

## Why Chasing Yield over Capital Growth Will Lose you Money

One of the most common property portfolio flaws we see is chasing yield at the cost of capital growth. As long term investors we believe the goal should be to maximize capital growth, because capital growth is what carries us to our wealth goals.

Yield is absolutely critical to the survival of the portfolio, but it's not the key to building wealth through property. In this article we look at the cost of chasing yield based properties, and suggest how to get the right capital growth/ yield mix for you.

### Define Capital Growth and Yield

First let's define yield and capital growth.

Yield is the annual revenue or rent from a property reflected as a percentage of the value of the property. In the table below we see that there is \$35k of rent for the year and the property is worth \$350k – so the yield is 10%.

Yield Example	
Annual rent	35,000
Value of property	350,000
<b>Rent as a % of value</b>	<b>10%</b>

The capital growth rate expressed as a percentage is the amount the property goes up each year reflected as a percentage of the value property. In the table below we see the value of the property is \$350k. By year 2 it is worth \$385k, so it has gone up \$35k. \$35k is 10% of the year 1 value. So the capital growth for the year is 10%. Of course we should take account inflation to be completely accurate, but let's keep it simple.

Capital Growth Example	Year 1	Year 2
Gain		35,000
Value	350,000	385,000
<b>Gain as a % of value</b>		<b>10%</b>

### What is the Potential Financial Impact?

The table on the following page shows what happens when your investment averages 10% growth versus 5% growth. Over 20 years Property 1 experiences 10% capital growth per annum which in dollar terms is \$1.791m. However Property 2 with a 5% capital growth rate gains only \$534k.

The difference in capital growth over 20 years is quite remarkable – more than \$1.256m. Sure, you might have saved a few pennies in the outset by investing in the 10% rental return property, \$155k, but it is still far more beneficial to have invested in the high growth property. So the net benefit of owning property 1, the higher capital growth property, is \$1.101m (being the \$1.256m of net capital gain less \$155k of rent that was not earned as a result of having the lower yield).

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Capital Growth Comparison	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10	Year 20	20 Year Gain	
<b>Property 1 - 10% growth per annum, yield 5%</b>									
Gain		35,000	38,500	42,350	46,585	75,026	194,597		
Value	350,000	385,000	423,500	465,850	512,435	825,282	2,140,568	<b>1,790,568</b>	
<b>Gain as a % of value</b>		<b>10%</b>	<b>10%</b>	<b>10%</b>	<b>10%</b>	<b>10%</b>	<b>10%</b>		
<b>Property 2 - 5% growth per annum, yield 10%</b>									
Gain		17,500	18,375	19,294	20,258	25,855	42,116		
Value	350,000	367,500	385,875	405,169	425,427	542,965	884,433	<b>534,433</b>	
<b>Gain as a % of value</b>		<b>5%</b>	<b>5%</b>	<b>5%</b>	<b>5%</b>	<b>5%</b>	<b>5%</b>		
<b>Difference in gain over 20 years - property 1 versus property 2</b>								<b>1,256,136</b>	<b>A</b>
Rental Return Comparison	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10	Year 20	20 Year Gain	
<b>Property 1</b>									
Income @ 5%	5%	5%	5%	5%	5%	5%	5%		
	17,500	19,250	21,175	23,293	25,622	41,264	107,028	<b>1,002,312</b>	
<b>Property 2</b>									
Income @ 10%	10%	10%	10%	10%	10%	10%	10%		
	35,000	36,750	38,588	40,517	42,543	54,296	88,443	<b>1,157,308</b>	
<b>Difference in rent over 20 years - property1 versus property 2</b>								<b>(154,996)</b>	<b>B</b>
<b>Net benefit of owning property 1</b>								<b>1,101,140</b>	<b>A+B</b>

### Why are High Yield Properties Not Usually High Growth Properties?

The problem with chasing high yielding properties is that to achieve that yield you usually have to compromise on capital growth. For example, you can get much better yields in the provinces, or smaller towns, but what is their capital growth story? If the saw mill closes down and that's the main employer, who will want to live there? There are far fewer people wanting to buy these properties, compared to the cities. In other words the demand is lower – low demand = low pressure on prices, and consequently price growth is slower.

The statistics prove that investing in the provinces will see you with less capital growth, and the gains you do get are often eroded to a greater degree than city prices when a recession hits. We saw that in the 2003-2007 boom – the regions experienced good gains, albeit later than the main urban centres, but then during the 2008 recession a lot of the value was wiped off, and as at Jan 2010 hasn't been recovered. Conversely some Auckland growth suburbs performed better than the national median during the boom and while they did experience price reduction in 2008, some are now back or close to their 2007 levels as at Jan 2010.

### Buy High Yield in a High Growth Area?

The solution you might think is just to find high yielding property in great capital growth areas. This approach is certainly a lot better, and for some people perhaps the right or only option, but it doesn't mean your capital growth will be as high as lower yielding properties in the same area.

For example, in the table below we look at an example of a 3 bedroom home on 800s/m of land versus a block of flats on the same size piece of land. It's fairly safe to say that the 3 bed home will at least track with the median house price change for the area. So let's say that capital growth in that area averages 10%, then this property will go up by 10%.

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<b>3 Bedroom Home</b>	<b>Year 1</b>	<b>Year 2</b>
Land	200,000	
Buildings	150,000	
<b>Value</b>	<b>350,000</b>	<b>385,000</b>
Capital growth rate		10%
Rent	18,720	19,469
Rate of inflation		4%
Yield	5.35%	5.06%

However, in the case of the block of flats it is not safe to make the same capital growth assumption. For the block of flats the buyer is more likely to be a yield conscious investor rather than an emotional home buyer. So they are more likely to look at the annual rent and ask themselves what yield this should represent. If rent is \$7k and they think they should be able to get a 7% yield, then they will pay only \$100k (7,000 divided by 7%) for this property, regardless of whether it has a great colour scheme and an inviting entrance.

So in the example below the rent is \$31,660 in the first year. If 7% is the prevailing yield then divide that into \$31,660 and you get a property value of \$450k. Great you think – this property is financially easier to service compared to the 3 bed property. But now let's look at the second year.

Remember that pricing of the block of flats is driven more on yield. So where do we start? With the annual rent. What has that done? It's gone up by the rate of inflation – and maybe a bit more because a lot more people want to rent in this area because it's a high capital growth area and owners and renters alike are flooding in. So let's say inflation is 4% and then a bit more for the extra rental demand – say 1%, so we have a 5% increase in rent. Rent is now \$33,243, but the average yield for blocks of flats in the area is still 7%. So same approach, rent \$33,243 divided by yield – 7%, and we get \$472,500.

The block of flats has gone up on \$22,500, which is a 5% increase.

<b>Block of Flats</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Capital gain</b>
Land	200,000		
Buildings	250,000		
<b>Value</b>	<b>450,000</b>	<b>472,500</b>	<b>22,500</b>
Capital growth rate			5.0%
Rent	31,660	33,243	
Rate of Inflation		5.0%	
Yield	7.0%	7.0%	

Admittedly this is a very simplified example. In reality the block of flats will probably go up by a little more than 5% because the underlying land value may attract other than just pure yield driven investors. But the block of flats will always be constrained in comparison to the 3 bed home as it will never have the emotional home buyer falling in love with it. It will never be able to appeal to the widest demand pool – the home buyer.

In essence, when investing in the block of flats there is more investment in the buildings than the land compared to the 3 bed home. But it's the land that goes up in

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value. So the underlying reason for a lower growth rate for the flats compared to the 3 bed house is greater ratio of buildings to land.

So, to a degree there is an inverse relationship between yield and capital growth. The higher the yield, the lower the capital growth is likely to be, and the higher the capital growth the lower the yield is likely to be.

What do we take from this? To maximize capital growth put as much of your spend into the land, and as little as possible into the building – in a high capital growth area.

### **What Capital Growth Rate Should You Aim For?**

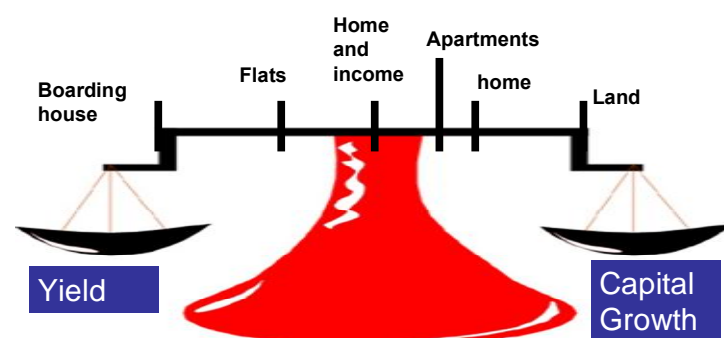
You'd think then, just go out and buy lots of bare land if that's what delivers capital growth. Well absolutely, if you've got lots of money and you can afford to service the interest on all the debt. Therein lies the problem... and the answer. As investors looking to build wealth, we usually can't afford to do this, so that forces us to look at ways of making an investment affordable. And that's the key - finding a high capital growth investment that is *affordable* for your individual circumstances. Not chasing yield for yield's sake, rather chasing capital growth with enough yield to make it serviceable.

For some it might mean some bare land and some 3 bedroom houses. For others it might mean all 3 bedroom houses, and then for others it might mean a home and income. It's really up to you to work with your financial advisors and your bank and broker to determine the right yield. But as always the primary objective should be to try to invest in optimal capital growth areas and types of property.

For example – it may be that you can afford to service an investment with a \$2,000 loss per annum after tax benefits. So then you go looking for a high capital growth area and then determine what you can afford in that area, remembering that you want to spend as much on the land as possible, and minimize spend on the buildings. If you can't afford a 3 bed home on 1,000 s/m, don't worry – look for something in the same area on less land. Our diagram below shows the capital growth/ yield continuum that has to be balanced according to your personal profile

As the diagram depicts, getting the right capital growth/ yield mix is a balancing act – going for great capital growth but not tipping the scales so far that it all topples over because you can't afford to hold your properties.

Happy balancing!



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