RENT & INVEST

OVERVIEW MARIA BEKIARIS

RENT V BUY – IT'S AN age-old debate. There's no denying that most Aussies love the idea of owning their own home but is it really the best option for building wealth? The reality is renting and investing any extra savings makes a lot of financial sense. Phil Ruthven, the chairman of IBISWorld, says you should not assume that owning a home is better in financial terms than leasing one.

"If individuals or families leased their home and invested the difference between the lease costs and the interest-plus-principal payments in shares they would have been better off financially – even over the past 45 to 50 years of sometimes high inflation," says Ruthven. "They will probably be better off over the next 45 to 50 years."

As the numbers crunched by IBISWorld show, you could be close to $1 million better off by leasing (see table).

A report by the Reserve Bank of Australia in June concluded that if future house price growth is less than the historical average, as some observers are suggesting, then the average household is probably financially better off renting than buying.

Some of us won't even have a choice. While the great Aussie dream of owning a home might be alive and well, it is becoming out of reach for more and more people.

As John Symond, chairman of Aussie, puts it, first-home buyers are "stuffed". Rising property prices across Australia, especially in capital cities, mean they need to raise a very large deposit to buy their first property, Symond explains. In Sydney, for example, where SQM Research's median house price is $970,000, you will need a deposit of at least $194,000 to avoid lenders mortgage insurance.

Some of those who are already on the property ladder have had to take on a huge mortgage to be there. This may be fine in the current low-interest-rate environment but will their mortgage stress be too much if rates go up by a few percentage points?

So it might pay to explore never owning your own home and building your wealth in other ways. Of course, there are pros and cons with both options and they're not all financial – there is undoubtedly an emotional element associated with home ownership.

Ruthven, who has long been a proponent of leasing over buying, says it's a myth that "rent is money down the drain".

Interest payments on a house have been, and still are, higher than rent even before capital repayments are made, says Ruthven. "So it is interest payments that are money down the drain, not rent." With a $400,000 loan at 5%pa over 25 years you will pay $233,600 in interest.

Ruthven adds that there are many hidden or conveniently "forgotten" costs of home ownership. "They include transfer costs (real estate agent fees, conveyancing fees and stamp duty) three or four times over 30 years, maintenance costs, alterations and additions to the home, rates (except water) and insurance (except contents)," he says.

These will add up to more than $400,000 over a 30-year period, IBISWorld estimates (see table). As a tenant you avoid such costs and can move without much expense; the landlord will be responsible for maintenance and other costs associated with ownership.

Another advantage of renting is that it gives you more options about where you want to live. You might not be able to afford to buy a home in a particular location but renting will be a cheaper alternative.

A big disadvantage of renting is the worry about getting kicked out if the landlord decides

GETTY IMAGES

YOU DON'T NEED A HOME TO GET RICH

to sell or not renew your lease. That's why Ruthven is a big proponent of "leasing" over renting. Ruthven favours leasing because the time frame is longer – 3+2 years or 5+5 years, which gives you greater certainty and emotional security. Such leases are not easy to find in Australia but Ruthven believes they will become more common.

Being a home owner has other advantages. You're not subject to periodic inspections and you can personalise your home, really put your stamp on it, without seeking permission.

A big plus is when you pay off your mortgage the home is yours – you no longer have to worry about making repayments – whereas as a renter you'll need to keep paying rent. And let's not forget the value of your home will grow and you can use the equity you build to invest in other assets.

You also need to decide where to invest your money. You may favour the bricks-and-mortar option but the danger of focusing on an investment property is that rules that benefit investors, such as negative gearing, may change. So it is a good idea to diversify and include shares, whether buying them directly or via a managed fund or ETF.

Renting and investing won't be for everyone. "People can and have grown rich by renting and spending their excess cash on investments like shares," says Symond. "However, many people do not have the discipline or cannot apply the excess funds to investments to grow their wealth, whereas a mortgage is a great way of enforced saving and also secures a property for both lifestyle and capital returns."

So if you feel you'll never be able to afford to buy your own home, or have one but feel the debt is too big a burden, don't despair. It is possible to get rich without owning a home.

Money has asked experts to come up with wealth plans for three different scenarios.

Julie Berry, from Berry Financial Services, offers tips for a single person in their 20s with no deposit; Joanna McCreery, from Majella Wealth, outlines strategies for a young couple with a sizeable deposit who are priced out of the market; and Catherine Stewart, from Arnold Stevens Finlay, has a blueprint for an older couple to make their non-deductible debt tax effective.

HOW THE NUMBERS STACK UP

$545,000 HOME OVER 15 YEARS

BUYING		LEASING	
Deposit (10%)	$5450	Leasing costs	$6,504,000
Interest	$327,500	Investment[2]	$54,500
Principal	$490,500	Other investment[3]	$590,100
Other costs[1]	$422,500	Other costs	$0
Total	$1,295,000	Total	$1,195,200
End value	$1,658,000	End value[4]	$2,448,500
Profit	$363,000	Profit	$1,253,500

Source: IBISWorld, June 2014. [1]Stamp duties, agent and solicitor costs, application fees over two homes in 15 years, plus rates, alterations and additions and maintenance, including DIY. [2]In lieu of house deposit. [3]The result of investing the difference in costs between leasing and owning in a super fund. [4]Assumes 13%pa annual return.

STORY JOANNA MCCREERY

Build up funds for a share portfolio or an investment property

SERIOUS SAVING

HOME OWNERSHIP has helped many Australians build wealth over the past decades. This has mainly been due to two factors: a mortgage forces you to save through loan principal repayments; and a mortgage gives you financial leverage to the value of an asset that typically increases over time.

The key to building your wealth is saving and investing. You do this when you buy a home to live in but you can also do this when you rent.

Just like rent, interest on your home loan is an expense. When you buy a house, you buy one at a price where you can afford the mortgage repayments on a loan that you repay over a period (usually 25 to 30 years). These repayments include the interest expense and principal repayment. Just like the mortgage repayment situation, when you rent you should rent at a price that will allow you to pay the rent as well as save some of your income.

In this situation, a couple pay $500pw in rent, or $2167pm. The house they rent should be worth around $650,000 (assuming a 4% rental yield). If they were to buy this house, after purchase costs and by using $70,000 of their savings, they would need a $610,000 loan to buy it. Mortgage repayments on this loan would be $3275pm at 5%pa interest. This repayment amount is more than the rental cost ($1108 more) but it includes principal repayments, which have the effect of building your net assets. If the price of this house grows at 3%pa, then in 30 years the loan would be fully repaid and the owner would have an asset worth $1.6 million.

By renting rather than buying this house, this couple saves $1100pm in housing costs. But to build their assets, they must save at least this amount every month.

Regular saving

Setting up an automatic monthly savings plan is a great way to save. It turns it into "forced saving" similar to mortgage repayments. If you saved $1100 a month into a bank account earning 3%pa, you could accumulate a balance of $640,000 in 30 years. Tax on this income would become more significant, so more tax-effective ways to save should be considered.

An alternative to saving into a bank account would be to save into an investment account. If this investment was predominantly Australian shares, you would benefit from lower tax due to franking credits. Your investment should also earn more over the long term. If it earned 7%pa, you could have a balance of $1.3 million in 30 years.

Contributing to super

An alternative to saving out of your post-tax income is to salary sacrifice into super from pre-tax income. This strategy allows you to save more, because a $1100 reduction in your after-tax pay results in $1427pm going into your super if you are in the 32.5% marginal tax rate.

The catch is that at 30 years old, you couldn't access these savings for at least 30 years. With the possibility of a family ahead, this inflexibility is probably not appealing. I would suggest some salary sacrifice but accumulating the rest outside super. As you get older, the amount of salary sacrifice could increase.

Borrow to invest

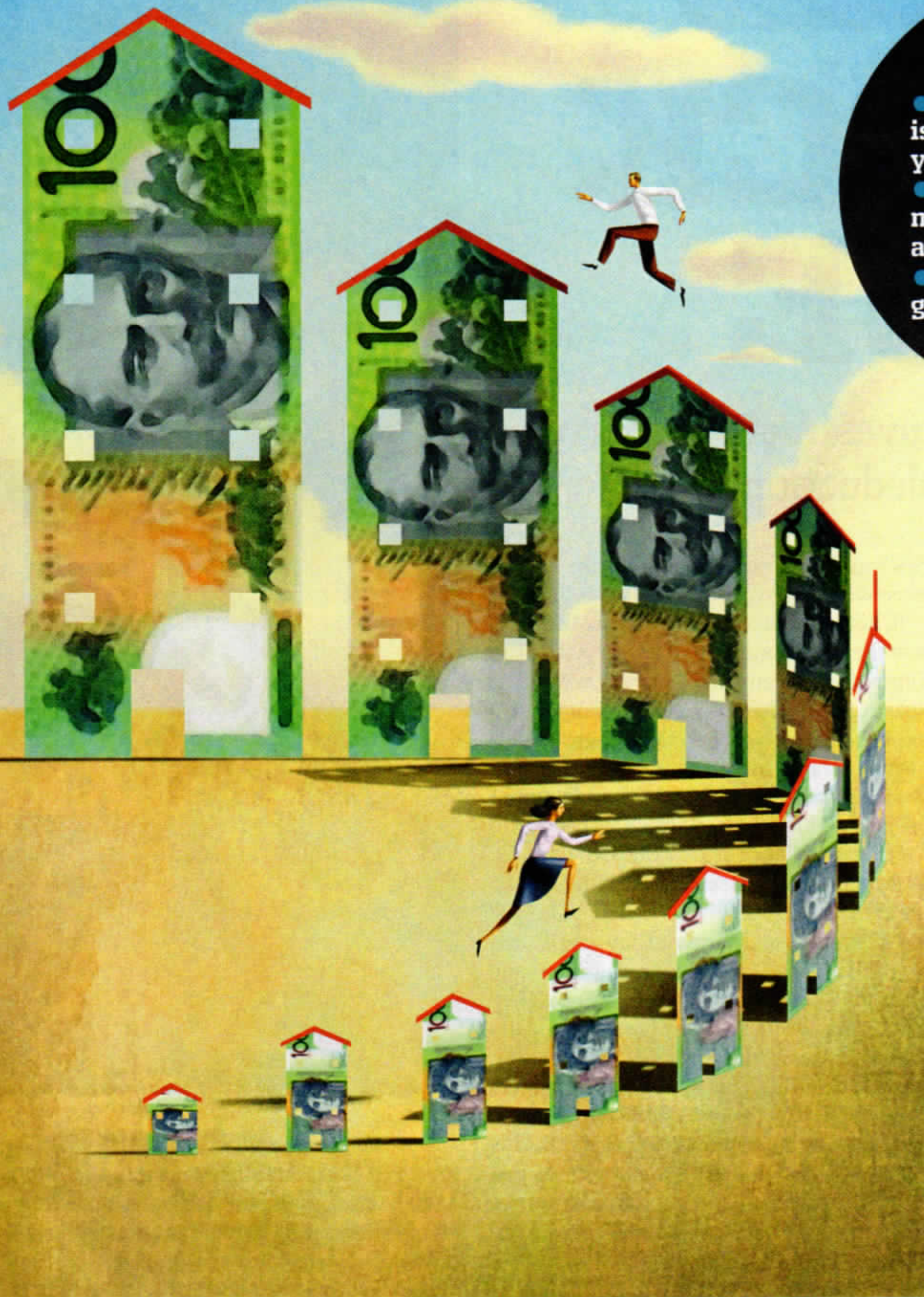
An advantage home ownership has over a monthly savings plan is that a greater amount of assets are growing for the whole period. When you start a savings plan, you begin with nothing invested and, even if your investment return was 7% for the year, if you only have $13,000 invested after year one, then you only increased your wealth by $924 through investment growth. If you had $650,000 invested (as you would with a home), a 7% price rise over the year increases your net assets by $45,500.

This is where borrowing to invest can help. Typically, you can borrow more at a lower rate if you borrow to buy a property. With $70,000 available to invest (leaving $10,000 worth of savings in reserve), you could buy a property for $500,000 with a 15% deposit. If the rental yield is 4% ($385pw), then after interest costs (assuming 5%) and other rental property expenses (assume $5000pa), the property costs you a net $640pm. Because this cost (and possibly depreciation) helps you reduce your tax, the after-tax cost would be less than this – potentially less than $300pm.

This would leave room for saving up to $800pm. To reduce the risk of gearing, these savings could be directed towards repaying the loan. Once the loan is fully repaid, the $800pm loan repayment can be saved and

HOW THE NUMBERS STACK UP

30 YEARS OF INVESTING; REGULAR SAVING $1100 A MONTH		
BANK ACCOUNT 3%pa	NET ASSETS AFTER 30 YEARS	$640,000
INVESTMENT ACCOUNT 7%pa	NET ASSETS AFTER 30 YEARS	$1.3m
INVESTMENT PROPERTY Value $500,000; yield 4%; after tax net annual costs $3600; annual loan repayment $7200. Once loan repayed $800pm saved earning 5%pa; property value grows @ 3%pa	NET ASSETS AFTER 30 YEARS	$1.7m
BORROWING TO INVEST IN SHARES Invest $70,000 plus $70,000 borrowed @ 7.5%; ann'l interest cost $5250; 8%pa return. Save $1200pm into portfolio,after tax credits and franking credits; increase margin loan by $5000 a year	NET ASSETS AFTER 30 YEARS	$1.7 m



3 KEY TIPS

- **Don't rent a place that is more expensive than you could afford to buy.**
- **Prioritise your monthly savings plan – and don't abandon it.**
- **Invest your savings in growth assets.**

earns 5%pa. If the property value grows at 3%pa, net assets would be $1.7m in 30 years.

One way to borrow to invest in shares is with a margin loan. You can generally borrow up to 75% of the value of your share portfolio. Beware, though, these loans have "margin calls" if your borrowings exceed your maximum loan to value ratio (LVR), which can happen if share prices fall. For this reason, you should borrow less than 75% and have cash available to add to your portfolio if share prices fall.

If you borrow the same amount as you invest (invest $70,000 of your money and borrow $70,000), your borrowing ratio is 50% and it would take a 33% fall in the value of your portfolio to trigger a margin call.

While margin loan interest rates are generally higher than mortgage rates, investing in shares has advantages. For instance, buying and selling costs for shares are much lower, the investment size can be customised to your needs, shares are easier to sell, there are no maintenance costs and you can earn franking credits.

If our couple invests a total of $140,000 into shares at 7.5%pa, interest costs would be $438pm. If the interest expense is paid out of the portfolio, they can save at least $1100pm into the portfolio. Given the tax benefits, we will assume they can save $1200pm. If the portfolio returns 8%pa, dividends are reinvested and they add to their portfolio by increasing the margin loan by $5000 every year (gearing stays at less than 50%because of portfolio value growth), then in 30 years, their net assets would be $1.7 million.

Summary

The chart compares all these strategies (except super contributions) with home ownership. Each savings strategy reduces after-tax income by no more than $1100pm. When added to the rental expense of $2167pm, this is no more than the mortgage repayments on a $610,000, 30-year home loan at 5%pa ($3275 pm).

All strategies depend very heavily on consistency and asset price growth over the long term. Home ownership forces that consistency. It requires more discipline to maintain a regular savings plan – but you can see that it can be just as effective at building your wealth.

HOW STRATEGIES COMPARE

Rent is assumed to remain constant — SOURCE: RP DATA

Joanna McCreery has 20 years' experience in the finance industry, is a certified financial planner and a director of Majella Wealth Advisers.