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Investors and their impact on the property market

Opinion by Alistair Helm Posted 1 December 2014

Property is a very interesting and somewhat unique investment class. Unlike other financial investments such as shares or bonds, all of which are entirely passive, property is an asset you can actually use and consume.

There are other investments which you can use, for example classic cars or antiques, however unlike these, property is resilient to wear and tear. Simply put: live in a house for 5 years and its likely value at that point in time will have far more to do with the local property market, whereas drive a classic car for 5 years and its value will be somewhat tarnished and devalued.

Add to this the fact that borrowing to buy a property is far more likely to receive a welcoming smile from your bank, whereas your application to buy a classic car might require a deeper inquisition.

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Then of course there is the not insignificant fact that you can operate a business based on a property, renting it out to recover the expenses of the mortgage and running costs, not to mention having the government generously grant you the right to expense interest costs in the business. So it doesn't take much to see why people are attracted to property as an investment.

In this country, whilst accurate numbers are scarce, around 30 to 40 percent of property buyers are investors, whose portfolios for many amount to 3 or more properties and are what they themselves consider a significant nest egg for their retirement, the benefit of which is that it is not taxed as there is no capital gains tax applied to such properties.

The most active period of property investment in this country was around 10 years ago when cheap interest rates and surging property prices matched economic growth, leading many to load up on investment property using an existing family home as equity. This drove total annual property sales to over 120,000 and powered the property market right until the GFC and the collapse of finance companies which conspired to destabilise the market and consequently saw property sales tumble to less than half the prior high.

A few years of quiet contemplation by investors ended in 2010 when keen eyes started to see the market turning and recognised the signs of the distressed state in which many over-stretched newbie investors found themselves. This generated a spark that rekindled the property market and has largely driven the Auckland market over recent years. It has effectively established a degree of a self-sustaining loop.

Investors have been buying up properties to rent out, which has satisfied a growing demand for rental property in Auckland. At the same time this has consumed a large portion of properties for sale, creating a sellers' market and inflating prices. This in turn has created urgency for others to enter the market with heightened expectation of capital appreciation and a healthy demand for rental property as would-be buyers have been priced out of the market. The loop has been reinforced, strongly fuelled by low interest rates and, up until the imposition of the LVR policy, high loan-to-value mortgages.

It appears that investment properties for rent are more popular here than say in the UK or US. This is largely, in my opinion, a function of the more landlord favourable terms of tenancy rather than for any tax reasons or capital appreciation.

Australia has a similar level of investor focus on rental investment property market and shares a similar landlord friendly approach to tenancy. Partly as a function of the higher level of participation in investment property, New Zealanders tend to set a lower expectation of yield for rental investment property, dependent upon the location in the country, but in the main this would be around 3.5 percent to 4 percent whereas in the UK the average yield is well over 5 percent. These are gross yields and at these levels few property investors can survive from a purely economic standpoint without the assumption of capital appreciation. This is why so much focus of investor's attention is to the Auckland market as few other regions of the country can demonstrate much, if any, capital appreciation over the past 5 years.

As with any investment, the wise advice is to diversify and not leave you vulnerable to market cycles in an asset class. This is where property investing falls down in purely academic terms.

Investment performance from property investing is tied to the property market, and its vagaries and uncertainties matched to the illiquid nature of the asset make it harder to dispose of quickly if circumstances change and cash is required. Despite this constant warning, the investment property market continues to be the most significant component of the property market, larger than first time buyers.

It does provide a healthy rental supply albeit heavily weighted in favour of the landlord and leaving tenants bemoaning the lack of security of tenure just at a time when as a consequence of this self-sustaining loop of spiralling price many younger people face the very real prospect of being the renting generation.

The fact is that rents have not been appreciating anything like the pace of property prices, and at the same time the costs of local authority rates and other operating costs such as insurance and maintenance keep rising, putting pressure on yields. This situation will place ever-greater pressure on rents to rise, however if the market continues to be supplied with more rental property, then existing landlords will continue to suffer this downward pressure on yield.

A healthy market balance is required to sustain an asset class. In the case of property this requires the balance of tenants prepared to pay, matched to costs of finance at levels, which match that rental income. There has to be a supply of property which can be purchased to meet this demand at a price that makes economic sense and naturally a capital appreciation or at least expectation of capital appreciation over the life of the investment to provide the necessary reward for the risk of the investment. None of these factors are in any way certain or guaranteed.

There is, in my belief, an over-placed confidence in property investment in New Zealand which originated from a fear of investment in shares borne of the worst of the stock market crash in the 80s which established a baby boomer generation fanaticism with property. This had driven the structure we have today which underpins our property market and has driven our property prices, particularly in Auckland, to these global highs.

There is fragility in the market structure that is over-reliant on investment property, which should be heeded by new entrants who may be blinded, by what at first sight may seem a perfect investment option.

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Alistair Helm is a property commentator who regularly reports on and analyses the property market and the real estate industry.

He is the founder of Properazzi a rich resource of insight and analysis on all things related to property and the digital transformation of the real estate industry.

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