



With a definite bias to real estate in investor portfolios, Australians are riding the crest of a property wave – but could be exposing themselves to a dangerous crash, writes JOHN McDULING.

# Hot property

**"A** man's home is his castle," actor Darryl Kerrigan famously said in the 1997 hit comedy, *The Castle*.

Perhaps no film captures the role that the family home occupies in the Australian psyche more accurately than the *The Castle* did, albeit humorously.

It's difficult to argue with the logic behind investing in real estate, because ultimately, very few asset classes have enjoyed the consistently positive returns that the Australian residential property market has delivered over the past 20 years.

According to the Australian Bureau of Statistics data, residential property prices in Australia's eight capital cities have on average, almost doubled over the past decade.

Looking at it from a slightly different perspective, Real Estate Institute of Australia data shows that Australian residential property has returned 9.2 per cent per annum over the past ten years, and 7.2 per cent per annum over the past 20 years – outperforming the returns of both the All Ordinaries Index and the UBS Composite Bond Index over both timeframes.

Australians could therefore be forgiven for thinking house prices just keep rising. But if the experience of the US, Ireland or Spain is anything to go by, they certainly don't.

Each of these countries has just gone through a devastating property

market bust with catastrophic consequences for their economies.

Either by accident or design, Australia dodged this bullet, so far, and a huge debate is raging around whether that can continue.

Boom or bust aside, the key question for advisers is whether the downside risks to housing need to be mitigated, and if so, how.

## Mitigating the risk

A recent study by Credit Suisse found that almost two thirds, or 64 per cent, of the average household's wealth in Australia is tied up in property.

As house prices continue their seemingly inexorable march higher, this has worked in our favour, making Australia one of the richest societies on the planet. But an allocation to any single asset class this high flies in the face of conventional portfolio theory.

A look at the asset allocation of Australia's largest super funds proves instructive on this point. According to Rainmaker Information, the average weighted allocation of the country's largest corporate, industry and government super funds to Australian direct property stood at just 9.4 per cent.

Obviously people need somewhere to live, and a home is overwhelmingly the largest financial commitment most people would ever make.

But Paul Bolstad, an adviser at AMP affiliated AGS Financial Group says that in his experience, many Aus-

tralians are overexposing themselves to property.

"In a lot of cases, it's because they have their principal place of residence, but then just one investment property distorts their portfolio potentially towards 70-80 per cent in property, just because of the size of the property purchased," he said.

Bolstad said our "love affair" with property could partially be explained by the fact that we have avoided the sharp declines experienced in other countries.

But another reason behind our property bias he highlights has, for anyone who paid close attention to the US' property market woes, a disturbingly familiar ring to it

"People in Australia do perceive property as a fairly low risk investment. Very few people say or acknowledge that property can go down. Most people think that worst-case scenario it will just stay flat," Bolstad said.

## DIY property

The explosion of interest in self-managed super funds (SMSFs) is well documented, but the trend could indirectly be exposing Australians even more to property.

A recent study by researcher Investment Trends found that gearing in SMSFs has doubled over the past two years and that gearing is set to increase by another 40 per cent in the next 12 months, largely to fund purchases of property.





GRAEME COLLEY



BRAD MATTHEWS



LEE HUGHES



PAUL BOLSTAD

But Graham Colley, technical services manager at ING, outlined a number of issues an SMSF trustee could face in being overexposed to property.

Once trustees reach the drawdown phase, high allocations to property could become problematic if rental yields are low, he said.

"And if an SMSF investor is negatively gearing property in the fund, and you don't see a great deal of capital gains in the investment, you are probably better off looking around for other investments," he added, because tax advantages are unlikely to make up for the capital loss.

But Colley said that in his experience, SMSF gearing to purchase property "hasn't taken off like a forest fire", and most of the investments into property are into commercial properties, many of which relate to the business already owned by the SMSF trustee.

Colley conceded that "there would be individual funds within that have high concentrations to a particular asset class, which could include property," but said that on balance, the SMSFs he is involved

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had asset allocations similar to a balanced super fund – with 40 per cent in equities, 30 per cent in property and the remaining 30 per cent in cash and fixed interest.

#### Diversifying exposure

Bolstad said that property is a growth asset and should play a part in a diversified portfolio, but added that people should be careful to not over-expose themselves at the expense of other asset classes such as equities.

Complicating matters further, however, is the fact that Australian equities them-

selves remain heavily exposed to the same property market risks.

Investors need look no further than the big four banks, who comprise over 20 per cent of the ASX200, and whose shares are widely held by investors of all stripes.

The banks are sitting on trillions of dollars worth of mortgages and any housing market issues are likely to be acutely felt. The US experience shows that if the banks get into trouble it can have devastating reverberations throughout the rest of the economy.

And it's not only equity investments that could be at risk. The banks are also among the largest bond issuers in the Australian market, and housing market distress could theoretically affect billions of dollars worth of fixed income.

**If we are so much more responsible than the Americans then how come we started with half the level of debt but now have caught up to them?**

Vivek Prabhu, a credit portfolio manager at Perpetual Investments, pointed out that the senior debt that the banks overwhelmingly issue is at the top of the capital structure, followed by subordinated debt, hybrid debt and finally equity.

"So (in the event of distress) as a holder of senior bank debt, there are 3 more junior ranking layers in the capital structure which bear losses first," he explained.

"From a credit quality perspective, in Australia, there are several loss protection mechanisms which protect residential property lenders," Prabhu added.

"Typically residential loans require mortgage insurance if the loan to value ratio (LVR) exceeds 80 per cent."

Increasing fears over a potential housing bubble both at home and abroad

prompted the ratings agency Fitch to recently conduct a stress test on the Australian banking system.

Under its most severe case scenario – a 40 per cent decline in house prices and an 8 per cent default rate – Fitch found that cumulative gross losses would approach \$9 billion, of which \$7 billion would be incurred by mortgage insurers.

Fitch concluded that the banks, whose current combined profits are more than \$20 billion, would be able to withstand the remaining \$2 billion hit.

#### The doomsday scenario

Collapses in real estate markets overseas, and the fact that we have managed to avoid them here has seen a plethora of doomsters from a variety of quarters emerge to predict our own property market bust.

Steve Keen, associate Professor of Economics at the University of Western Sydney has been one of the loudest voices predicting a property market bust in Australia, for the longest time.

He famously lost a bet with Macquarie Bank strategist Rory Robertson that Australian house prices would fall 40 per cent, peak to trough within two years of the GFC, and was subsequently forced to walk from Canberra to Mount Kosciuszko.

Keen said that Australia's mortgage debt level relative to GDP has gone from 28 per cent of GDP in 1990, half the comparable level in the US at that time, to almost 100 per cent of GDP in 2010, worse than it has ever been in the US, even at the height of the bubble.

"If we are so much more responsible than the Americans then how come we started with half the level of debt but now have caught up to them?" Keen asks, before reeling off a number of figures he believes prove that Australia's housing market is massively overpriced, including house prices to GDP per head, and the cost of servicing debt.

For some time, Keen was the lone voice crying "bubble", in the face of a chorus of believers in the Australian property song. Slowly but surely, he is starting to receive support, and from high places, mostly overseas.

The *Economist* magazine recently weighed in on the topic, claiming that Australian house prices are 61 per cent overvalued relative to their long-term average rental incomes.

And Jeremy Grantham, investment oracle at Boston based asset manager GMO, has been another high profile, outspoken advocate of a housing bubble in Australia.

Grantham, a self confessed student of economic bubbles, has focused on the jump in house prices relative to in-

## The insto view

Australia's super funds' exposure to residential property is negligible. But while their commercial property investments are one step removed from the bubble debate, that hasn't kept the sector, both listed and unlisted, out of the headlines in recent weeks.

It also means that while the boom-and-bust scenario in property is top of mind for financial advisers and their clients, the real game is how super funds and their combined \$1.3 trillion-plus in assets is moving within the asset class – through listed or direct exposures.

Some of the recent high profile developments in the A-REIT sector include Westfield's restructur-

ing plan, Centro confirming that it was in negotiations to offload a substantial portion of its assets, and a consortium led by Goodman Group swooping for the ING Industrial Fund.

Meanwhile, AustralianSuper said it was considering increasing its direct property exposure while MaritimeSuper has combined its direct and indirect property under one asset class.

Mark Wist, of Atchison consulting, said that while direct and listed property share the same underlying asset base, they are markedly different in terms of pricing, because direct investments are based on appraised values, while listed property is marked-to-market each day on an exchange.

As a result, the discounted cash flow analysis for direct property and listed property trusts may include different assumptions, reflecting different expected growth rates, management skills, types of property, financial management and any liquidity premium.

Direct property tends to be synchronised with the business cycle as reflected in GDP growth, while listed property trusts, like shares and other listed investments, can act as a leading indicator to the rest of the economy, as they are linked into the interest rate cycle.

All of these factors go some way towards explaining how returns between direct and listed

property vehicles can deviate so wildly, as was the case during and in the aftermath of the GFC.

It also helps explain why some REITs trade away from their underlying net tangible assets (NTA), motivation behind the Goodman consortium's plans to acquire the ING office fund.

Wist said that Westfield's restructuring will alleviate the problems that it posed for managers by comprising such a huge part (roughly 40 per cent) of the benchmark ASX300 A-REIT Index.

He said the move reflects the requirement of investors to have exposure to pure play high grade retail not polluted by both underperforming US real estate and development activity. ●





comes as his justification for prices being overvalued.

As far back as April, Grantham confidently predicted a 40 per cent decline in Australian house prices, arguing that if that does not come to pass "it will be the first time in history that a bubble has not behaved in this way."

More recently Grantham said "Australians violently object to the idea that their houses, which have doubled in value in 8 years and quadrupled in 21, are in a bubble."

"Does anyone think bubbles occur without a cause? They always need two catalysts: a near perfect economic situation and accommodating monetary system. The problem is we live in a mean reverting world where this all changes. In Australia's case, the timing and speed of the decline (in house prices) is very uncertain, but the outcome is inevitable."

Mainstream opinion on Australian residential property is, however, comparatively sanguine.

Lee Hughes, a property analyst at Melbourne-based Atchison Consulting, concedes that affordability has deteriorated with interest rates steadily increasing post GFC, but says that in terms of mortgage payments relative to income, house prices are "not historically anything significant and in terms of house price to income ratios, comparable to the rest of the world."

"In essence prices went up quickly in 2009 but the interest burden to the borrower doesn't appear to be out of control," Hughes said.

Hughes argues that undersupply of housing and population growth should

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prevent Australian house prices from falling sharply. And while migration will decrease in the next few years, it will remain above the long-term average because of employment growth, he said.

"You would need to get a sharp increase in unemployment to cause an over-supply of property for sale on the market," he said, an outcome that appears unlikely in the current economy.

Brad Matthews, head of economics and investment research at Hillross Financial Services said that while he expects price growth to be weak, and prices even to decline in real terms, he is not in the "disaster camp."

Matthews said some of the alarmist arguments about the Australian property market probably have some validity, and to some extent explain why he doesn't expect a lot of price growth.

"But none of those arguments reduce people's willingness to pay. From an advisers perspective you have got to make a distinction between investors and owner-occupiers. They (owner-occupiers) are there for shelter and for the long term" he said.

"There is a long history in the Australian residential marketplace of a boom and then a plateau, and we'd expect to see that this time around," he concluded.

#### It's not a house, it's a home

The Australian property market is receiving increasing attention overseas, partially because of the fact that we managed to avoid the precipitous price declines experienced almost everywhere else.

But the consensus is overwhelmingly against a cataclysmic meltdown in Australian residential property. It would seemingly require a "perfect storm" of unlikely events for it to transpire.

A spike in unemployment appears a remote possibility in the current environment, and it certainly isn't in the forecasts of any economists from either private financial institutions, the Government or the RBA.

Even if unemployment did rise sharply for some reason, and people started struggling to keep up with mortgage payments, the banks aren't likely to start foreclosing on mortgages lightly. Rather

than risk setting off a negative chain reaction by doing so, they are much more likely to capitalise any lost interest onto their loans.

But even if a property market crash is a remote possibility, that doesn't mean advisers should be any less vigilant in protecting against the potential downside risks to real estate.

After all, economic history is littered with examples of bubbles that unexpectedly burst – from Dutch "tulip mania" in 1624, to the Great Depression, our very own Posideon bubble in the 1960s, and more recently, the tech wreck and subprime.

With so much riding on the housing market, the topic is certain to continue to feature prominently in barbecue discussions across the country this summer.

If Darryl Kerrigan from The Castle were here to witness the hysteria, we can have a reasonable guess what he would make of it.

"Tell 'em they're dreaming!" ●



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