which Loan Is Best For Me?

Principal and Interest or Interest Only?
An issue investors must continually re-examine is trying to decide the best way to set up their finances. For example, you need to think about:

- What percentage loan-to-valuation ratio (LVR) do you seek?
- Do you go for a principal and interest or interest only loan?
- How long should your loan be? and
- Do you ask for a variable or fixed interest rate?

I'm going to discuss these four issues over the coming months, starting now with the issue whether to seek a principal and interest, or interest-only loan.

Let's start from scratch and explain a definition for each:

A *principal and interest (P&I) loan* is one where each repayment is the combined sum of the appropriate interest plus a portion of the original loan amount. The amount of each repayment is calculated as a present value, which is a statistical term where the only way to easily work it out is by using a financial calculator.

On the other hand, an *interest-only (IO) loan* means that your repayments are simply 100% interest and no principal, which of course means that your loan always stays at the same amount.

Applying these definitions provides two essential differences between P&I and IO loans. These are:

1. The loan balance at the end of a P&I loan should be less than the loan balance at the beginning. Furthermore, unless there is a loan residual (ie. a balance left at the end of the loan), the amount remaining at the conclusion of the loan should be zero.
2. Because P&I loans contain a principal component, the repayments should be slightly higher than the IO alternative... well, at least at the beginning of the loan that is.

Let's look at an example to flesh out the concept.

Bette buys an investment property for $150,000. She has arranged finance at 90% LVR and is given the following choice:

A. Interest-only loan at a variable interest rate of 6.5% for a term of 10 years. The weekly repayment would be $168.75. The loan after ten years would be $150,000.
B. Principal and interest loan at a variable interest rate of 6.5% for a term of 10 years. The repayment would be $209.92 per week and the residual or amount owing at the end of ten years would be $104,551.38.
C. Principal and interest loan at a variable interest rate of 6.5% for a term of 25 years. The repayment would be $209.92 per week and the residual would be $0.

Which loan should Bette choose? The answer is whichever loan brings her closer to her investing goal in the least amount of time within the context of weighing up the risks vs. the rewards.

The interest-only loan has the lowest repayments, yet the debt balance does not reduce. The principal and interest loan repayment is higher, yet the balance owing progressively reduces.

P&I Loans

With the exception of commercial loans (for reasons outlined below), all my loans are on a P&I basis. This is a deliberate choice, because I want to reduce my debt. This in turn has the effect of mitigating my exposure to a rise in interest rates.

Of course, when debt goes down so too does my interest payments, which then increases my cashflow in the long-term.

Perhaps the biggest risen for the choice of adopting principal and interest loans is the teachings of my Grandfather, considered a wise man by many, who said "no-one ever went broke because they owed too little."

I firmly believe that recycling debt, as opposed to repaying debt, places the investor in dangerous and uncertain waters **unless** an allowance is made to repay debt at a later date.

Interest-Only Loans

There are some circumstances when it's perfectly appropriate to select an interest-only loan. An immediate example that comes to mind is one of our commercial properties. The bank would only provide a ten year loan term and gave us the option of either interest-only or P&I.

If we had of chosen P&I then our loan repayments over ten years (on the basis of a zero residual) would have made turned our monthly cashflow from positive to negative because of the substantial principal component.

Instead, what we have done is to allocate or quarantine a potion of our cashflow to repaying debt, but just held this cash in a mortgage offset account rather than applying it against the loan. By doing this we arrive at the same outcome (ie. debt reduction), but just from a different angle.

Knowing Which One To Choose?

A common theme that you'll see reappearing over the next few newsletters is that you need to let the circumstances of your deal dictate the way you structure your loan within the context of your risk profile and long-term goal.

Just watch out for the mistake of borrowing money and not having a structured plan for repaying it. Where possible I'd advocate that a P&I loan be used in preference to an IO loan since the quicker you repay your borrowings, the less risk you have when interest rates rise and also the higher your cashflow will become as you pay lower and lower interest.

The Wrap Dilemma

A few days ago I sent you an e-mail outlining my observations in the wrap market - namely that there were some blatantly unethical and immoral investors out there giving everyone a bad name.

In the e-mail I mentioned how a person had told me about a deal they had set up that saw them make interest only payments off their loan, while his wrap client paid P&I repayments of his vendor finance debt.

I outlined that this was wrong, yet didn't really go into why. Well, I've received a few e-mails requesting to explain in more detail so for the benefit of all, here's a broader discussion.

The short answer for why it is the wrong thing to do is that, simply, it's illegal as it breaches the Sale of Land (Vic.) Act, which requires (at least) that your client's principal repayment be applied off your mortgage.

However, besides this, I think that there are also some longer term issues to think through too. For example, what would happen if your client made his/her last repayment and expected title to the property only to discover that your mortgage still exists and must first be cleared? What would happen if you couldn't afford to pay it out?

As I understand it, it's this exact issue which saw the government change the law so that a seller using vendor finance must pay down his/her loan by the amount of the wrap payment.

Hopefully my explanation has now shed some more light on this matter, but if not, please just make a post on the forum.

The second part of my e-mail details of an upcoming seminar **exclusively** devoted to success wrap investing. Again, having received many requests for information, I'd like to answer some of the questions that seem to keep repeating.

1. Will I be running another wrap seminar in the near future in another city (Sydney, Brisbane etc.)

The answer is no. The last wrap seminar I ran was in Melbourne, as is this one. It's just too much of a logistical problem to book a venue at short notice and cart everything interstate. As an alternative I kept the price of this event within very affordable limits so people having to travel could manage comfortably.

2. The Wrap Library - when will it be re-released?

At this point I'm expecting mid-September 2003. I will actually be taking the audio from this event as the basis for an expanded and updated resource for the new product.

3. What if I want to come to the seminar... is there a special offer?

I'm not sure I communicated this very well in the original e-mail. The short answer is YES. If you attend the seminar and end up buying the revised Wrap Library (within 30 days of the event) then *I'll credit 110% of your seminar fee against your purchase*.

Just to remind you of the details - it's on July 26, 2003. The venue is here in Melbourne with an 8am start and a 6pm finish. It's fully catered for and the cost to attend, $1,099.95, includes all notes and a copy of the actual wrap contract that I use.

As expected, the event is already over 50% sold out with many tickets being pre-reserved or sold on a payment plan. If you have any questions or comments then please e-mail Brent or call on 1800 660 630.

To book for the seminar visit: http://www.propertyinvesting.com/resources/12

Be quick though... seats are going fast.

Summary

This month I briefly touched on the issue of house prices rising far more quickly than increases in pay or salary. Sadly, in years ahead we will look back now on quite a large portion of investors and homeowners who bought property during a time of historical low interest rates and believed that the good times could last forever. **When** interest rates rise there **will** be a significant number of households that will be in a dire financial position.

While you'd never want to capitalise on another's misfortune, the reality is that people in a position where they have to sell will drive the overall house market down. The economically polite term is a correction, for those involved though, it will be a disaster.

This month we also began the first of a four-part analysis on financing. We looked at the difference between P&I and IO loans. Wherever possible and financially feasible, I recommend going with a P&I loan as, as my Grandfather said, "no-one ever we broke because they owed too little."

However sometimes an interest-only loan will be appropriate. In these circumstances go ahead cautiously and always have a plan in place that will see you repay rather than recycle your debt.

Well, that's probably enough for this month. For us Aussies, today is the last day of the financial or tax year, so on that note I wish you a very happy new year for tomorrow. Best of luck with your property investing and remember that success comes from doing things differently.

Regards,

Steve McKnight

P.S. As the last day in the financial year, if you're interested in buying one of the many fantastic resources available at PropertyInvesting.com, today would be excellent timing. That's because you can claim an immediate tax deduction (subject to eligibility - click here for more about this) since the tax year ends today! Check out the resources on offer.

P.P.S. Don't forget to tell your friends about the site and this newsletter. The easiest way to do this is by using our simple "refer a friend" facility at: http://www.propertyinvesting.com/files/pop_welcome.htm

P.P.P.S. To read the back issues of this newsletter visit: http://www.PropertyInvesting.com/backissues

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