Ask the Property Experts

Your most common property investment questions answered!

Your Host: Michael Yardney
Director, Metropole - Property Investment Strategists
Property Investors!
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About the experts

Michael Yardney is a successful Melbourne based property developer and property investor. As director of Metropole Property – Investment Strategists, his opinions as a property commentator are highly sought after and frequently quoted in the press and on radio.

Michael is publisher of Australia’s leading monthly property investment e-magazine “Property Investment Update” with well over 45,000 subscribers. He is author of the best selling property book “How to grow a multi-million dollar property portfolio in your spare time” and co-author of “All you need to know about Buying and Selling your Home” with Pamela Yardney and of the top selling book “Secrets of Property Millionaires Exposed.”

He bought his first investment property in his early 20’s without a deposit nor understanding the rules of the game, and then went on to build a multi-million dollar investment property portfolio in his spare time. He then became a property developer and grew this portfolio in quantum leaps. Michael and his team at Metropole Property Investment Strategists have bought, sold, advised, invested in, negotiated for, developed, built or project managed hundreds of millions of dollars worth of property to create wealth for their clients.

Michael is regularly engaged as a keynote speaker at conferences and seminars throughout Australia and SE Asia. Many people consider Michael Australia’s leading expert in developing financial independence through property investment.

Ed Chan is principal of Chan and Naylor, Businesses and Tax Accountants, which is recognized within the profession as one of Australia’s leading accountancy firms.

Ed is a seasoned and passionate property investor and developer, with his own extensive portfolio. He co-authored the top-selling books, How to Legally Reduce your Tax without losing any money, Wealth for Life and How to Control your Super.

Ed is widely regarded as one of Australia’s top property tax experts and has been a regular presenter at property investment seminars around Australia. He also regularly presents to accountants on best practice.

Together with Michael Yardney, Ed is the host of Wealth Retreat, Australia’s ultimate networking and educational event for investors, business people and entrepreneurs.

For more information about the services of his firm Chan and Naylor accountants or to organise your personal Financial Health Check visit www.chan-naylor.com.au
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Following are responses to some of the most commonly asked questions received from listeners of our regular and very popular WebCasts, and readers of our free Property Update newsletter throughout 2008.

We trust you find this information helpful to your own property investment journey and remember, for loads of expert advice make sure you join the 45,000 plus subscribers who receive Property Update - delivered straight to your inbox every fortnight with contributions from some of Australia’s leading property, finance, legal and taxation advisors and commentators.

I know many people are very successful with property investment, but I’m still scared to take the first step. Why is this so and what should I do?

**Michael says;** The main reason you’re afraid to take that first step is because our education system has taught you to think the same way most Australians do; and there’s very little financial and property education available.

Basically, you’re taught to study hard, work hard, get a good job, buy a home, pay it off and live below your means so you can save a little bit to build a nest egg, before one day retiring and probably living off less than what you earned when you worked.

They teach you to save money and get out of debt. While real estate investors train themselves to think in exactly the opposite manner. They don’t want to live below their means and they willingly take on good debt. So the reason many Australians are fearful of getting involved in property is because they have old ideas…often their parents’ ideas, and it is very hard to go against these ingrained notions.

You might also be fearful or perhaps cautious, because not everyone who invests in real estate does well either. This is because many beginning investors don’t understand what a good real estate investment is and they make decisions based on emotions. This is fine when you are buying a house, but not necessarily the best way to buy an investment property.

I’ve been told by every financial advisor to pay off your own home first. But Ed advises not to do this and instead invest in investment properties. I am trying to get my head around this concept. Could you explain in more detail please?

**Ed says;** There is nothing wrong with paying off your home loan first, but for me it’s simply too slow. I can show you some numbers that will demonstrate how you will be millions of dollars behind if you pay off your home loan before you start investing in property. There’s nothing wrong with paying it off, but it’s a bit like a savings strategy in that it’s very slow, whereas if you bought another investment property or another two or three investment properties, you’ve increased the size of your assets straight away and then you have a larger base to increase further from as opposed to a smaller base to increase from.

I’m thinking about investing in property. I’m single, on an average income and have about $20,000 to get started. What advice would you give a rookie like me to get on the right track?

**Michael says;** I’m going to make a couple of suggestions for you, because property is fun and exciting, but how do you know where to start?

First of all I advise you to do lots of relevant reading and research and educate yourself. There’s an article I wrote a little while ago on the Property Update website called, “What
would you do if you had to start all over again?” That’s a great article to read and there’s some welcome knowledge in there for everyone.

Buy books too, such as the one I wrote with Pam entitled, *All you need to know about buying and selling your home*. That’s a great book for beginners, as more often than not the best place to start is by purchasing your own home.

Another thing to consider is attending seminars conducted by the right people. Be careful who you listen to – make sure the speaker is someone who’s done what you want to achieve. Additionally, don’t be scared to pay good advisors. I’ve found most beginning investors won’t because they think it’s too expensive or they want to do it all themselves.

But the biggest lesson I’ve learned is to pay for good advice up front.

So to sum up, as a beginner you can; Start with your own home and take advantage of the first home owners grant. Buy a property, get into the property market and then add value to it; do it up, improve it and as it appreciates in value borrow against the increasing equity of your house to buy your first investment property. The first one’s always the hardest to get into.

**What percentage loan’s the best to use – 80% or 100%?**

**What are the pros and cons?**

**Ed says:** There are really no cons with going as high as you can on your Loan to Value Ratio (LVR) and as close to 100% as possible, because the higher it is, the safer it is. This is because you’ve now increased your buffer. We often say that the reason people get into trouble is because they don’t have the capacity to continue paying when things go wrong. For example, interest rates increase or you lose a tenant or your job. But if you have a large buffer, it allows you to buy more time.

The higher the buffer, the more time you can buy and the more time you can buy, the safer you’ll be.

I encourage my clients to increase their Lines Of Credit (LOC). Even if you’re not ready to buy a property, if you’re just sitting back looking at the market, the first thing you do is increase your line of credit to the maximum and that makes the whole thing safe, giving you time to determine what you want to do.

Of course you don’t just draw down on it and spend it, you have to leave that buffer aside for emergencies, for what we call buying time. And the bigger it is, the safer you’ll be. There’s no cost if you don’t use it – it’s just like an emergency bucket of money that’s sitting there. You only start paying interest once you draw down on it. So as a matter of course everyone should increase their LOC automatically. I constantly do that with my portfolio, even though I’m not buying anything, and leave it there as my safety net.
Is it a good time to invest or not? I’m interested in knowing the correct way to invest so that I make a safe and profitable investment, can you help?

**Michael says:** There are so many mixed messages in the press and even sometimes in the same newspaper. On one page they mention unaffordability and difficulties with people being able to buy homes or keep their homes, rising interest rates and the sub-prime crisis and on the next page they’ll tell you that rents are zooming up, properties can’t be replaced at the cost they’re available at today and that we have a shortage of properties, so I can understand why people become confused.

Ed and I have both been investing in property for around thirty years plus, so we’ve actually been through these cycles and seen it all before. Essentially, there’s nothing new about any of this. In fact periods of mixed messages and uncertainty, I personally feel, are periods of opportunity.

So to answer your question of how to invest safely – I guess my first response would be, don’t buy with emotion. It’s easy with all of the news out there to get involved emotionally. So you need more than just knowledge, you need a system and the system takes the emotion out of it. You also need to adopt the right mindset and start thinking like a successful investor and you need a good network of smart people around you.

You may have heard me say before that if you’re the smartest person in your team you’re in trouble. That’s why we are very comfortable to work with Chan and Naylor, great accountants who understand the network and who are good finance and property investment strategists. So surround yourself with a good team who can help you.

You also need to understand that there’s more than one property market. In fact in each state there are usually two or three or more property markets. This means that the things reported in the papers are too general. The truth is most of our cities have two tiered property markets; with some suburbs doing very well and others underperforming.

I’d also like to make the point that when the masses panic and see doom and gloom, smart investors with a long term focus tend to see and take advantage of opportunities.

But yes, there are some risks involved and some risks ahead for 2008. Interest rates may go up again and you have to factor that in by maintaining a big enough buffer. The possibility of a stock market crash – it’s going up, it’s going down, there’s still the fallout from the sub-prime crisis and it all still hasn’t worked its way through, so we’ll see some further fallout. I also think that although they haven’t admitted it yet, the US economy is in recession – so how will that affect Australia? Well maybe not as much as it has in previous times, but to put some perspective on it, the good news is there are strong driving forces for our property cycle.

We have an undersupply of properties and we actually have a good economy despite all you’re reading; rents are rising and construction costs are increasing and all of these are strong drivers that I believe will, in the medium to long term, counteract the negative forces the press love to talk about.
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How will an investor’s borrowing capacity be affected by the current financial crisis?

Ed says; Personally, after all of the emotions have subsided I don’t believe that the US will have such a large impact on us as all the media hype suggests. This is because in reality, the amount of trade we do with the US is only a fraction of the amount of trade we do with Asia.

Having said that, we do have some lenders who have sourced their funds for sub-prime loans from the States and they are undeniably suffering, but the number of lenders in this position is very small. Essentially, it’s mainly the shadow of doubt and concern that this crisis has cast on the world finance markets that’s affecting lenders locally.

Yes, the number of lenders out there has reduced, but what our finance department (which helps our clients obtain loans) has found is that it’s pretty much business as usual. The only difference being that business is now being directed to a lot of smaller lenders who have stepped up to the mark and made funding available, whereas in the past a lot of the bigger banks were controlling the lion’s share of mortgage lending.
I think the whole thing and the scare it’s caused is going to blow over, so we just have to hang tight and weather the changes it brings. Rest assured though, during my investment career which spans the last thirty years, I’ve seen high interest rates, low interest rates, recessions, high unemployment, and basically every single economic condition imaginable. Having seen it all, I know one thing – we have always pulled through regardless. So I’m confident that we’ll emerge from this uncertainty without too many concerns.

What fallout can we expect in the Australian property markets due to the property meltdown in the US?

Michael says; Everyone’s asking that question. Maybe it’s not just the property meltdown in the US, but maybe let’s talk more generally about the economy and interest rates going down in the US and the economy in the US being in recession. I think we have to recognise that despite our strong fundamentals of lack of supply, low vacancy rates and the pressure of strong demand from an increasing population and immigration, we are going to be affected.

In fact we’re already being affected; it’s already being seen with decreased confidence out there. People are starting to worry. People at the end of last year, even at the beginning of 2008, were going into the property cycle feeling very confident and then all of a sudden the stock market crashed so we’re feeling it in lack of confidence.

We’re seeing it in higher interest rates – interest rates just keep rising here, the opposite of what’s happening in America. Then we’re also seeing it in lenders becoming more cautious and pricing risk appropriately. A couple of years ago they became pretty lax. Not like the subprime crisis in America where they gave away money – they actually called it NINJA loans, people who had no income, no job and no assets. Lenders here in Australia have been a little bit more cautious, but they did lower their criteria and almost anyone could get a low-doc or a no-doc loan without any proof of being able to service it. So we’re currently seeing lenders being more cautious, giving lower loan to value ratios and also charging higher interest rates.

I think all of this is going to mean that our property prices are not going to grow as fast as they did last year, or in fact as fast as was predicted at the beginning of this year. But last year Melbourne, Brisbane and Adelaide had over 20% average growth which means some suburbs did much, much better than that. And even Sydney, which was reasonably quiet, last year had about 8% average growth and we saw some suburbs with 20 and 30% growth. But that’s really unsustainable, so I’m not too concerned that things are slowing down a bit because we’ve got to get back to closer to the averages.

I guess another affect that this fallout will have is that construction will slow. Builders are nervous, banks are nervous – they’re charging more with higher interest rates and they’re not lending as freely with builders and investment finance. What this means is that construction will continue slowing and there’s going to be more pent up demand for housing.

I think the US is already in recession and I think this will affect our own economy. But I’m not an economist, I don’t know to what degree, we don’t know how well the Reserve Bank in America’s going to pull the country out of recession and how many months or quarters
it’s going to be in recession. But only yesterday they dropped interest rates again. There’s no doubt it will affect us a little bit and it will affect our trading partners as well, which will slow our economic growth a bit.

But our fundamentals are still reasonably positive, so there’s little chance that we’re going to see a US type housing bust here. Our overall economy is sound and really should be able to absorb the US problems.

I have built up chunks of equity in various properties, each bit is not enough to use separately. How do I combine these into a useable block of equity without cross-collateralising?

Ed says; Firstly you need to work really hard to get the right valuer to value your property; because you can ask five different valuers and they’ll value it five different ways. So you have to select a valuer who’ll provide the maximum value – that applies to all your properties. Then you up-stamp all of the loans on each property, so each line of credit (LOC) that you may have on each of the properties is at the maximum. To make it practical, you then simply draw down to the maximum on the LOC for each of those loans into one LOC and then draw the money from that one LOC. It’s all tax deductible because the purpose of the loan is to put towards an investment property.

I have found that there is a fair amount of conflicting opinions on the 'right' strategy to take. I would really appreciate some advice on the best investment approach.

Michael says; My strategy is to buy the best property you can afford – and buy well located properties that will increase in value over time. I suggest you time your purchase judiciously by selecting a state that is in the upturn stage of its property cycle. Then invest in capital cities rather than regional areas.

Further, I fine tune this strategy by recommending you only buy your investment in a suburb that has always exhibited above average capital growth. And within that suburb I choose areas or localities that have greater amenity and appeal. I then choose a street that has more ambience – some streets are more “liveable” than others.

I avoid main roads and secondary main roads. I like wide streets with a mix of nice properties. Then in that street I look for the type of property that will have enduring appeal – a property that will be sought after by both owner occupiers and tenants.

And finally I look for a property with a “twist” - with something extra or special. For example one to which I can add value through refurbishment or renovation. Then I hold this property for the long term and in time, leverage off its increased equity to purchase further properties.

This strategy works well for me – it has for over 30 years - and it has worked well for many other wealthy property investors. Of course there are other strategies such as buying high cash flow, low growth properties and I guess they all have a place. Mine is not the only way to make money out of property – but when I look at the seriously successful property investors they have all followed a similar strategy.
If you subscribe to my investment philosophy, the more property you own, the more the “system works for you.” You have the combined factors of leverage and compounding working for you growing your wealth.
So my initial thought is to buy the best property you can comfortably afford. But if this is your first investment I can understand that there may be some concerns about buying a more expensive property. Worries about the size of your debt or whether you can afford to service the loan. Remember fear is what holds back many investors, but with time and knowledge you should be able to overcome some of your concerns.

**My wife wants to continue paying principle and interest on our housing loan, but I only want to pay the interest and utilise the principle elsewhere, what’s the best approach?**

**Ed says:** Let me say upfront that there’s nothing wrong with paying principle and interest, but it is a very slow way of accumulating wealth because as you’re paying off the principle, it’s like a drip feed, like a savings plan. There’s nothing wrong with a savings plan, but is it very, very slow.

What we abdicate is increasing the size of your asset quickly by borrowing money, buying property and leveraging it. For instance, if you went out and bought a $500,000 property then you’ve got a $500,000 asset working for you instead of paying $1,000 a month off your mortgage, which is like saving $1,000 a month, and is a very slow way of doing it.

To give you comparable figures, let’s say you were paying $10,000 off your mortgage per year, so over ten years you will have paid off $100,000. But instead of paying that mortgage off, if you use that $10,000 to fund negative gearing on a $500,000 property - what the negative gearing is will depend on what your tax rate is - but let’s take a ball park figure of $10,000 negatively geared on a $500,000 property. In ten year’s time, let’s say it increases to $1 million; you’ve now made $500,000. When you compare that to the $100,000 mortgage that you paid off in the first scenario, you’re $400,000 behind and that’s just on one property.

So it’s not rocket science; you’ve got $500,000 working for you instead of drip feeding $10,000 off your principle over that year.

If you increase the size of your asset by buying two properties, you can see how that’s extrapolated out. So over a 30 year period on just one investment property, you are $2.5 million better off. So, there’s nothing wrong with paying off your principle, but it’s just a very slow way of accumulating wealth.
What are the top five things you should look for when assessing a mentorship program, mortgage broker, buyer agent, accountant, financial planner in order to ensure you have the best team possible in order to build a successful property portfolio?

**Michael says:** There can be so much advice out there – how do you choose the right advisors? It is difficult because there are so many people and some obviously have better results than others.

First of all I’d look for people who are doing it themselves, and find out how long they’ve done it for. They really need to have been in property for more than a cycle and preferably two cycles because times are changing.

It’s really interesting to have a look at whose giving advice on property and property tax today and who was giving it three and four and five years ago and where are they today? A lot of the people who had the latest ideas and concepts aren’t around anymore because they worked well in certain stages of the cycle but not others.

I’d also look at how they get paid – whose side are they on? It’s OK to get paid – I think your mentors, accountants, financial consultants and brokers should be paid and I’m happy to employ the best people I can to have the best consultants on my team, they deserve it. But who are they paid by? I want them to be paid by me, not by the seller, the developer or the vendor to make sure that they give me impartial advice that suits me.

Mortgage brokers actually do get paid by the banks and I have no issue with that, but I don’t want somebody who just knows about first home loans. I think you should look for somebody who is an investor themselves – who invests and understands the concepts.

Same with buyer’s agents, you need one who has bought investments and understands it all because a lot of people say I’ll find a good investment property for you, but not every property makes a good investment. You need a buyer’s agent who can offer a variety of markets, who’s not just in one state, and who understands the concepts of tax and structures and finance to get you the right strategy.

And with accountants it’s really easy – find somebody who understands property or business or whatever your accounting need is. I’ve seen so many people go to accountants and be given the wrong advice – told they shouldn’t buy property or they can’t buy property or they’re advised of the wrong structures because the accountants themselves are not investors or are a bit scared of investing.

How can I get funds and manage repayments for multiple investment properties when I’m an average salary earner and don’t have enough savings? How can I convince the bank to give me a mortgage for all those properties in the first place?

**Michael says:** This seems to be a continuing common question that comes up over and over again. The answer is that most people don’t know how to - otherwise more investors would buy multiple properties.
It’s a strategy that’s well outlined in my book, *How to Grow a multi-million dollar property portfolio*. In the book I give an example of Courtney and Mark, who buy their own house with the first home owner’s grant (FHOG), add value to the house, use the increasing equity to buy their first investment property and then leapfrog and pyramid, never having to put their hands in their pocket again.

You may not be able to grow your portfolio as quickly as you like. So you don’t have enough savings and you have an average salary, but why is it that some people without savings and with a below average salary can buy property? It’s because they understand how to work the system and they understand how to save some money. Why haven’t you got some savings?

**What is the best way to make up the shortfall between rent return and repayments on investment properties?**

**ED says:** For us it’s about the investment being safe and that’s about being able to make the repayments on those loans. With the shortfall we work out a buffer which comes from the equity of your property and generally when people get into trouble it’s because they haven’t bought time.

They may have bought time for one week because that’s all they can afford and when the interest rates go up or they lose their job temporarily then that’s when they get into trouble. If you put a plan in place and build a buffer in so it allows you to service the loan for a period of time, whether it be three years, five years, ten years, or wherever you feel your comfort level is, then you won’t get into trouble.

You shouldn’t buy so many properties that you don’t have a buffer - that’s too risky. In a rising property market, you can take a little bit more of a risk. For instance, if you’ve got a million dollar property portfolio and it went up 10%, then you’ve made $100,000 and if the bank refinances you that $100,000, they’ll give you 80% of $100,000, so you’ve got another $80,000 in a line of credit to service the loan for a bit more time, so you buy more time. So in an up market you can take a little bit more risk, so your buffer can drop a bit, but in a down market, you want to have a bigger buffer so you can buy your seven to ten years and make the investment property safe.

To answer your question in a nutshell, it’s all about having a buffer; it’s about how to make equity in your property portfolio work for you and how to extract that line of credit. The whole thing comes together in our *Wealth for Life* book.

**Should I buy properties in the same area or several areas?**

**Michael says:** I’ve found that successful investors don’t do a hundred different things, they do one thing well and they do it over and over again a hundred times. So Pam and my property portfolio is concentrated on a number of suburbs, but we own a number of properties in the same suburbs. We’ve found areas that perform well and continue to do well.
I remember Napoleon Hill in *Thinking very rich* found that one of the traits of successful people is that they specialise. So find an area that you know well and become an investment expert in that territory. Now after a period of time you have to diversify, so you diversify in different types of properties and sure, you diversify in different geographical areas and maybe from one state to another as well.

But if you find an area that does well, I have no issue with owning a number of properties in the same area or a number of blocks of apartments as Pam and I do in the same area. Find something that’s always done well and you should be carried by the weight of that area.

**What factors do you use when deciding if you can afford another property?**

**Ed says:** What I work on is whether it’s safe or not and I guess the definition of safety depends on how long you can weather the storm. So if interest rates went up or you lost a tenant or your job, how long will you survive?

Survival is obviously about cashflow and your cashflow comes from different sources, like your rental, but it also comes from your wages, and from your line of credit. So we just work out a buffer depending on where the property market is at that particular time – if it’s at its peak then you need to put a buffer in place to buy more time until the market turns and comes back up again.

If your property’s in Melbourne and Melbourne’s moving forward, then the buffer is smaller because if the property’s going to achieve a 10% increase next year and another 10% the year after, then you can refinance your LOC as the property’s going up and up-stamp your loans to instantly give you more buffer.

But if it’s in a downward trend then you need a bigger buffer because it might take seven years before the property market turns around.

So to determine when you can afford another property is simply where the economy is at the moment and where the property market is to determine the amount of buffer you need to make it safe.

**How can investors convert a negatively geared property to achieve positive cashflow?**

**Michael says:** Well I guess everyone’s wanting positive cashflow or at least many people are because they think it makes it easier to hold properties. But the best properties to give you long term wealth are not positive cashflow properties; they’re what tend to be negative cashflow properties because in Australia, in my mind, residential property is a high growth, low yield investment. If you’re trying to find high yield investments, maybe you shouldn’t be looking at property; maybe you should be looking for managed funds or commercial property or things like that.

Having said that though, there’s a couple of ways you could do it, you could pay cash – if you don’t borrow or you don’t gear, you could get positive cashflow, or you could borrow
less and have a lower loan to value ratio. But then you’re losing one of the biggest benefits of property which is leverage.

Or you can make your cashflow better by adding value through renovations or redevelopments - that will give you better returns. But still in today’s climate it’s unlikely to be positive cashflow in most suburbs.

**What’s a good return on an investment for rental properties?**

**Michael says;** Well, that’s a good question because I guess when you’re investing you really have to understand what you’re comparing it with and how you get returns on other investments. You get your returns in four ways with property; you get your returns with capital growth, that is the passive growth of the property going up; you get your returns from active growth, the equity you build, you manufacture by adding value, which could be from doing things like refurbishments, redevelopment, renovations; you get your returns from the rent that comes in and you get your returns from tax benefits such as depreciation and negative gearing.

So you shouldn’t be so focused on just one of those, rather you have to get a balance of each. Still I think capital growth is the most important. We decide how good one property is against another by taking a balance of all of those and then bringing it back to what’s called an internal rate of return. We use Jan Somers program PIA (Property Investment Analysis) to analyse how a property is going to return income using all of those four things; passive growth, active growth, rent and tax benefits because what you’re left with after tax is capital growth that is actually your best return. You can purchase that program, PIA at the online bookstore at Property Update.

How do you decide what is a good return? Well I like to outperform the averages and I can do that with property. I have real difficulty doing it with shares because by the time I find out about shares, the share market has moved on and the shares have gone too high. But with property, by investing in the sort of areas that outperform and not looking for the next hotspot, or the next fad, but by finding areas that have always done well, I can ensure I get good returns.

Sure I may miss a percentage or two from the next speculative area, but I’m going to consistently perform well. So by finding certain suburbs that have outperformed Melbourne, Brisbane and Sydney and investing in those, I can get above average growth. Average returns for property investments are 10% capital growth over a 10 year period, which means some suburbs will perform better than others. So I try to get into those and then get an additional about 4% rental return over a long period of time.

I’d much rather get a larger portion of capital growth and less rental income, because I can borrow against the increasing capital growth to buy further properties.
I am an employee. Do I need to look at putting properties into a trust or is that just for companies and investors who are self employed?

Ed says; The answer is no – putting a property in a Trust isn’t just for someone with a company or who’s self employed. There are lots of reasons. I guess for every ten people that come to see us, 6 to 8 will end up in a trust structure and the others will require a different solution. So it just depends on your circumstances and I guess the more investments you have, the more likely it is you’ll require a more sophisticated answer.

To give you an example, if you had some properties in Queensland and you held them in a trust, the trust will give you a separate land tax threshold. Now once you’ve used up that threshold, if you set up another trust you’ll get another land tax threshold. So in Queensland, you can set up a whole series of trusts and never pay land tax.

Another example is if you bought the property in your own name and something happened, like if the tenant got electrocuted and sued you, all of your assets are exposed. So your home that’s in your name’s exposed to litigation and all your investment properties are exposed. So some people put investment properties into a trust for asset protection reasons, where if a tenant was to sue they can only sue that property and they can’t touch the other assets in your name. There are lots and lots and lots of different reasons, but the quick answer is no, it’s not just for companies and the self employed.

The usual value of well located properties generally doubles every seven to ten years. However with the extremely high cost of properties today, is that now a feasible rule of thumb?

Michael says; That’s a good question because people keep saying, well properties have gone up so much, they can’t keep going up, are property prices going to increase, can property prices double?

The bottom line is, this is an argument I’ve heard since I first started investing in property in 1970 and even at that time properties were expensive.

I recently found a study done by Massey University in NZ which went back to 1920 and found that under the Liberal government, properties returned 15.3% per annum. That’s a combined return of capital growth of around 10% and rental of about 5% and under the Labor government they returned about 14.8%, so there’s not a significant statistical difference.

But the bottom line is since 1920 they’ve found that property provides around a 15% per annum return, a large portion of which is capital growth and some is rental return.
When investing in property, when is it advised to buy through a trust? What are the advantages? How do you go about setting up a (family) trust? Can I claim negative gearing deductions if I buy a property in a discretionary trust? Or does it have to be a Unit trust to be able to claim the losses against my other income?

Ed says: Not everyone should buy a property through a Trust and there are many different types of Trust used for different things. Even in different states different Trusts are used due to the various ways States charge land tax.

The worst Trust to buy the investment property in is a Discretionary Trust because you will trap all the losses in the Trust and won’t be able to claim it against your wages. I would not use a Unit Trust either because properties held in a Unit Trust, due to an E4 Event, will pay more Capital Gains Tax (CGT) when you sell the property.

I guess I am biased but I would only buy an investment property in our “Property Investors Trust” (PIT) because it allows you to claim the negative gearing against your wages and does not trap the losses in the Trust.

The next best Trust to buy it in is a correctly written up Hybrid Trust. Most Hybrid Trust’s are not written up correctly and the ATO may have problems with it. For example they may have Income units that can only be redeemed at cost and the ATO is unhappy about this, whereas our PIT has a capital component to it.

The Hybrid Trust may also have a Vesting date after 80 years which means all the assets get passed down to your children or grandchildren automatically, creating a CGT and stamp duty issue. In our PIT’s we do not have a Vesting date so it never dissolves after 80 years.

The main advantages with the PIT is that it gives you lots of flexibility and provides asset protection and Estate planning opportunities, whereas just holding them in your own name is very inflexible.

We see many clients who get in trouble when their circumstances change, such as when their spouse goes back to work or where the spouse stops working and because the properties are held in their own names they are stuck with stamp duty and CGT should they try to change the ownership.

The PIT can allow you to change the legal title without incurring stamp duty and CGT.

We find around 70% of people that come to see us need some sort of Trust and the other 30% need some other solution.

Should I buy a new or established house or unit?

Michael says: I believe that in the current market it’s better to buy an established property than a new property and that investors may be better off looking at established units rather than new units.
I like my investment properties to be new and clean and have good depreciation allowances, but I don’t like paying a premium for that. As a property developer I can build new properties at considerably below market price and achieve the best of both worlds.

But for most investors, I still think that established properties are the way to go. Let’s look at the benefits and disadvantages of both old and new properties.

With **new or off the plan** properties there are a number of advantages, including:

- They are more appealing to owner occupiers and tenants. They are new and clean and therefore easier to rent.
- They have greater tax depreciation allowances
- They usually have low maintenance, but don’t be mistaken some new properties still have maintenance and structural issues

**The disadvantages of new properties include:**

- They are harder to add value to because they’re already in top condition. You usually have to pay a premium for the developer’s margin, the agent’s commission and the marketing cost, which usually means you’re giving away the first couple of year’s worth of capital growth to the property developer and he really doesn’t deserve it!
- There’s usually slower capital growth in the first few years because you paid a premium for a new property.
- The price of new or off the plan properties usually suffers the most when the market slows.

**The advantages of buying established properties include:**

- It’s easier to negotiate a good price for established property because you’re dealing in an imperfect market with emotional vendors. Buying new property from developers usually means you’re buying off a set price list, so it’s hard to negotiate. I find that with established properties vendors tend to be more motivated and it’s easier to buy at a good price.
- In our current market you can usually buy established properties below replacement cost. Currently we can often find established apartments 20% to 30% below what it would cost to replace them.
- Established properties usually give you the opportunity to add value through refurbishment.
- There’s usually better capital growth for established properties compared to most new properties where there’s generally less capital growth in the first couple of years.
- It’s often easier to get a hold of market research to establish a reasonable price for established properties as there’s more historical data.

**The disadvantages of established properties:**

- Established properties often are not as appealing as a new property, but in today’s market with the shortage of rental properties, tenants flock to established properties.
• Established properties may have more maintenance issues than new properties, but my preferred investment strategy is to buy an established property and add value and when you do so, you can take care of any minor maintenance issues.

So in summary I believe most investors are better off buying an established property at a good price and then adding value through refurbishments, which will give them a higher yielding, tax efficient investment.

**What are the benefits of owning property in a trust set up?**

**Ed says:** Firstly let me explain what the disadvantages of holding the property in your own name are. Normally the person who pays the most tax buys the property in their name to claim the negative gearing. This is the normal advice from your accountant, so he can then claim tax at the highest rate. But eventually this property may become positively geared and then he has to pay tax at his higher marginal rate. Likewise if he ever sells the property then CGT will be charged at his higher tax rate. Also there’s more land tax to pay; for example if you bought two, three or four properties then the land tax is aggregated to you because you’re the owner.

Now eventually he might have a few properties in his name and all the rental income is positive and it all goes to him and is taxed in his name, with no income or tax splitting with his wife. And of course there’s no asset protection. So if you’re a doctor or someone who’s in business who might be at high risk in terms of litigation, and you have all these assets in your name, if someone sued you and you’re a director of your own company or you’re running it as a sole trader then all those assets are exposed to ligation.

So we generally don’t advise people to buy properties in their names because the risks are too great, there are too many downsides and the costs of moving things out down the track are too high. So you can see the potential problems with this over a long period of time.

Now if the property was held in a Property Investor’s Trust (PIT), you pretty much eliminate most, if not all of the problems that I just mentioned – with one exception – that is land tax in NSW. So our PIT gives you asset protection, you can negatively gear against your wages, you can split the assets to your children with no stamp duty or CGT and if your property’s ever sold you can split the capital gains to a person who’s on the lowest tax bracket.
I’ve heard you say you should invest in areas going through a transition, what does that mean?

**Michael says:** A suburb going through transition is one of my favourite places to invest because apart from getting a boost from the natural property cycle in the suburb, in the state, you get a super charge from a particular suburb transforming and growing in value.

Transitional areas are neighbourhoods moving up from one economic class to the next. This process is sometimes called gentrification. They tend to be older areas that are rediscovered and redeveloped, where the old properties have reached their use by date and young families move in and renovate them or developers move in and pull them down and build new apartments or townhouses.

You can easily identify these neighbourhoods by driving up and down the streets. You’ll see a mixture of run down homes with a lot of character, others that have recently been fixed up and new homes or townhouses being built where old homes have been torn down.

In other areas you’ll find conversion of old, run down warehouses into funky apartments, or old industrial buildings being pulled down and replaced by new apartment blocks. As you drive through the area you’ll notice that some of the old shops have been replaced by modern shops to cater for the new residents, cafes and take away food shops for example.

It’s also worth having a look at the cars on the street and in the driveways. You’ll probably find a mix of older cars and new vehicles. As the number of new and up-scale car models increase, the more the transition has progressed.

You’ll find areas of gentrification in most states, but it’s often the locals who are last to discover them. The trouble is many of them have long held perceptions or emotions about an area which are difficult to change. These negative views of an area can cause the transformation of an area to go unnoticed by locals until it has well and truly occurred.

How do you deal with valuations that are significantly below the market value of the property? Valuations determine the amount the banks will lend to purchase more properties.

**Michael says:** It is a difficult question of how to get valuers to give you true market value, especially in a rising market. One of the things we have found recently at Metropole is valuers are giving different valuations by up to 20%.

Recently one of Pam and my properties was valued as part of a re-valuation of our whole portfolio and the valuer valued it at $700,000 when I know it was worth close to $1 million. He was 30% under. I gave him all the statistics, all the information and his answer to me was, “Well it couldn’t have actually gone up any more than 15% from last year and I valued it at $600,000 last year.”

I said, “Yeah, but you valued it wrong last year too.”

Valuers are conservative and concerned about their professional indemnity insurance. The other thing is you have to understand how valuers get paid. Valuers get paid a really small
amount, most don’t even go to the property or into the property, they drive past and do a whole lot of valuations every day.

The best way to do it is to control the valuation process yourself by not using the bank’s valuers, but by using the bank panel’s valuers. In other words, find out who the banks will listen to because not every bank will accept every valuer’s valuation. Then instruct the valuer to work for you. Give them all the information you can and pay that extra for the valuation to let them go through the house because when that happens, you’re going to get a better valuation, accepting the fact that the valuation will not be the true market price – it never is.

I believe there was a change last year in superannuation legislation that now allows self managed super funds to borrow to buy residential property can you please explain how this is done?

Ed says: First I’ll explain why it’s important that we’re now able to do this. We were able to do it before, but it’s now legislated to be able to do it and there’s a little bit of a difference. We found a way around the legislation but now that it’s legislated, it brings it out in the open. That’s important because if you had $100,000 sitting in your AMP fund or GIO fund, then you have $100,000 working for you. But if you’re able to use that $100,000 as a 20% deposit and borrow 80%, you can go and buy an asset worth $500,000. So now you have $500,000 working for you instead of $100,000 working for you.

That’s the fundamental basis of why this is exciting; because it allows you to increase the size of your asset instantly and we’ve written in our books that it’s not the return on your investment, it’s the size of your asset that makes you your money. The idea is to try to increase the size of your asset and the operative word for that is leveraging. Now we can leverage our superannuation fund, whereas before it was a lot harder.

So let’s explain how it actually works. We’ve spent a lot of time coming up with our own self managed superannuation fund, Warrant, because we work very closely with our tax lawyers. And what we found was that a lot of the products out there that a lot of the banks are pushing don’t work practically.

Basically the difference is that we hold the property in a bare trust as opposed to most of the other ways of doing it where others hold the property in a superannuation fund. Why is that difference important? Well if you hold the property inside the superannuation fund, if the tenant sues, they not only sue for the property but all the other assets that are held in the super fund as well, so it exposes the rest of the assets in the super fund. Whereas ours doesn’t.

So the self managed super fund borrows money from the bank and together with the money that’s already in the super fund, you can go off and buy property - ours is bought through a bare trust - and you can instantly leverage your assets from the $100,000 I was using as an example to $500,000 and the negative gearing can be serviced by your 9% superannuation guarantee. Or you can service it by putting extra contributions in each year and a lot of the other warrants don’t allow that.
What’s your view on purchasing off the plan units in Sydney or Melbourne as a way of getting freak capital growth for a couple of years? Also considering where these investments are on the investment clock?

**Michael says:** You’re asking is it a good time to buy off the plan units because you perceive that capital values will grow in the future and therefore you’ll get some of that capital gain without putting much money down. That’s a very good theory if it would work. The problem is in practice it tends not to. You’re correct, it is the right time in the cycle for that to occur because if the market’s growing and you buy it today and lock it in at today’s value, but don’t have to settle for two or three years time, you could benefit. But as a general rule, I’d say avoid off the plan because I have seen so many more people lose out by doing it than the few I’ve seen succeed.

The problem is you really need to buy at a discount for all the uncertainty – the uncertainty of whether the project will even go ahead; whether the developer will complete it; whether it will be finished to the standard you expect; what will interest rates be like when the project is completed; will there be other competitive developments there at the time; what will the vacancy rates be?

So given all these unknowns for buying in advance, you should be getting a significant discount but in fact you don’t. There are too many variables and currently we have found that in Melbourne, Sydney and Brisbane you can buy established properties at 15 to 20% below what you’d buy off the plan properties for, so you’ve already got built in capital growth that way. The simple answer is avoid off the plan at this stage of the cycle.

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Which one is better, buy and hold or buy and sell in the name of a company?

Ed says; I think everyone that knows us knows that we abdicate that you buy and hold. If you read Wealth for Life you see that we’ve outlined all the advantages of buy and hold over the buy and sell strategy, especially after you take all the taxes into account.

There are lots of taxes when you sell a property, but sometimes people buy and sell through a company to try and reduce their tax. But in a company, you don’t get the 50% exemption from capital gains tax, whereas an individual in a PIT and other trusts would get the 50% exemption so, in a nutshell, I think it’s better to buy and hold and refinance it as the property value goes up.

What is your opinion of Serviced apartments in terms of the pros and cons and basically are they a good investment overall?

Michael says; That’s a great question and opens up an interesting element of what makes a good property investment. It includes aspects of risk v return, growth v cash flow and property v income investments.

A serviced apartment is generally an apartment (or townhouse dwelling) for which you relinquish total responsibility in regard to management, cost and maintenance, usually to a corporate organisation as a tenant. It generally involves a very long term lease, a fixed rental income with annual increments and an agreement that running costs, non capital maintenance and repairs will be covered by the corporate tenant. This organisation will use your property for their business, providing short to medium term accommodation for temporary residents, travellers and tourists. Generally these investments are cash flow positive.

Sounds very good doesn’t it? For the high net worth investor with a large portfolio these investments do have a place in their portfolio. However, for the new investor or those with a smaller portfolio who might be more attracted by this style of investment due to the cash flow element, they have many negative components;
Banks and mortgage insurers don’t like them as much as general property and are less likely to give a higher LVR for this type of asset, which means the investor has to come up with more cash or equity to finance the acquisition or more importantly, is limited in their use of the equity to finance further acquisitions.

Capital growth will be absolutely restricted to growth in the rent and it is capital growth that we purchase for. Capital growth is King of investing and any asset with restricted growth will restrict your portfolio growth.

The market for any resales is severely limited to investors who want serviced apartments. This completely excludes owner occupiers and limits interest from ordinary investors who are more comfortable placing their investment in the general rental market.

The corporate tenancy lease will generally incorporate clauses that allow the initial tenant to assign the lease to any entity they choose and you as landlord must agree. The initial lease may be with a strong, experienced operator with a good track record. However, an assignee may be a brand new entity, a $2 company owned by people with no expertise or experience in the industry. Their business may be very risky, jeopardising your investment and return and you have no redress if something goes wrong.

If you are considering investing in a serviced apartment, please consider your whole portfolio and ensure your decisions are made with independent, professional advice.

Wealth for Life discusses borrowing the equity in your investment property and using the borrowed funds as living expenses. What are the tax implications of this strategy?

Ed says; The borrowings are not tax deductible because the money is used for private purposes. In determining whether something is tax deductible or not the ATO looks at what you’ve used the money for so, in this case, if you used it to live off, to buy food and so forth, then the interest is not tax deductible.

However the interest rate is somewhere between 7 and 9%, so this is still cheaper than GST which is at 10%. Therefore in the latter stages of your life, it’s probably more important that you have cash flow and a good standard of living and be able to go travelling, etc rather than worrying about taxes. So if you’ve got to pay a little bit of tax to get more cash flow, then I know what I’d be doing, I’d be taking the cash and paying some tax. Yes, it will cost you a bit in tax deduction, but make sure the investment is good and treat the tax side secondary.

With a limited budget is it better to buy an outer suburb house or an inner suburb house?

Michael says; I think the question is should I buy house and land, because we hear the old adage that land goes up in value and houses depreciate, or do I go closer into town? Well not all land goes up, so if you’re looking for capital growth, which is the investment
strategy that Ed and I recommend, then you want to choose the sort of areas that are going up in the short term as well as the long term.

We know that currently the outer suburbs are experiencing difficulty, with higher interest rates and higher petrol prices; they’re under a bit more mortgage stress. So I would rather own an apartment, townhouse or flat in the inner suburbs, even though it has a smaller land component because that’s where prices are going to keep going up as there’s greater demand from owner occupiers and tenants. In fact that’s exactly the sort of property that I personally buy and that we buy for our clients because in the short term, it will perform better and in the long term, it has always performed better.

Apart from the 50% reduction in Capital Gains Tax (CGT) once the property’s owned for over a year, is there a way to further reduce CGT?

Ed says: The short answer is yes – if the property is held in our PIT you could actually distribute the capital gains to a beneficiary at a lower tax bracket. So it gives you the flexibility to distribute it to someone else like a child (has to be over 18) or a different family member who may be on a lower tax bracket and you can actually get below the 50% reduction in CGT. But you must have held it in the PIT to begin with, that’s why we always say it’s so important to structure your investments right from the beginning; it can cost a lot to fix things up later on.

When selecting an inner city unit, what is your checklist of essential criteria?

Michael says: Well, first of all we look at comparable sales, you have to know what’s around, and we want something that has a good land to asset ratio. That doesn’t mean it has to have a lot of land, but it has to be on land that’s valuable, even though it may only be a sixth or an eighth or a tenth of the land that you buy when you buy the apartment.

We want it to be close to amenities, maybe close to the CBD or the water and it should have a pleasant streetscape. We look at the floor plan, because some are more workable than others. We don’t necessarily like bedrooms that are coming off living areas where there’s noise. We like, if possible, to have a separate toilet and we want laundry facilities. We want an apartment that has good natural light. Car parking’s important – in boom times everything sells but in tougher times, people do want something a little bit special.

We make sure that there’s good privacy and that there’s noise insulation. Then we investigate the building for structural issues, check the body corporate to make sure there are no issues there and get our solicitor to check the contract to make sure there are no legal issues.
My Financial advisor states that you can buy an investment property in lower income spouse name - and the rental will be taxed at her rate but the loan can be in higher earning spouse and so he could still get the negative gearing tax advantages?

**Ed says:** It’s best if the property is held 50/50 and the higher tax payer can salary sacrifice his wages through his employer against the rental expenses and the lower taxpayer gets the other 50% of the rent without any property expenses against her portion. I would not do either 100% or even 99% to the lower taxpayer as that would be falling under Part 4A where you have only done this for tax avoidance and the ATO can deny the deductions. It’s best not to get the ATO mad.

I’m just starting out as a property developer. I’ve heard that many developers don’t succeed and in fact go broke during the development process. What are the most serious pitfalls I should be wary of and how can I maximise my chances of success?

**Michael says:** Well I guess I’m probably able to answer that question pretty well because I’ve been involved in property development since the mid 1980s. I actually started during a boom time and thought that I was really smart, but looking back, I made so many mistakes. Thankfully the rising property prices carried me. If it wasn’t for the inflation in those days, I probably would have gone bust.

I’ve actually tried to work out why many people who start developing property go bust, and I guess they usually pay too much for their site because they haven’t done an accurate feasibility and taken into account all the figures.

Many don’t understand the town planning requirements. The other big thing is that they haven’t allowed enough contingency. The actual cost always overruns because of things you’re just not aware of; rocks in the soil, other issues that hold you up, so they haven’t allowed enough funds.

Often it’s simply because they’ve never done it before and it’s different than renovating your kitchen. So it’s mainly not understanding the process or paying too much or not having done your sums correctly.

Do you have a general rule of thumb on the maximum amount that should be spent on renovation work, predominantly kitchen and bathroom, and as a percentage of the purchase price or current market value to avoid over-capitalising?

**Michael says:** As a very broad rule of thumb, about 10% of the value of the property is the maximum you want to spend. So don’t do structural changes unless it’s really necessary because they can’t be seen. In other words avoid buying properties that require things like new plumbing, wiring and floorboards, because people can’t see that, so we look for cosmetic things that add the best value.
Kitchens and bathrooms are good, a coat of paint is good, things that present well, a split cycle air-conditioner for $2,000 separates your property from other people’s and if tenants have a choice, they’ll always go for the home with air-conditioning. It’s also depreciable as opposed to other things which may not be. So spending around 10% of the value of the property means you shouldn’t over capitalise.

**What’s the worst property investment loss you’ve ever made?**

**Michael says;** It may shock readers, but the worst loss I’ve ever made in real estate was close to $1 million. But how it actually occurred is probably not what you would think. I’ve never made a loss buying real estate because I’ve bought wisely. My biggest loss came from selling real estate. My first investment, bought in 1970, cost me about $18,000 and I ended up selling it for around $23,000 a number of years later.

I thought I needed to sell it because I needed some money to buy my first marital home. I remember I made about $2000 out of that deal after paying tax and commissions and I thought I was really wealthy. The problem is that property is worth close to $1 million today, so I lost the opportunity of owning a property that is now worth well beyond what I had paid for it – almost 6 figures more! What’s even worse is that I have to drive past that property two or three times a week, so it acts as a constant reminder of my biggest ever real estate mistake and my biggest investment regret – having sold a property.

**What is the secret to successful property investment?**

**Michael says;** Let’s boil it down to maybe four secrets. To be successful, I think you need the right knowledge. There’s so much out there, you’ve got to work out what’s correct and what’s right, then you need the right system, a correct system. It’s something that’s repeatable, something that your emotions don’t get in the way of, something that you can do over and over again.

You need the correct structures for tax and asset protection because really it’s not how much money you earn, but how much you keep after tax so you can compound it and make it keep growing for you. Then you need the right network of people. If you’re the smartest person in your team, you’re in trouble. So to be a successful investor I suggest you have a good tax accountant, a good solicitor and a good property strategist as part of your team and together, those four things will help you become a successful property investor.
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