Cuffelinks
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## This Week's Top Articles


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## How Japan's 'Abe-nomics' affects Australian investments

Ashley Owen

'*Abe-nomics'* is the name given to the economic programme of Japan's Prime Minister Shinzo Abe, with another former PM Taro Aso as Finance Minister, since they were returned to power in December 2012. This radical programme has important implications for Australian investment markets.

**Japan's boom and bust**

Japan's economy has been virtually stagnant since the great Japanese bubble burst at the start of the 1990s. Japan was the great 'emerging market' of the post WW2 era – much like China has been for the past two decades. Actually Japan was more of a 're-emerging' market since it had previously 'emerged' from three centuries of isolation to become an industrial and military giant in the late 19th century and early 20th century. Japan grew literally out of the rubble of WW2 to become the richest country in the world by the 1970s and 1980s. It became the second largest economy in the world behind the US despite having only half the population of the US. Over the same period the US went from being the world's largest creditor nation to the largest debtor while Japan became the largest creditor. In the late 1980s, the Japanese stock market even overtook the US market in total value.

But it all came crashing down when the bubble burst after peaking on the last day of the 1980s. The collapse triggered a massive banking crisis that still has not been fully resolved nearly 30 years later. Prices of Japanese shares and real estate have still not recovered their late 1980s peak values even today (so much for 'buy and hold' investing!). The economy stalled and has been drifting in and out of recession ever since. Even worse, deflation took hold, driving up the yen and hurting exports and tax revenues. Japan is now the world's largest debtor and the largest creditor is China.

**Abe-nomics**

After more than two decades of stagnation and failed experiments, Japan needed a radical new plan. Shinzo Abe and Taro Aso's radical 'Abe-nomics' programme has several aims: to stimulate growth by cutting interest rates and raising asset prices to encourage spending and investment; to depress the yen to assist exporters and protect local industries from imports; and to create inflation so people will spend rather than save.

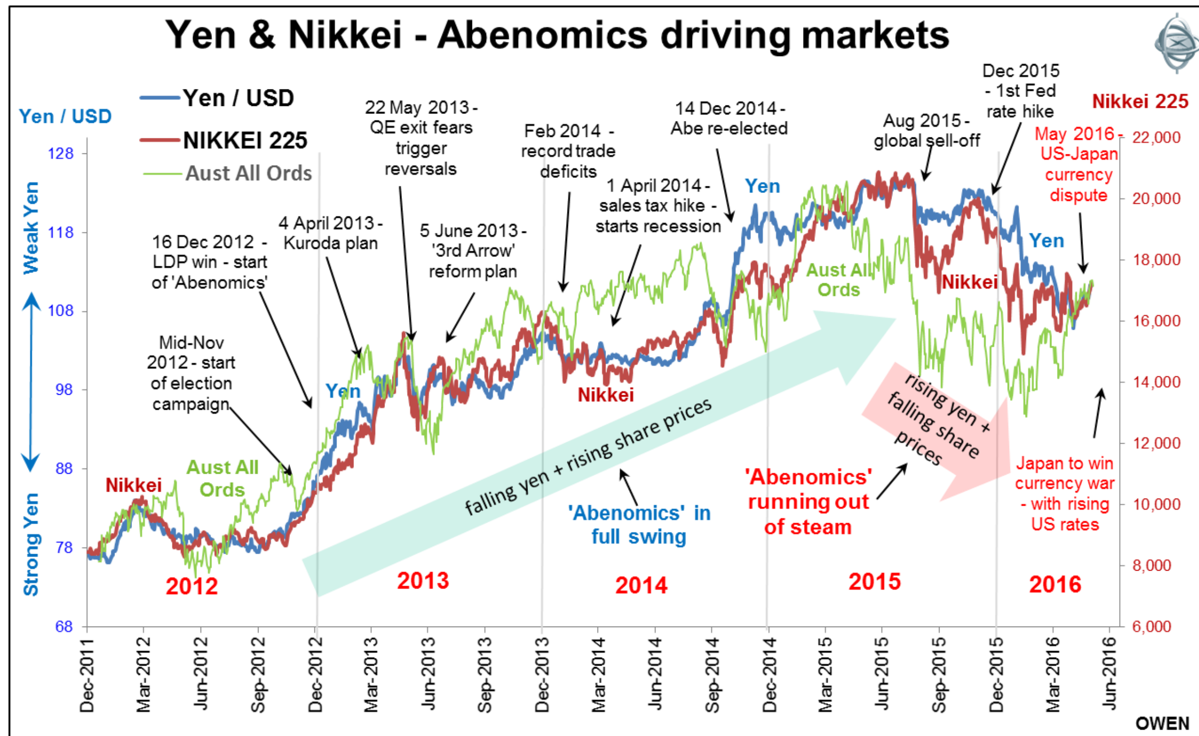
**The four arrows in the plan**

There are four 'arrows' in the plan:

1. Monetary policy, with low and now negative interest rates and QE and central bank buying of assets with newly printed money).
2. Fiscal policy, with deficit-funded spending programs
3. Structural reforms, such as in the labour market and in protected industries.
4. (An unwritten but potentially very powerful fourth) Nationalism, aimed against China, since there is nothing like uniting a nation against a common enemy to spur confidence and spending.

There are also additional measures, including directing pension funds to invest more in shares and other 'risky' assets.

From late 2012 until mid-2015 Abe-nomics worked well on the yen and share prices but did nothing to revive economic growth or inflation. The yen fell 40% and the Nikkei 225 index of stock prices rose 140% in lock-step, as shown in the chart below.




Then Abe-nomics ran out of steam in mid-2015 and things started to reverse: the yen rose and share prices fell back. Ultra-low and even negative interest rates and QE were losing their effect and structural reforms ground to a halt.

**Impact on Australia**

Why is this important for Australia? Japanese buying of foreign assets (driven by negative Japanese interest rates and a collapsing yen) provided a major boost to the prices of Australian shares, bonds and property (listed and unlisted) since 2012. The above also shows how the Australian All Ordinaries Index has followed the path of Japanese stock prices and the yen during the period.

The Abe-nomics effect is likely to receive another boost (flowing through to Australian shares, listed property and bonds) in the coming year as the yen resumes its falls while the US dollar rises with US rate hikes.

Three factors are now in play.

The first is that the US Fed is looking more likely to be getting ready for more interest rate hikes. This expectation is driving up the US dollar once again after it receded in early 2016 while the Fed sat on its hands.

The second is the Japanese government and central bank appear to be getting ready for further stimulus action after several months of inaction.

The third is geo-politics. With the US dollar rising again the US is now openly opposing yen depreciation – a big switch in strategy since it had supported Japan's depreciation efforts initially. A big factor in the switch in US policy has been the increasingly protectionist rhetoric from both Donald Trump and Hillary Clinton in the US election race.

We expect Japan to win the next phase of the currency war, which would see the US dollar rise, the yen fall and more Japanese money flowing out of Japan to buy foreign assets like Australian shares, property and bonds.

Rising global currency wars and protectionism means the RBA may need to cut rates even further to keep the AUD from rising as the US, Europe, Japan and China all compete to lower their exchange rates. Further rate cuts here would reduce interest rates on bank deposits and would also risk re-igniting the local housing bubble.

*Ashley Owen (CFA, BA, LLB, LLM, Grad. Dip. App. Fin) has been an active investor since the mid-1980s, a senior executive of major global banking and finance groups, and currently advises UHNW investors and advisory groups in Australia and Asia. This article is general information only and does not consider the personal circumstances of any individual.*

## Opportunity knocks in global small cap companies

### Nigel Douglas

There are compelling reasons for Australian investors to select global small capitalisation (cap) equities as a complement to large caps in a diversified portfolio.

As the aggregate pool of assets in Australian superannuation grows through mandatory contributions, investors have to consider moving greater exposure outside Australia. This has been led mostly through global large cap or global all cap investment strategies. However, a dedicated allocation to global small caps is an opportunity due to persistent excess returns evident over the last 10 to 15 years.

The size of the global small cap universe depends on the range of definitions reflected in the cut-offs used for maximum company size in various listed market indices. These range from US$2 billion up to US$5 billion.

For developed countries, a commonly-used index is the MSCI World Small Cap Index ex Aus ('MSCI WSC') which at A$6.4 trillion represents about 13% of the total listed global equities market of A$49.3 trillion. For MSCI WSC, there are currently 4,191 stocks in the index which indicates the vast number of possible investments.

The complementary developed countries large cap index is the MSCI World Large Cap Index ('MSCI WLC') which accounts for 84% of the total universe. In this index, there are currently only 1,581 stocks listed.

**Global small caps add diversity**

It is useful to compare sector and regional weightings to show how global small caps add diversity to investor portfolios:

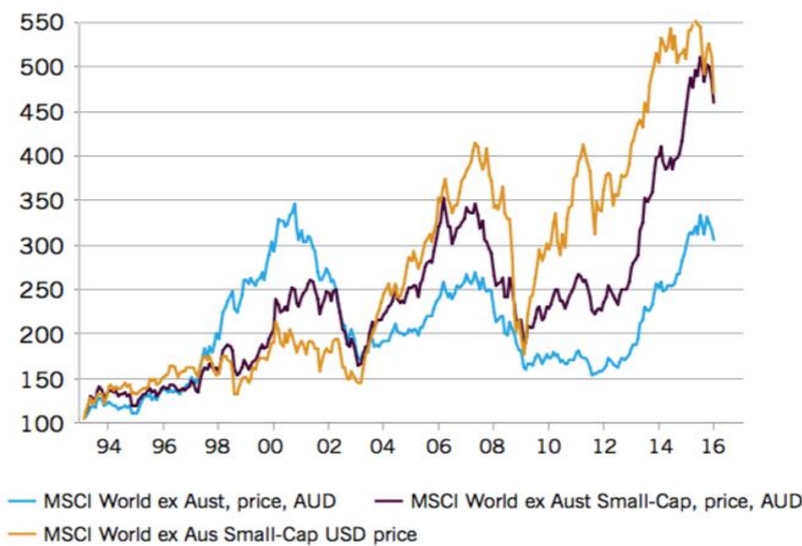
1. Global small caps (MSCI WSC) currently have proportionally larger weights in industrials, financials, materials and consumer discretionary. The large caps (MSCI WLC) have major weights in consumer staples, energy, healthcare and telecom services.

2. MSCI WSC, compared to large caps, currently have proportionally larger weight in Japan and Pacific ex Japan and less in the US and Europe.

3. Comparing MSCI WSC with the sector weightings in Australia's small ordinaries index shows Australia proportionally has over-weightings in materials, consumer discretionary and to a lesser extent telecoms.

Over the last 15 years, compared to other asset classes (in AUD terms), global small caps have been less volatile and generated better returns than Australian small caps and global emerging markets equities (in particular). As shown belowin price index terms, over time, global small caps have outperformed global large caps, particularly as the global equities bull market commenced after the global financial crisis in March 2009. However, there was a period of significant underperformance during the tech boom period of 1999-2000.

**Global Small-Caps relative to Global Large-Caps performance since Dec 1992**




Source: MSCI

The graph also shows the currency impact for global small caps (includes both AUD and USD terms). The fall in the Australian dollar over the last few years significantly boosted USD returns which was the reverse of the 1998-2002 period.

This raises the question of the relative volatility of global small caps relative to global large-caps. As would be expected, global small caps which tend to be less liquid and more peripheral in investor portfolios (that is, have a higher 'beta') are more volatile in both up and down markets. Australian small caps (the orange line on the chart) have a different volatility pattern, reflecting the boom bust commodity cycle.

**Investment styles and allocations to small caps**

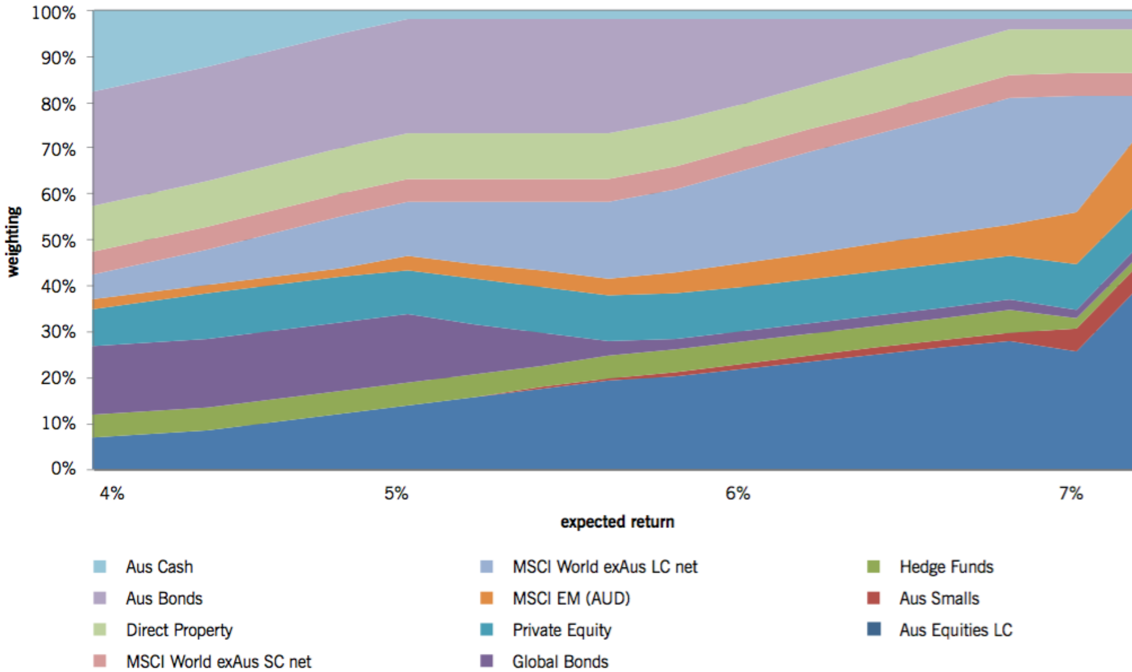
With respect to style bias, in the period to end January 2016, the growth style has outperformed value over the last 1 year, 3 year and 5 year periods respectively. More recently, over the last six months, growth has begun to underperform.

Based on assumptions and modeling work, we estimated a range of efficient portfolios allowing the strategic weightings to global and Australian small caps to maximise at 5%. The chart below shows the combination of optimal portfolios for expected return with the asset class weighting on the left axis. Asset classes are shown in various colours.

The illustration below shows that for virtually all expected return projections, it is warranted to hold a 5% weighting in global small caps (shown in pink). Australian small caps (shown in red) start to appear in the

model simulation around 6% and grow to the 5% maximum at 7% expected return. If account is made for Australian dividend imputation then the optimal weighting would be lower, say at 3%.

Efficient Portfolios (with Alts, with Global & Aus Smalls, max 10% each)




Source: Heuristic Investment Systems (HIS) 9/2/16

**Case for active management**

As the MSCI WSC index currently includes 4,191 stocks, it is not highly concentrated, and active fund managers can construct well-diversified portfolios with high active share positions.

Analysis of global small cap manager returns (using a large USD data set) shows that managers that are in the 25th percentile and above (according to eVestment data covering the last 10 years to 31/12/2015) are consistently able to generate alpha (excess returns) of around 3% plus which is well above the median. The last three years have been particularly good for active fund managers with the higher performers generating excess returns between 3% and 9%.

There is a wide dispersion in manager returns over all time periods. This supports the view that managers need to actively manage their risks across a range of dimensions, particularly liquidity, unintended sector and macro positions, stock quality and currency.

Overall, there are sound reasons, supported by comparative market, asset class optimisation and manager return analysis, to maintain a significant strategic weighting in global small caps - up to 5% - in a well-diversified Australian balanced portfolio.

*Nigel Douglas is Chief Executive Officer of Douglas Funds Consulting Pty Ltd, drawing on statistical analysis by asset allocation specialist research firm Heuristic Investment Systems and Eaton Vance Management (International) (EVMI). This article is general information and does not address the circumstances of any individual.*

# The investment case for Europe

## David Bassanese

While most Australians think of Europe as a great holiday destination, it probably remains under-appreciated as an investment opportunity by many investors. After all, Europe comprises a wide range of countries with differing cultures and business climates. The region's economy has also struggled in recent years with relatively low growth and stubborn price deflation, and debt problems in countries such as Italy and Greece.

Europe offers a potentially good investment destination and diversifier for Australians. Thanks to the continued growth in the Australian exchange traded fund (ETF) industry, it has never been easier for Australians to get exposure to the performance of European companies.

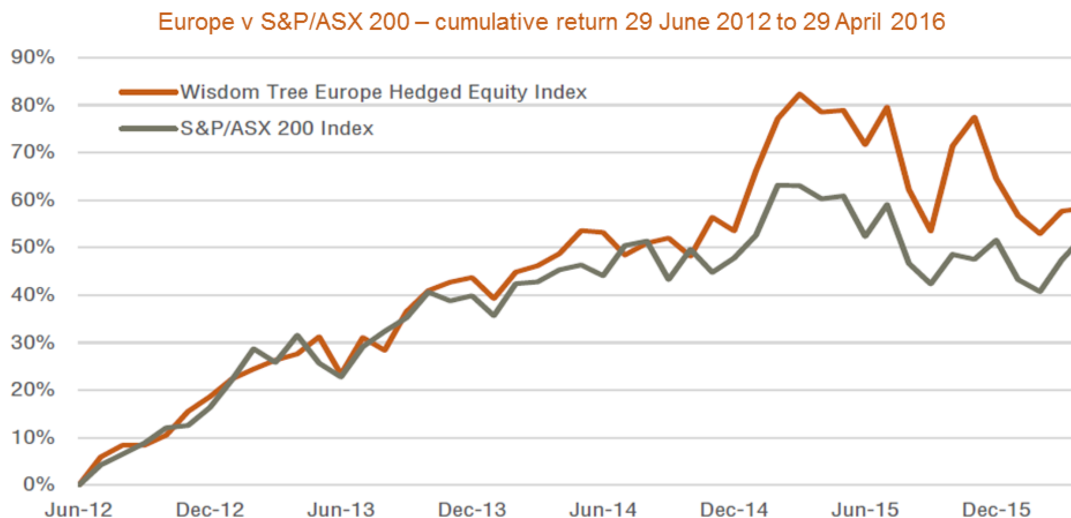
**Europe's equity performance has been surprisingly good over the medium/long-term**

Although its economies have continued to struggle of late and the European equity markets have pulled back over the past year, it has performed relatively well in recent years and its medium-term prospects remain favourable. As seen in the table and chart below, the Wisdom Tree Europe Hedged Equity Index (in local currency terms) has produced annual compound returns of 7.4% p.a. over the three years to April 2016, compared to 5.0% p.a. for the Australian S&P/ASX 200 Index.

**Europe v S&P/ASX200 Total Return equity performance to 29 April 2016, local currency**

| | 1-year | 3-years | Since Inception* |
|---|---|---|---|
| Wisdom Tree Europe Hedged Equity Index | -11.3% | 7.4% | 12.7% |
| S&P/ASX 200 Index | -4.9% | 5.0% | 9.4% |

Source: Bloomberg. Table shows performance of Wisdom Tree Index and S&P/ASX 200 Index, not ETF performance and does not take into account ETF management costs. Returns for periods longer than one year are annualised. Past performance is not an indicator of future performance of index or ETF. Inception date of WisdomTree Index 29 June 2012.



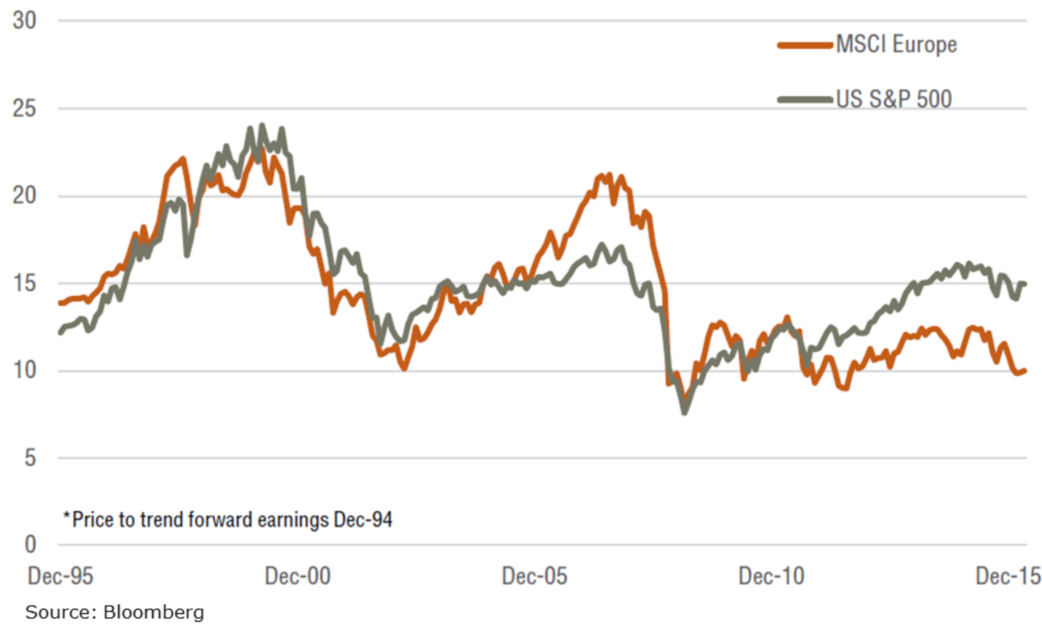

Source: Bloomberg
Graph shows performance of underlying index relative to S&P/ASX 200 Index, not ETF performance and does not take into account ETF management costs. Past performance is not an indicator of future performance of index or ETF.

Unlike Australia, Europe is a net-commodity importer, meaning it has benefited from the decline in commodity prices in recent years. What's more, due to low inflation and relatively more spare capacity, the European

Central Bank is likely to remain more accommodative than the US Federal Reserve for the foreseeable future, meaning European stocks could benefit from ongoing monetary stimulus and a cheaper and more competitive currency.

**Relative valuations for Europe are attractive**

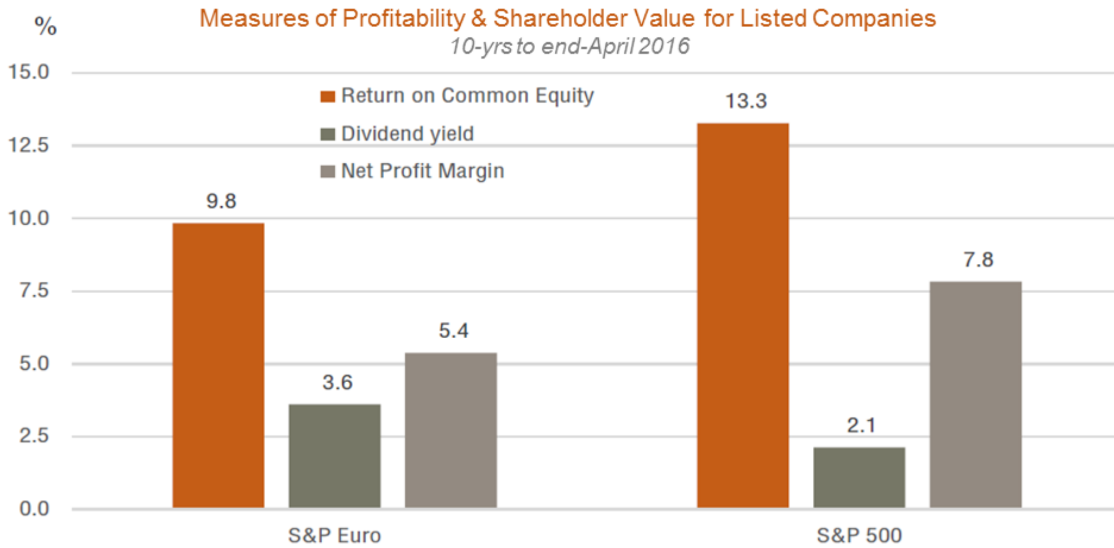
Relative to underlying growth in their respective economies, the European equity market appears to offer comparably good value to that of the United States. As the chart below suggests, although both markets have broadly posted similar performance over past cycles, the US equity market has outperformed that of Europe in recent years. There is catch up potential in Europe should the historical performance similarities return in the future.



Source: Bloomberg

**Good dividends and scope for better profitability in European companies**

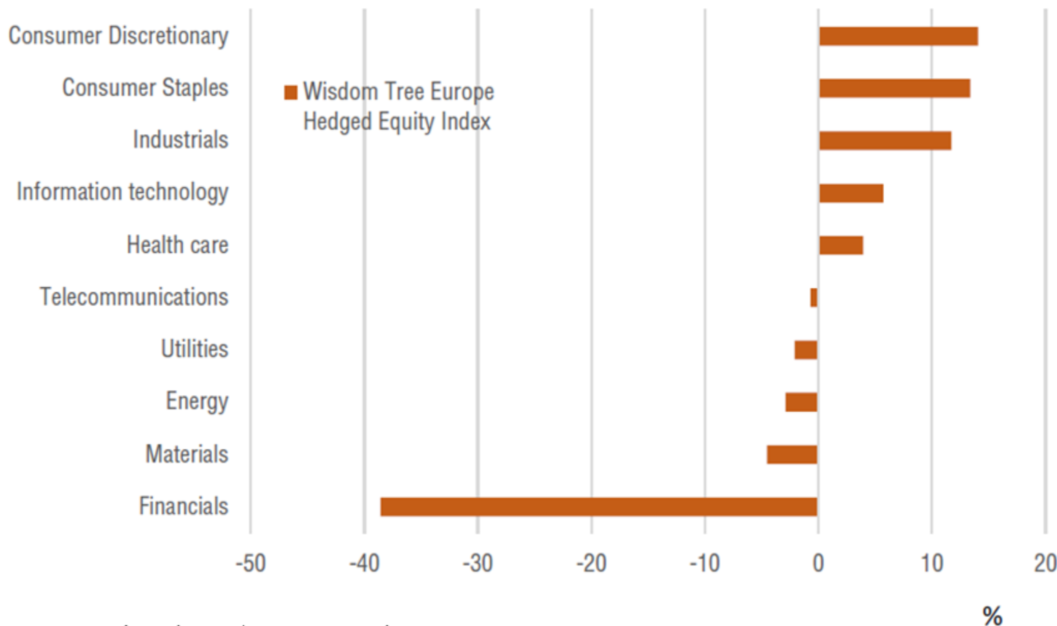
Another feature of European equities is that companies in the region tend to pay out higher dividends than their US counterparts, meaning they offer one of the better sources of income potential for Australian investors seeking international equity exposure. On some profitability measures – such as return on equity and profit margins - European companies still tend to lag US companies, so there's scope to improve earnings as companies strive to improve shareholder value.




Source: Bloomberg. Past performance is not an indicator of future performance.

**A good source of diversity**

As most investors would appreciate, there is value in having a diversified portfolio. Europe offers distinct sector exposures from those found in Australia, with notably less weighting to financials, offset by more exposure to the consumer, industrial and technology sectors.




Source: Bloomberg. *As at December 2015.

**An investment in Europe is easier than ever**

The growth of ETFs has made it easier to invest in Europe, with several products available on the ASX designed to provide Australian investors relatively easy and diversified exposure to the European equity market through a single, transparent fund, with competitive management costs. For example, the ASX-listed ETF, HEUR, tracks the Wisdom Tree Europe Hedged Equity Index.

When investing internationally, investors have a choice to either hedge or not to hedge currency risk. Not hedging currency risk effectively means investment performance will often reflect two disparate factors: the performance of the international equity market itself, and the performance of that market's relevant currency. In the case of an unhedged investment in Europe by Australian investors, for example, any returns from the equity market would be offset to the extent the Euro fell against the Australian dollar – though, of course, returns would also be boosted if the Euro rose in value.

Another advantage of currency hedging in Europe with very low (in fact currently negative) overnight interest rates is that it provides Australian investors access to the 'carry trade' (i.e. the relative difference between European interest rates and those of Australia). This carry trade currently provides investors with approx. 2.25% per annum benefit. This interest rate differential is essentially passed on to investors which boosts returns over time (so long as the interest rate differential remains positive). That's because the process of hedging currency risk is akin to borrowing Euros (at very low rates) – to offset the currency exposure from the investment in European equities – and then using these borrowings to buy Australian dollars which earn a higher interest rate return.

*David Bassanese is Chief Economist at BetaShares Capital. This article is general information for educational purposes and does not address the specific needs of any individual investor.*

## What tax deductions are available to property investors?

### Bradley Beer

When looking to purchase an investment property, there are many important questions. While most investors consider location, purchase price and tenanting ability, depreciation is often overlooked. Depreciation can help unlock the cash flow potential within an investment property, often resulting in thousands of additional dollars for the investor each financial year.

**What is depreciation?**

As a building gets older, items wear out – they depreciate. The Australian Taxation Office (ATO) allows property owners to claim this depreciation as a tax deduction. Depreciation can be claimed by any property owner who obtains income from their property.

**Claiming building structure as a deduction**

Capital works allowance deductions are based on the historical cost of the building excluding the cost of all 'plant' and non-eligible items. As a general rule, residential buildings which commenced construction after 15 September 1987 and commercial properties which commenced construction after 20 July 1982 are eligible for the capital works allowance.

Although these restrictions apply, often older properties have undergone renovations. Renovations completed within the legislated dates can also entitle the owner of the investment property to deductions, even if the deductions were completed by a previous owner of the property.

**Common depreciable items in an investment property**

Plant and equipment items, commonly known as removable assets, are also eligible for depreciation deductions. Each plant and equipment item has an effective life set by the ATO. The depreciation deduction available on each item is calculated using the effective life. Some plant and equipment depreciable items commonly found within a property include:

- Hot water systems
- Ceiling fans
- Dishwashers
- Carpets
- Blinds and curtains
- Exhaust fans

- Light shades
- Ovens
- Furniture
- Range hoods
- Smoke alarms
- Garbage bins
- Cook tops
- Door closer

**Case study**

Amy purchased a nine-year-old three-bedroom house for $610,000 one year ago. Prior to making her depreciation claim, Amy's investment property was earning a rental income of $495 per week or a total income of $25,740 per annum, while her yearly expenses (including loan interest) totalled $41,028. Towards the end of her first year owning the property, Amy's annual after-tax outlay amounted to $9,631 or $185 per week, based on her 37% marginal tax rate. Of course, the reductions in taxable income are even more valuable to people in a higher tax bracket.

A thorough site inspection led to a detailed tax depreciation schedule showing the deductions available for her property for the next 40 years, including $9,585 in the first year. The following table provides a summary of Amy's scenario for the first full year, both before and after depreciation was claimed.

| Property purchased for $610,000 | | | |
|---|---|---|---|
| **Scenario without depreciation claim** | | **Scenario with depreciation claim of $9,585** | |
| Annual expenses | $41,028 | Annual expenses | $41,028 |
| Annual income ($495 x 52 weeks) | $25,740 | Annual income ($495 x 52 weeks) | $25,740 |
| Pre tax cash flow (expenses - income) | -$15,288 | Pre tax cash flow (expenses - income) | -$15,288 |
| **Total taxation loss** | **$15,288** | **Total taxation loss (pre tax cash flow + depreciation)** | **$24,873** |
| Tax refund (tax loss x tax rate of 37%) | $5,657 | Tax refund (tax loss x tax rate of 37%) | $9,203 |
| Annual costs of the investment property (pre tax cash flow + refund) | $9,631 | Annual costs of the investment property (pre tax cash flow + tax refund) | $6,085 |
| Weekly cost of the investment property | $185 | Weekly cost of the investment property | $117 |
| **Difference of $68 per week** | | | |

2014_TP1

The depreciation deductions in this case study were calculated using the diminishing value method of depreciation. The BMT Tax Depreciation Schedule reduced Amy's annual outlay for the property to $6,085 per annum or $117 per week, a difference of $68 per week or $3,536 per year.

To claim depreciation, investors should obtain a comprehensive tax depreciation schedule from a Quantity Surveyor.

Quantity Surveyors are qualified under the tax ruling 97/25 to estimate construction costs for depreciation purposes and are one of a few select professionals who specialise in providing depreciation schedules. They are affiliated with industry regulating bodies and gain access to the latest information and resources through their accreditations.

**Claiming depreciation during renovation**

Existing assets within a property can be worth thousands of dollars. When old assets (like carpet or hot water systems) are replaced during a renovation, the owners may be entitled to claim any residual depreciation as a tax deduction. Property owners should consider a pre-renovation depreciation schedule if they are considering making any renovations to an investment property. They should also update an existing tax depreciation

schedule after work is completed to ensure they capture deductions for any new items added to the property during the renovation.

*Bradley Beer (B. Con. Mgt, AAIQS, MRICS) is the Chief Executive Officer of BMT Tax Depreciation, a leading provider of tax depreciation schedules for investors.*

## The amazing world of exotic assets in SMSFs

### Will Munro

Despite being involved in auditing SMSFs for many years, I still sometimes pick up an SMSF for audit and just think 'wow' ….

Whether it be the creativity of some investments, the risk-seeking nature of some trustees or just trying to get my head around what the trustee(s) were thinking when they put their hard-earned retirement savings into a particular investment, I can assure you that auditing SMSFs never gets boring.

I'm going to share with you some of my favourite investments from my time as an SMSF auditor. It certainly has opened my eyes to a world outside of listed shares.

As an SMSF auditor, aside from the yes/no compliance aspects, I am primarily concerned with a few key assertions with respect to investments – being existence, rights and obligations, and valuation. As you will see below, sometimes getting comfortable over all of these can be very difficult.

**Animals** – yes, believe it or not, some trustees have placed their retirement savings into animals, bulls to be precise. In September 2015, the Australian record for a bull sale was smashed, with an Angus bull being sold in NSW for $150,000!

**Memorabilia** – I've seen a cricket cap, *Back to the Future* memorabilia and many others. The irony of retirement savings being ploughed into *Back to the Future* memorabilia was certainly not lost on me! Genuine baggy green cricket caps, when they go to auction, can do very well indeed. One sold for over $400,000 because it was a Sir Donald Bradman cap.

**Transport** – I've seen taxi plates, plane hangars, a marina berth and a caravan, to name a few! Unfortunately for trustees who invested in taxi plates a few years back, with the rise of Uber, market values of taxi plates have dropped significantly in recent years, from a high of around $425,000 in 2011 for a Sydney plate to around $230,000 in December 2015. In fact, they dropped from $300,000 to $230,000 in one month at the end of 2015! Since November 2014, the value of taxi plates in Sydney has fallen by 38% and is now at its lowest level since January 2002. Marina berths are an interesting investment – they are generally long-term leases (without an option to renew), not actually direct ownership. So, while an SMSF may pay a significant amount of cash (hundreds of thousands of dollars in many cases), it does not actually own the site. The money is, quite simply, rent in advance. The way that trustees generally try to make profit from a marina berth is by renting it out short term at higher than the rent prepaid, plus of course the interest paid on borrowings for 25 years' rent up front.

**Bible pages** – one of the most interesting investments I have come across is pages from the original King James Bible! Rare antiquarian (antique) bibles that are investment-grade can often increase in value each year by 15 to 25% or more. The finite supply is continually bought-up by collectors and institutions.

**Whisky** – I've come across trustees investing in barrels of whisky, worth around $10,000 each! As the famous Irish playwright, George Bernard Shaw once famously said: "*whisky is liquid sunshine*!". Here's hoping the sun is shining on these investments!

**ATMs** – Most people think of their super as their own personal ATM for retirement – well, how about actually investing in an ATM! With many ATMs in Australia charging upwards of $2 per transaction, if only 50 people per

day use the ATM that works out at $36,500 per year (less rent). Dependent on the location of the ATM, this could even be a conservative figure.

**Moon rock** – certainly one of the more unusual investments was a piece of moon rock, reportedly brought back from one of the moon landings.

There are many other exotic investments, including the infamous story of an SMSF that owned a pride of lions, which they leased back to a circus.

**Compliance obligations of a trustee**

Before you do decide to invest in some of the more exotic investments, always remember your compliance obligations as a trustee. The auditor of your SMSF will require evidence of the existence, rights and obligations, and valuation of your investment, as well as storage and insurance for collectables.

As the Australian Taxation Office advises, collectables and personal use assets are things like artworks, jewellery, vehicles, boats and wine. Investments in such items must be made for genuine retirement purposes, not to provide any present-day benefit. So collectables and personal use assets cannot be:

- leased to, or part of a lease arrangement with, a related party
- used by a related party
- stored or displayed in a private residence of a related party.

In addition:

- the investment must comply with all other relevant investment restrictions, including the sole purpose test
- the decision on where the item is stored must be documented (for example, in the minutes of a meeting of trustees) and the written record kept
- the item must be insured in the fund’s name within seven days of the fund acquiring it
- if the item is transferred to a related party, this must be at market price as determined by a qualified, independent valuer.

For collectables and personal use assets held before 1 July 2011, remember that trustees have until 30 June 2016 to comply with these rules.

*Will Munro is Manager of the SMSFs Audit team at Deloitte. This article appears on Deloitte’s SMSF Inside blog. This article is general education and does not address the circumstances of any individual, nor is it taxation or investment advice.*

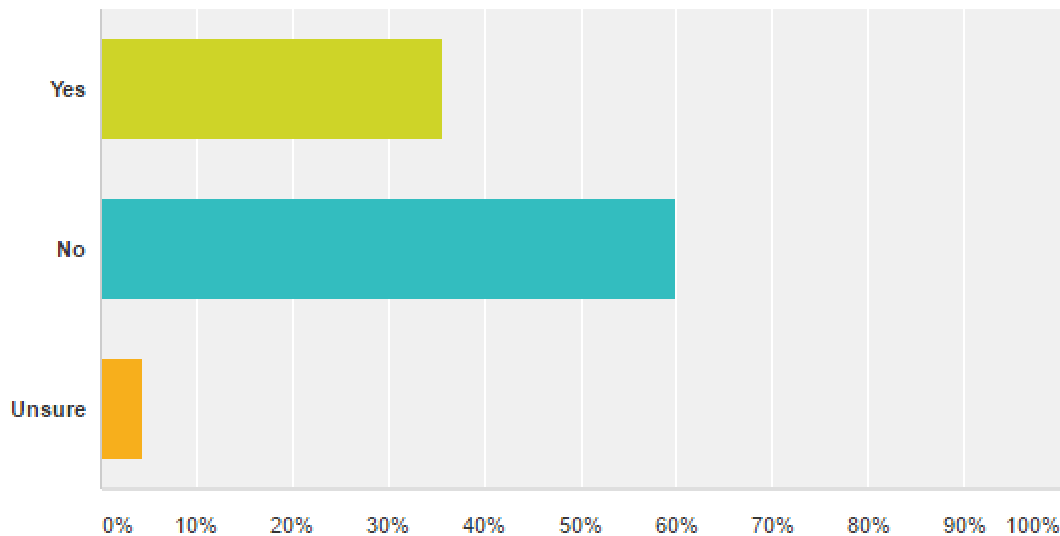
## Surprising negative gearing and capital gains survey results

Graham Hand

Another strong response to our survey, with some surprising results.

Before we go too far analysing the numbers, we should acknowledge that opt-in polls are not as independent as using a statistical method to pick respondents. It's important how people are chosen, and where the respondents choose themselves, pollsters argue the sample does not reflect the general sentiment.

This might explain why 60% of respondents believe negative gearing should not be retained in its current form.



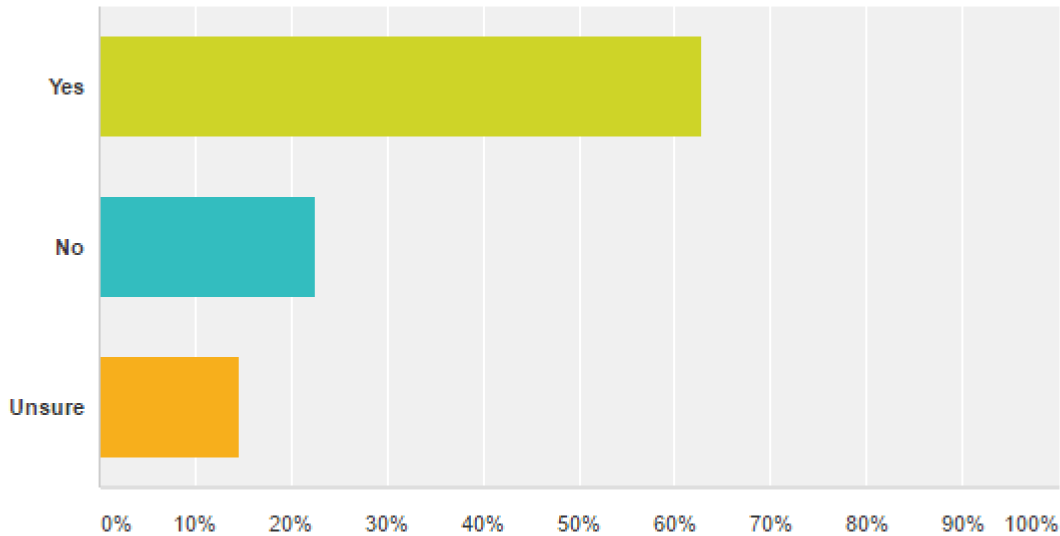

The comments reveal the rationale for this result, with responses dominated by two groups:

1) those against negative gearing argue property investment has become speculative and is contributing to making housing unaffordable for first-home buyers. There are equity and intergenerational issues and it is a subsidy from the taxpayer.

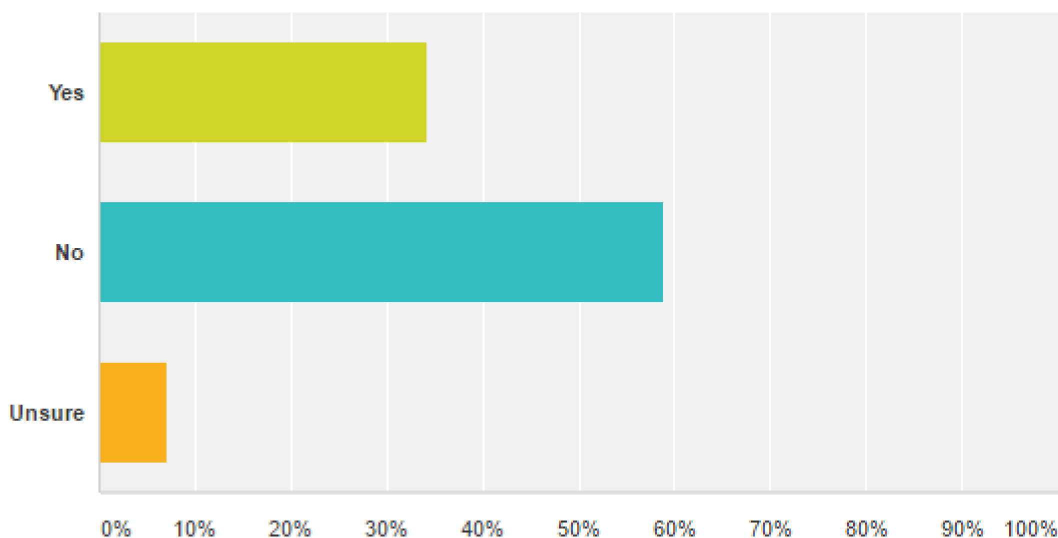
2) Those in favour of negative gearing argue it is a basic principle of investing and business that an expense is a tax deduction, and negative gearing is used by medium-income earners to build security, not only the wealthy.

There was a lot of support for capping the loss in some way, either by the number of properties or the type of income the loss can be claimed against.

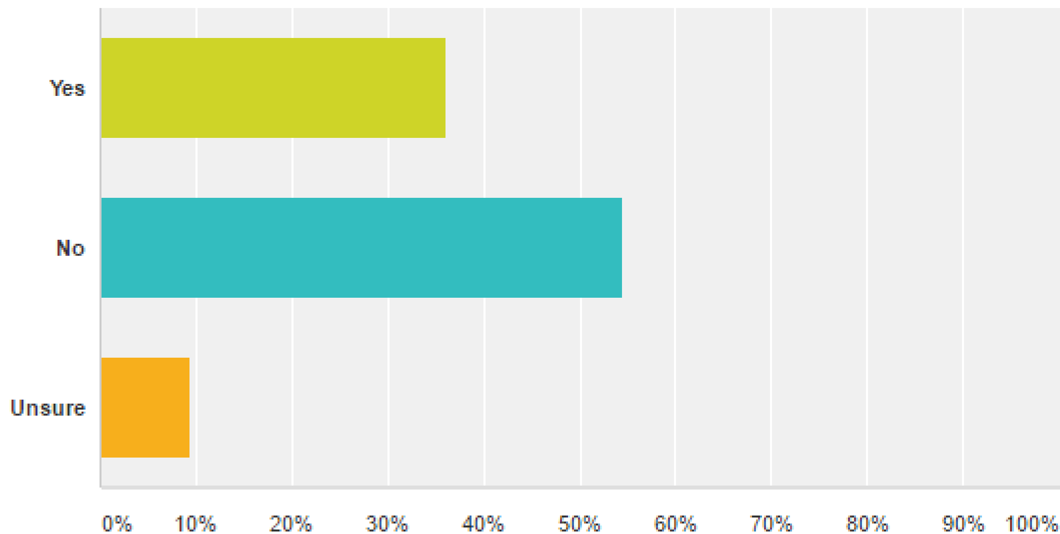
Respondents strongly believe that the current policy leads to higher house prices, with only 22% saying it does not. Main reason is that the tax benefits encourage demand for investment property.




On the proposed Labor Party policy of restricting negative gearing to new properties from 1 July 2017 (and retaining existing arrangements), 59% disagreed, mainly because it would create distortions and lift the price of new homes.




On Labor's proposal to cut capital gains concessions, although a strong 55% were against, there was decent number arguing the current 50% is too high, with 36% in favour of the change.




## [The full survey results are linked here.]

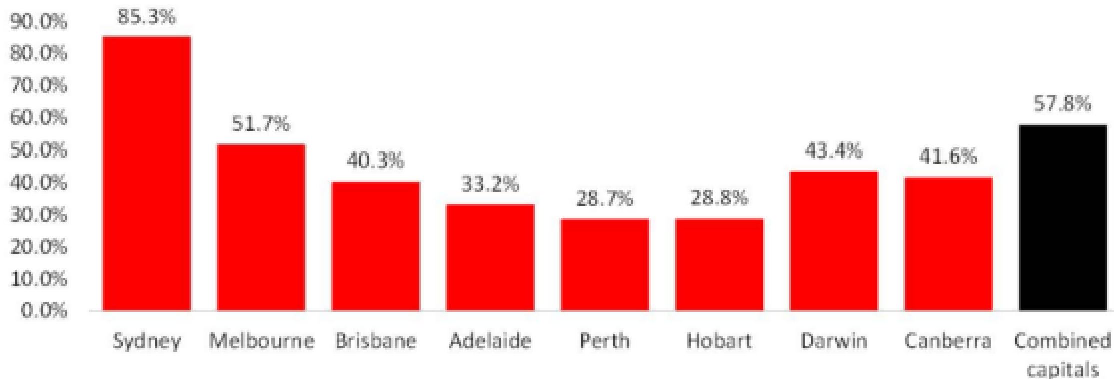
There are many good comments in the final section, too numerous to reproduce here.

A few observations on the policy differences:

1. Labor will retain negative gearing on new property, in a policy designed to encourage a supply of new housing, but there's a potential downside. Already, many new apartment developments are over-hyped in elaborate marketing campaigns, glossy brochures and photographs taken from the top floor. With obvious exceptions like Barangaroo, early resales are often disappointing when the building is actually finished. The negative gearing on new property and the easier access to these apartments for foreign investors may lead to an even more expensive primary market and a disappointing secondary market. Plus there will be a rush by investors to buy residential property before the 1 July 2017 deadline.

2. For the majority of Australians, owning their own home is an important part of life's journey. The dream goes like this (warning: sweeping generalisation coming) – have a good education, find the right job, meet a partner, buy a home, start a family, pay off the mortgage, buy an investment property, move onto other investments …). Unlike other countries where it is acceptable for even senior executive to rent homes on 10- and 20-year leases, in Australia, home ownership is a right of passage. With average household income about $80,000 a year and median capital city house price about $723,000 (and over $1 million in Sydney), the nine-times house-to-income ratio is destroying dreams, or creating massive debt burdens, notwithstanding lower interest rates.

3. Many property investors over-extend themselves believing prices can only rise. There's a naivety about piling into debt to buy property rarely seen in other asset classes. Investors are willing to accept property expenses exceeding income in the hope of future gains. The latest CoreLogic rental data for combined capital shows average gross rental yields of 3.3%, which would net to around 1% after costs (council rates, strata fees, repairs, etc). Subtract mortgage costs of at least 4% and there's the negative gearing. Rental yields are at record lows. Fuelling the fire, the expected capital growth has certainly played out in the last five years, as shown below for total returns from residential property (including capital gains):




Source: CoreLogic RP Data Accumulation Index.

Little wonder housing investment remains popular. There's not enough space to outline what can go wrong in future with this plan, but suffice to say that the thousands of inexperienced property investors borrowing five to ten times their annual gross salary to buy an off-the-plan apartment in an over-supplied market will end in a lot of tears.

It's a complex policy area of intergenerational equity, rich versus poor, renters versus landlords and massive personal debts and leverage. So far, the people who own the properties are mostly the big winners.

*Graham Hand is Editor of Cuffelinks.*

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