BE A FARMER, NOT A HUNTER

STORY BRYCE HOLDAWAY

To provide an adequate income in retirement, one property won't cut it. Happily, the mechanics for growing a portfolio over the long term are fairly simple

'Why bother?" Simple question, right? In fact, of all the questions I ask a potential client wanting to build a property portfolio, this is really the only one I need to know the answer to! Without a clear "why", I wonder how they will defy the odds and build a passive income that will offer them a meaningful life in retirement.

Too blunt? Perhaps. But after almost 20 years showing people the "what" and the "how" of building a property portfolio, I've finally come to realise that without a clear "why" most people will be unlikely to finish the job they so enthusiastically started and will end up disappointed with their financial lot in retirement. Essentially, the "why" evokes the positive feeling and provides the internal drive necessary to overcome the inevitable headwinds a property investor will face on their way to success.

But don't take my word for it, according to the tax office, of the just over 2 million property investors we have in this country, most of them stop at one property – 73% of them to be exact! But to be brutally honest, one investment property is not enough to provide a passive income! The good news is, however, that the mechanics of building a property portfolio are very simple and easily adopted: buy the right property, correctly finance it and hold it long term and add to the portfolio whenever your household cash flows allow.

So what's your "why"? What's your purpose, cause or belief that inspires you?

Once you know this, then I can show you the "what" and the "how" and help you become one of the minority who do build a portfolio of property and the passive income that comes with it.

Once we're clear on the big picture, the next question I ask is "Do you know your number?" In other words, how much passive income do you need your portfolio to produce to enable you to fund your lifestyle. If you don't know your number then you're not alone, as I usually see the full whites of people's eyes at this point in the discussion. But you should make it a priority to work it out. I commonly hear that "I want to be rich, financially free or wealthy" but those dreams turn into tangible goals very quickly once you've worked this number out.

So how do you do that? Simple. Break your living expenses down into the following categories:

- Bill payments – any expense with zero discretionary component, eg mobile phone, council rates and electricity.
- Discretionary spending – this is your lifestyle spend and is most likely to fluctuate week by week, eg lattes, smashed avocado on toast, holiday and Friday night dinners.
- Investment costs – this is what it costs to hold your portfolio, eg interest, landlord insurance and management fees.
- Loan payments – the costs of "renting" other people's money, eg mortgage, credit cards and personal loans.

Now fast-forward to retirement: your goal is to have paid off your family home and have no other short-term debts so the loan payments category should now be zero. Equally, if done properly, you should have built your investment portfolio to be self-sustaining with no money coming out of your own pocket to service it, so you've also eliminated the investment costs from your yearly budget and all you're left with is your bill payments and discretionary spending. Simply add these two remaining categories and you will know how much your lifestyle is costing you today and you'll know what you're aiming for.

Now you know your number. The next step is to build a strategy around this number. So how much residential property do you need in your portfolio to achieve your number?

> *If you aim at nothing then you'll hit it every time*
>
> Zig Ziglar

The rule of 25

Let's assume your number is $65,000pa. Simply multiply this by 25 and you can work out the value of income-producing assets you require outside the family home. In this case you'd need $1.625 million in today's dollars. But what if you want to go on more holidays and spend more money on the grandkids in retirement – say an extra $20,000? No problem, as the same formula applies: $85,000 x 25 = $2.125m in income-producing assets. The logic is simple: if you had $2.125m earning 4%pa gross this would give you the $85,000 in passive income you desire.

So how does your number stack up in retirement? Only need $50,000? Perhaps you need more? The table on page 57 will help you get clarity.

Four foundational levers

We all have different goals, risk profiles and appetites for leverage. In building a portfolio there is no one-size-fits-all approach. To illustrate the point, think of a bulldozer with two levers to operate it. To move the bucket forward or backwards, sideways, up or down. The driver makes incremental changes in the levers to ultimately get where they need the bucket to go. Similarly, while building a property portfolio, instead of making incremental changes to two levers we have four – income, expense, time and target – which we need to navigate to get us where we want to go.

Logically, every person has a different circumstance, ranging from the 30-year-old with plenty of time to retirement but limited equity for leverage to the mid-50s investor with suitable equity but less time on their side. What about the CEO who earns six figures or the person starting their career on a graduate salary? How about the person who's a good steward of their money versus the person who spends more than they earn, and how this will impact on how much income they need in retirement? Some people have high material needs while others need very little to be happy. It's all a moving feast and you can see that adopting a one-size-fits-all strategy simply won't be effective.

The result of this tailored approach using these four levers is a timeline that defines:

- How many properties are required.
- The price point for each property.
- What year to buy each property.
- The required capital growth rate.
- The expected yield.

In my experience, the good news is that three to five investment properties are often enough to achieve an average income in retirement.

Location

The most common mistake a property investor can make is what I call the "bottom-up" approach where they first decide on the type of property they want to buy, then they decide on a suburb based on where they can afford their desired property.

I think they have this the wrong way around.

I prefer the "top-down" approach where they set the context of the portfolio first through setting the strategy based on household cash flow, determine the location and only then buy the best property they can comfortably afford in that suburb.

The logic is simple: location does 80% of the heavy lifting, so why make the primary focus the property if it only delivers 20% of the results? Consider two identical period houses built at the same time during the gold rush era in Victoria – one in Hawthorn and the other in Castlemaine. Both cost the same in materials and have the same builder's craftsmanship and prestige. However, fast-forward to today and the Hawthorn property will now set you back $2m-$3m while the Castlemaine property would cost you just over $1m ... the only difference is location.

Equally, there has been a shift in the household landscape that makes location more critical than ever. In previous decades, the rising tide lifted all ships, meaning that all you needed to do was put your name on a title and let time do the work for you. I don't think that will be the case in future.

To illustrate, think back to the 1970s when the average household usually had one income – typically, dad went out and worked and mum stayed home to look after the kids. But as the kids grew up, mum got a part-time job initially and then went full time, which meant it became a double-income household. Also, girls who grew up in the 1980s now have full-time professional careers and as a result each household has the potential to have two full-time professional incomes. As a result, household cash flow has reached its peak organic growth potential from an income perspective across the population.

Equally, from a household expense point of view, the high interest rates that were experienced in the 1990s have now been organically reduced, given rates are at historical lows and no significant rate rises are tipped for the near future. This lack of organic growth in household income and the simultaneous reduction in expenses will have a limiting effect on borrowing capacity and raises the question of where the price growth will come from in future? Answer: choosing the right location will be more important than ever. The science of investing will be about identifying suburbs where the demographic profile shows people are in control of their income growth from their own efforts. Think of a sales executive or business owner as they aren't waiting around for a CPI pay increase to their income but rather they're in control of their household income growth through promotions, bonuses, dividends and profit distributions. This additional income will allow them to borrow more money, which means they can afford higher prices, which puts upwards pressure on the demand for their target suburb.

The other variables to consider is what I call understanding the human interest and human behaviour associated with the suburb. The former relates to the lifestyle opportunities that exist from schools, parks and cafes to how easy it is to commute to their place of work via train, bus or tram as congestion increases and driving becomes less desirable. The latter is all about status – both positive and negative (stigma) – and what living in this suburb says about your social standing, and ultimately it will influence where those on higher incomes want to buy.

A concluding consideration on location, if you live in a market that is not ideal for investment purposes then consider being a borderless investor. Australia is not one big market but rather hundreds and hundreds of sub-markets and you can accelerate your portfolio's performance by buying counter-cyclically outside your home state or territory.

Property

Now we finally get to talk about property but a word of caution here: property investing is a game of finance not a game of bricks and mortar. Mastering the art of building a portfolio requires you to be very comfortable with lending and debt structure. Successful portfolio builders know how to harvest their equity to buy additional properties (see "The power within", page 22) and they understand that lending is like a game of chess where they need to think two or three loans in advance and understand the importance of having stand-alone lending. My tip here is to have an investment-savvy mortgage broker on your team.

As building a portfolio is about buying more than one property, it's important that we become familiar with the types of properties that the banks like. The best advice here is to buy properties that have owner-occupier appeal. As investors, we need to be price takers not price makers and by that I mean we need to let owner-occupiers drive the market and we as investors get sucked along for the ride. I see too many investors get stuck when they buy "investor appeal" properties – eg, medium and high density apartments, student accommodation, apartments under 50sq m – that don't appeal to 70% of the market. It needs to be investment grade not just simply investment stock.

It also helps to view properties in the following three broad groups, all of which have very different roles to play within your portfolio: growth assets, balanced assets and income assets.

Someone's sitting in the shade today because someone planted a tree a long time ago

Warren Buffett

HOW MUCH YOU WILL NEED

Passive income	Portfolio value
$50,000	$1.25m
$60,000	$1.5m
$70,000	$1.75m
$80,000	$2m
$90,000	$2.25m
$100,000	$2.5m
$125,000	$3.125m
$150,000	$3.75m
$175,000	$4.375m
$200,000	$5m

All things being equal, you would chase growth assets first. This is where the trade off from chasing the higher growth potential results in lower yields and a negative cash flow.

Broadly speaking, growth is what you get out of the market whereas rent is what keeps you in the market so early on in our accumulation phase we want to buy as many of these properties as our cash flow will allow.

As our cash flow starts to tighten, after the first one or two properties, we'll need to start looking to buy balanced assets. These are properties where we compromise a little on the expected capital growth in return for increased yield to help neutralise the cash flow impact.

Income assets are what I call 'cash cows'. As our ultimate goal is to reduce (and ideally eliminate) the debt in the portfolio before retirement, these properties are in the portfolio to do the heavy lifting on cash flow. They are often in regional locations and the attractive rental yields are the carrot to the investor so that they can channel the positive cash flow to the debt reduction.

Warren Buffett, one of the greatest investors of all time, encourages us as portfolio builders to be farmers, not hunters. Farmers play the long game and aren't looking for the quick kill like hunters. They know that they need to have a multi-year outlook and appreciate that if a storm hits them this season they can recover next season. Interestingly, 99% of his wealth was accumulated after his 50th birthday and 95% of it was after his 60th birthday – talk about long-term strategies!

My advice to anyone who wants to build a property portfolio is that success leaves clues. Why not stand on the shoulders of giants and embrace the power of compounding so that you can sit in the shade of a tree you planted a long time ago while pondering the legacy of your "why". ***M***

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