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HD Property v shares

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ASSET ALLOCATION

The accepted wisdom is that you're better off with shares, but our analysis shows it's all in the timing.

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No one recommends flipping a coin when it comes to asset allocation but for those investors with a foot firmly in one camp or another, that's exactly what they are doing. Even investment novices know the importance of diversification and yet, despite this, you don't have to look too hard to find those who have made money from property, and nothing else, and those who have made money from shares, and nothing else.

The accepted wisdom is that Australian shares have a better return profile than residential property, thanks to dividends and franking credits, which significantly enhance returns over time. But at the same time, most property investments are heavily geared, which doesn't so much improve returns as supercharge them.

In order to get to the bottom of this, we've needed to dig deep into more than 100 years of returns and the answer, unsurprisingly, is complex. If forced to provide an answer that would fit on a Post-it note, we'd have to go with "it's all in the timing".

The data feed

For the truly objective, the answer lies in the data. But how can investors make a proper comparison when the frequency and transparency of data fail to match up?

On good terms

If the volatility levels viewed in the sharemarket are a result of supply and demand being reported in real time, it may be fair to assume the property market is a more "rational" place.

But whereas about 2000 companies are traded on the ASX, each one divisible into perhaps **billions** of identical shares, the property market comprises **millions** of indivisible lumps.

"Every house is different in time and space, every buyer is different in terms of capacity and every seller is different in terms of motivation and agenda," Australian Property Monitors senior economist Andrew Wilson says.

The results of each property **sale** feed into city, regional and national aggregates, which are hard to relate back to a buyer's or seller's expectations. Buyers have enjoyed lower interest rates for the past 18 months and sellers have enjoyed the boost this supply of money has delivered to prices.

"We had a similar scenario in 2009-10 when affordability was improved," Dr Wilson says. "Then we had the reverse, where we had interest rates rising."

Movements in prices reflect marginal sales and only about 6 per cent of property is traded a year. In the sharemarket, 86 per cent of all shares were traded in 2012-13.

"That's the essence of the difficulty in finding that underlying noise," Dr Wilson says, where "noise" is the data that feeds price fluctuations. The chances of picking a short-term winner in a region or suburb are made ever slimmer by the low number of observations, even over a quarterly period.

"The rate of growth and rate of decline reflect local economic factors, local supply and demand factors, but overall the nature of the housing market mechanism in this country is that it follows the same underlying pattern of activity over the long term."

The trend reflects the business cycle and movements in interest rates, he says, and useful forward indicators are housing loans data from the Australian Bureau of Statistics and auction clearance rates.

Believers in property hold on to your seats: Dr Wilson is about to give us an idea of the money that can be made by holding this favourite asset class.

"My rule of thumb is 3 to 4 per cent is [nominal] underlying house price growth in Australia," he says. "That's maybe 1 to 1.5 per cent above inflation."

Well, that's a bit underwhelming. We're not sure what to say now.

Renovations in reverse

Pitcher Partners executive director of investment advisory Sue Dahn cuts to the chase when comparing shares with property.

"Shares are liquid, residential property is not. Shares have a high yield, residential property does not. Shares incur a one-off, very small [transaction] cost, residential property incurs ongoing costs. Shares are massively divisible, you can buy a thousand and sell one, but I can't sell the bathroom of my house."

No surprise, then, that in Dahn's opinion shares are a "demonstrably superior" investment to residential property. Comparing them on the measure of growth, however, she says they are "like for like", with the caveat that ongoing costs are never factored for.

"People say, 'I bought that property for $250,000 and now it's worth a **million**, and aren't I a genius?' But they've never factored in the years of rates, insurance, repairs and maintenance, let alone renovations and improvements."

Neck and neck

Every home needs a homemaker, as advanced decrepitude is a massive turn-off for buyers and incumbent vendors alike. Property is pleasant and has benefits well beyond capital gain and money spent on renovations pays dividends in the standard of living. But this comparison isn't for home-owners: it's for investors.

The costs of fixing and improving property may not be included when most Australians calculate their return on a deal but AMP Capital head of investment strategy and chief economist Shane Oliver says it is the missing piece which, when slotted into the national investment puzzle, shows returns from shares and property are about the same over time.

Real house prices have increased about 3 per cent a year since 1926, according to data from the Australian Bureau of Statistics. "That's roughly in line with national real income growth and real GDP growth," Dr Oliver says.

If it sounds like the value of property is determined by wages and the economy (which makes sense from the perspective that you can borrow only what you can afford to repay), Dr Oliver has also shown that $100 invested in Australian shares or Australian residential property in 1926 would have returned about the same amount, with a nominal return of 11.5 per cent from the All Ordinaries accumulation index and 11.1 per cent from property including net rental yields, where he assumed maintenance and tax costs of about 2 per cent a year.

"[Returns from shares and property] cycle around each other," he says. "You go through a phase where sometimes you're better off in property and other times when you're better off in shares."

Great Australian bite

Risk is the standard deviation of returns from the average and shares are more volatile than property without doubt: for the past 10 years, annual returns were within 13.9 percentage points either side of the average in 68 per cent of cases; the same measure for property was 6.5 percentage points.

If that sounds dull and technical, a warmer view of risk can be gained by putting on some Australian sunglasses.

"Risk in an equities portfolio is very misunderstood," says Perpetual head of investment markets research Matthew Sherwood, who points out it is as appropriate to value risk as the probability of capital loss as it is the variance of returns from an average. When viewed that way, equities stand out as "the greatest compounding machine the world has ever known".

Since 1974, shares have outperformed other asset classes because earnings have been "effectively" reinvested, Sherwood says. In his eyes, Aussie equities are "low risk" against cash and **gold** because those assets do not produce equivalent net income. "The income growth in shares is the lowest risk of any asset."

Property seems safer than shares because it is only valued on average once every seven years in Australia, he says, "And that is when you buy it and when you sell it. If the sharemarket traded one day in every seven years and each house was valued daily, I'**m** sure that people would sell those volatile housing assets and **purchase** those safe shares."

An after-tax comparison of shares and property is fraught, as everyone's situation is different.

The sharemarket offers a tax advantage through franking credits, whereas property investors are given a tax credit via negative gearing if they lose income.

"It's always better to be making income in investments as the basis of wealth creation," Sherwood says. "The general population would believe that property has better tax advantages than shares but to me that is not the case, and history has borne that out quite conclusively."

The general level of franking credits in distributions from Australian companies is about 70 per cent; an investor would declare the remaining 30 per cent as income and receive a tax offset for corporate tax paid on the rest. The individual would then pay the difference between his or her marginal tax rate and the corporate tax rate. "No other yield of any other asset gets that tax advantage," he says.

Is growth guaranteed?

Looking ahead, Sherwood says there is evidence of growth in the economy which won't be picked up in ABS data for at least 18 months. Yes, **mining** investment is down, but **energy** exports will rise as projects come on line. Credit growth, housing finance, building approvals, trade and retail sales are looking good. "There is a cyclical improvement already in the Australian economy," he says. Rate cuts and a lower dollar are flowing through to the economy.

"You put all that together and that tells you the Australian economy is going to continue to be one of the strongest of all the advanced economies," he says. "We're going to be one of the strongest, if not the strongest, economies in the next decade."

If Sherwood's right, earnings will grow and share prices with them. It's a signal, then, to borrow and invest in shares… right?

Slight pause.

"Well, whether people leverage into the sharemarket is a personal choice," he says.

Other people’s money

Borrowing to invest is a hard call and you'd better think long and hard about where to do it because you can end up losing more than your initial outlay. Looking over the past 10 years, Russell Investments found those who borrowed the equivalent of their own principal to invest in Australian shares made returns about 2 percentage points higher than non-geared investors on average.

Investors in residential property did not enjoy the same happy returns.

Once all borrowing costs were taken into consideration, those in the lowest tax bracket made 1 percentage point a year less if they borrowed; those in the highest bracket made just 0.1 percentage points more.

More bad news: the returns Russell reported don't take in the rapacious costs of renovations and maintenance.

So if the result for geared investments into property doesn't add up, what hope has a retail investor got of buying property for cash? Russell weighed data for the 20 years to 2013 and found residential property investments geared to 50 per cent made slightly more than 1 percentage point higher than non-geared.

Relax, it’s only tax

Tax generally tears at investment returns but credits from franked dividends can see after-tax returns for Australian equities outstrip gross returns for lower income earners. For those in retirement, a $1 fully franked dividend is worth $1.43 after tax.

For investments in residential property, Russell Investments reckons the Australian Taxation Office took 0.7 percentage points off returns from super funds and those in the lowest tax bracket and 1.9 percentage points from those in the highest.

The franking credits from shares since 1988 are virtually equivalent to the residential property market's income since 1990, says Sherwood at Perpetual, "Which means you get all the dividend growth in the Australian sharemarket virtually for free, relative to the residential property market."

Equities is the only investment alternative where you get a tax advantage when you're receiving income, he says. "And income is the basis of wealth creation."

Sherwood takes a detached view of tax and at the same time shares an important reminder of what the end game is. "We undertake investments solely to boost our wealth and no investor should undertake an investment solely on the basis of tax," he says. "Nevertheless, shares have tax advantages when you earn income, through franking credits, whereas property has a tax advantage when you lose income.

"Investors may be able to halve the income loss, but negative gearing will never change the net income detraction if loan repayments are greater than rental income."

Where next for property?

AMP Capital's Shane Oliver concedes it's hard to measure unlisted assets and so there is a lot of uncertainty around property as an asset class.

"You can't invest in an index that will track the property market," he says. Well, for the moment anyway. Nevertheless, a cycle can be observed.

Referencing a chart which displays the drawn-out nature of the property cycle, he points to the early 1940s, where the line drops off the chart.

"It was 1942, I think, when midget submarines broke into Sydney Harbour and the people in the eastern suburbs decided to sell up and go to Bowral."

In the mid-1990s, the market broke from a long range it had been trading in since the early 1970s as Australia shifted from a high interest rate environment to a low interest rate environment, he says.

"That was also the time Australians started to ramp up their debt levels and that set off the biggest boom in the Australian property market in recent times."

Things "petered out" around 2004 and the market is now well above trend, he says. "I think we're in for an extended period of relatively range-bound property prices, reflecting the fact that at current levels the property is relatively richly valued."

Although many measures of valuation suggest Australian property is expensive, supply is still restricted. Regardless of expectations of (or hopes for) a crash, it just hasn't happened. Restrictions on land release and development requirements have held back supply, whereas it was allowed to boom in markets such as Ireland, Spain and the United States.

The story ended badly in those markets, and others, when rising interest rates hurt highly geared borrowers. In some countries, supply of new housing exceeded demand. Vacancies and defaults soared.

The same hasn't happened here and it probably won't.

"We're concentrated in a handful of cities on the coast, and coastal cities always cost more," Dr Oliver says. "We've kept them relatively green, which is all very good for quality of life but it has led to relatively expensive housing."

In the absence of a huge supply response or economic shock in Australia, such as a crash in **China** or jump in interest rates, it's hard to see the property market crashing, he says. More likely there will be good years and not-so-good years.

Property is offering a relatively low yield, he says, between 3 and 5 per cent, which after costs becomes 1 to 3 per cent. The dividend yield on shares is about 4.5 per cent, or nearer 6 per cent for those who can claim back all the franking credits.

"The starting point yield is a bit better for shares than it is for property at the moment," he says. "But history tells us over the very long term they're probably going to have similar returns."

If the dictum of making profits from shares is to buy low, sell high, the rules are different for property because of the cost of borrowing. When interest rates are low, money is considered to be "cheap". That's when prospective buyers take out ever-larger loans and together they bid up prices for available stock. To keep up with prices, investors will ask for longer loan terms so that lower payments of principal and interest result, but there will be more of them.

A patient investor, who was ambiguous about shares or property and who was determined to make a binary decision, would know that is exactly the wrong strategy. If you want to pay down the principal as fast as you can, you ask for as short a term as you can afford.

"That's the name of the game for banks," says Dr Wilson, at Fairfax-owned Australian Property Monitors.

"There's a motivation for people to take shorter-term fixed-rate mortgages and that's why banks typically play that fixed versus variable game."

Owners hold property on average for seven years, he says. If you want to strike when prices are low, it would make sense to wait until interest rates are high and borrow at a variable rate. That way, as rates slowly return to a long-term average you will benefit from lower payments.

Can you handle the volatility?

Volatility in the sharemarket is a nauseating phenomenon that can create wealth or burn it to a cinder.

Yes, Australian equities have outshone other asset classes in the long term, but there have been blowouts along the way. "Those returns do come in a rather volatile way," says Towers Watson head of investment Australia Graeme Miller. "Most of that volatility is driven by investor sentiment."

Share prices are much more jumpy than can be explained by the fundamental data that is fed into the market, such as profit results, payout ratios, debt levels and so forth. The efficient market hypothesis, which says prices reflect all available information and nothing more, is not at all strong, Miller says.

"The efficient market hypothesis assumes that prices are set by mythical creatures that don't have any emotions, such as fear or greed, whereas in reality that's simply not the case."

The most successful investors buy assets that are cheap. Yes, we know it sounds obvious but it isn't easy to do. When fear is cast over the market, the natural human inclination is to be reluctant to **purchase**. "But history tells us time and time again that is the very best time to **purchase**," Miller says. "And the very worst time to **purchase** is when there is irrational exuberance dominating market pricing."

But when were shares cheap? That's easy. Just look at the On The Slide chart (left). OK, but when will they be cheap again? That's a bit harder.

Here's a test: place a piece of paper over the chart at the left so that everything to the right of the first line is covered.

Now move it right to the next line. Shares are 25 per cent cheaper. Would you buy? Move it to the right again. Shares are 25 per cent cheaper again. Would you buy? The same phenomenon applies in reverse to a bull market, Miller says, and to bubbles, which are always identified in retrospect.

"Everyone knew in the early 2000s tech bubble that pricing was completely unsustainable and yet people who sold 12 months before the peak left an enormous amount on the table relative to those who sold at the peak."

Keep pedalling

The market always moves in cycles but the length and amplitude of cycles is variable and difficult to predict. Knowing at which point to jump in is another impossibility.

"In the short term, market prices are dominated by 'noise'," Miller says, using a shorthand term for jagged short-term fluctuations. "There is very little predictability about the way prices are going to move over short-term periods."

Investors who try to understand noise and anticipate gains by trading frequently sustain substantial costs, he says, and there are very few who can do it consistently well.

"That's because the noise dominates the signal over these short-term periods," he says. "A stock is more likely to change in value due to random influences over a period of a day, a week, even a month or a year, than it is as a consequence of a change in the underlying fundamental value of that stock."

One of the most reliable valuation metrics, he says, is the Shiller price-earnings ratio, which uses a 10-year average of inflation-adjusted earnings to avoid a valuation being distorted by fluctuations within the business cycle.

"The period over which the payoff can be expected to be delivered needs to be similarly long," Miller says. To expect short-term gains is "just fanciful". All the most successful investors have a long-term focus.

Many times over

At Perpetual, Sherwood likes to use multiples when describing past returns. Since the end of 1974, the return for **gold** has been 14 times invested principal, cash has been 28 times, residential property 56 times, listed property 109 times and the Australian sharemarket has been 217 times.

"Interestingly, the reason shares outperform is not what people think," he says. "The capital gains from property and shares since 1974 are reasonably equal. The reason for shares' outperformance is the after-expenses income generation and its reinvestment, relative to that of property, where half of the income is lost to the expenses of running and maintaining the property asset."

And the winner is...

If you are an expert at picking property, then it's obvious there are ways to make gains in that asset class. The experts describe two obstacles to pricing the property market: the data is imperfect (many costs are not included) and infrequent (making it difficult to isolate the best opportunities).

A buyer who is honest about inputs will know the true returns received.

For shares, well, an investor who chooses that route to wealth will be faced with many, many choices. Providing you can handle the capital volatility, the opportunities to exploit mispricing are almost endless.

But if you believe, like some experts, that over the long haul the returns from property are roughly equal, the only question is which asset behaves in a way that you are most comfortable with and where are we in the cycle.

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