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My best investment idea is … dump the investment property.

If you are like me; one half of a couple who are 40-55 years old and earning $180,000, you need to evaluate your portfolio with a critical eye, because if there are problems … you only have a few years to turn them around.

Eight years ago, we subscribed to the common-held investment strategy:

- buy an off-the-plan investment property in a new suburb
- secure borrowings of 80% of purchase price against the property
- secure remaining borrowings against your primary place of residence
- wait for the magic wand of Capital Growth to fatten your Golden Egg so that the value of the property exceeds the borrowings.

Capital Growth is the driving force behind this strategy.

In 2009, we bought an off-the-plan investment property for $365,000.

Our total borrowings were $400,000 and we chose the Prime Cost method to calculate depreciation.

Now, the property has dropped in value to $325,000. The Prime Cost method stacked our deductions into the first five years of ownership. Our out-of-pocket expenses have increased considerably to $10,000 per annum.

This is a rather common scenario in our age group. But not many people have worked out why their investment properties have become so expensive and why hanging on to them is such a bad idea.

Macro vs Micro

One of the biggest mistakes is to treat the investment property as two separate balance sheets. One is the macro-level capital gain/loss vs debt. The other is the micro-level interest vs rent subsidised by negative gearing.

This compartmentalisation of the equation prevents the investor from appreciating the full impact of their losses.

To get the full picture:

- Calculate your out-of-pocket expense per year.

Please note, this is the amount that it costs to maintain the property *after* negative gearing, in our scenario; $10,000.

- Add all the annual out-of-pocket losses for the period you have owned the property; $55,000 over eight years.
- Take that figure from the amount the property is currently worth - $325,000 - $55,000 = $270,000.
- Remove the amount of debt on the property - $400,000.

How big is that loss?

$130,000.

Ouch.

And remember … in this scenario, the loss is increasing by $10,000 a year.

Sometimes you just don't want to look at all those numbers together. It is a sober and depressing prospect. It is much easier to divide the equation up into macro and micro views and make the chunks of bad news smaller and more palatable. Doing so means the larger picture can go unnoticed for years.

Investment window

Your 'investment window' is the number of years you can afford to sacrifice a percentage of your salary into an investment vehicle.

Prudently, this window would end a year or two before retirement so as to take best advantage of your subscription to the tax system and its benefits.

How many years of your investment window remain? In our case, I think we have eight years left.

Increasing expenses

If you have use the Prime Cost method of calculating your depreciations, the out-of-pocket annual expense will increase from the sixth year of ownership onward.

Therefore you need to carefully consider the amount of money you are paying out of your pocket each year against the amount you have (theoretically) earned in Capital Growth.

And right now, Capital Growth is an oxymoron

Capital growth is the engine of property investment and that engine has stalled.

Do your sums:

What percentage of Capital Growth is required to push your investment back into the black?

Do not be tempted to generalise the Capital Growth figures based on nearby, but not neighbouring, growth suburbs.

Is this figure feasible?

If you are going to hang your hopes on a wait-and-see solution, be sure that solution does not require a miracle.

In our example; we will incur $10,000 for each of the remaining eight years of our investment window. That takes our total loss to $210,000.

Our investment property will have to be worth $535,000 within eight years to *break even*.

That is a 60% capital increase or a compounded average growth of 6.5% per annum.

Getting out now is not so bad

Even if we do *break even* this represents a zero return on our investment and we will have squandered the entire investment window.

If we sell the property now and incur a capital loss of $75,000 this loss can be carried forward and applied against any future capital gains.

We will liberate an investment budget of $10,000 per annum that we can place in a better performing investment vehicle. And the potential capital gains from that alternate investment vehicle can be offset against this capital loss.

Summary

On the face of it, owing $400,000 on an asset worth $325,000 doesn’t seem too bad if you take the optimistic long term view.

But if you include the increasing ongoing losses and the shortening investment window, that picture doesn’t look so rosy.

So when you prepare your Tax Variation for the coming financial year, take a long, hard, sobering look at the amount of money coming out of your pocket to subsidise your investment property.

Conclusion

If you are in a similar scenario, you should get out now because:

- You have lost too much of your investment window to recoup your compounding losses
- The market is very unlikely to improve quickly enough to recoup your losses before retirement
- Your annual out-of-pocket expenses can be directed to an alternate investment vehicle
- The loss you make now can be offset against the future capital gains of that alternate investment vehicle.

To determine whether this investment strategy is worth your while, you need to include all your losses in the equation and have realistic expectations of market recovery.

Be in possession of all the facts before making your decision.