E fpadmin@nac.com.au
W www.lifestylewealthpartners.com.au

The Lost Decade of Australian Shares

- and the supremacy of residential property?

14th February, 2017

Logic is the beginning of wisdom, not the end.
Leonard Nimoy

Lost time is never found again.
Benjamin Franklin

Logic will never change emotion or perception.
Edward de Bono

Son, this is the only time I'm ever gonna say this. It is not okay to lose.
Homer Simpson

Happy New Year! Yes I know it's February and it's a little late but I am personally still struggling with the concept that the year is already more than 10% over!

This newsletter is written in two sections. The First Section is focused on the question in the title. Section Two dives into the numbers, words and mathematics a little deeper for those who may appreciate more detail.

Background

My wife and I used to own a number of residential properties for investment purposes, we now own none. It's not that we lost all our money, we just don't invest in residential real estate at the current moment in time. I will show you why in this paper.

By now you must think I am regretting this decision given the last 10 to 12 years? Well actually no and that is reason for this paper. We invest in commercial property, Australian and international shares and other investments.

Shares are always offered as the main alternative to residential property so I have chosen to compare property with shares… yes that old chestnut! Given the recent performance of the share market since the GFC you must think by now I must be losing it?

As I always say, the family home is a lifestyle choice, one decision in which you use your HEART first and head second. When you are making financial decisions outside of this, it is important to use your HEAD first, relying on logic, numbers and facts, not perceptions or 'common wisdom'. This discipline is applied to all our decision making processes when advising our clients.

I have no objection to residential property as an investment class, I just think that the returns are a lot less than people think and let's face it, it is expensive, especially compared to the available alternatives.

Often overlooked in this process is the source of "proof" that a particular strategy is the more successful. When looking at statistics there are a significant number of material issues in their application and accuracy when making sound long term decisions. This is explored more deeply in section two of this newsletter.

Making sound investment decisions involves clear thinking, identification of true facts and an awareness of the hidden agendas that beset almost every investment process and asset class.

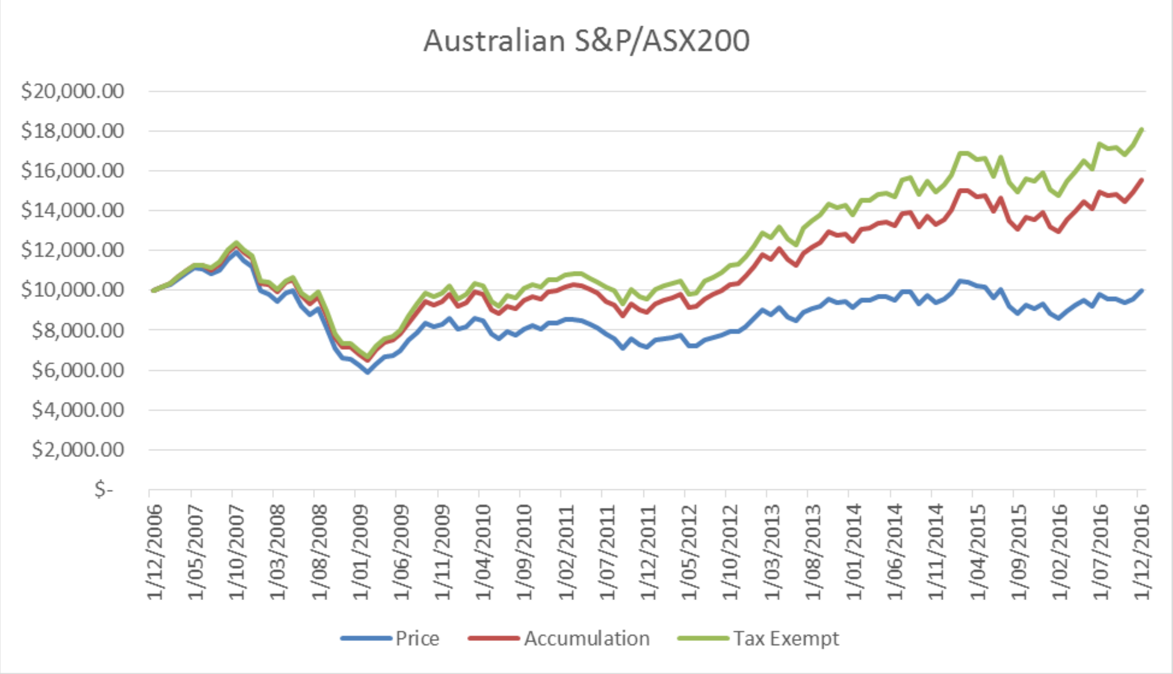
The lost decade – Australian Shares

Anyone who follows the Australian share market closely will know that the peak of the market was in the 3rd quarter of 2007 at 6800, today it rests at around 5,700, depending on the day. This is a loss of 16.17% over the 10 year period shown in the chart below.

Chart 1

The chart results in the perception of the Australian Share market being a poor performer in this period however it is important to understand that this index is just a price chart. If you did the numbers inclusive of dividends and franking credits a different story would be told.

Dividends and Franking credits!



Source: Plato Funds Management

Chart 2

Many people discount franking credits when making an investment decision, although to be fair, most SMSF trustees do love them. The reason is clearly shown in the above chart. From 2006 to 2016 the compound annual return was 5.5%; this was inclusive of the actual 16% capital loss mentioned earlier. Not fantastic but better than you may have thought?

Party Time – Sydney Residential Property

Every "investment expert" will tell you Sydney residential property has been the best place to invest your money for the last 10 years and well… forever! It is hard to dispute; the media constantly runs stories about runaway growth, affordability issues etc. Secondly, for these 10 years, it has been a good investment compared to equities.

Let's look at the numbers.

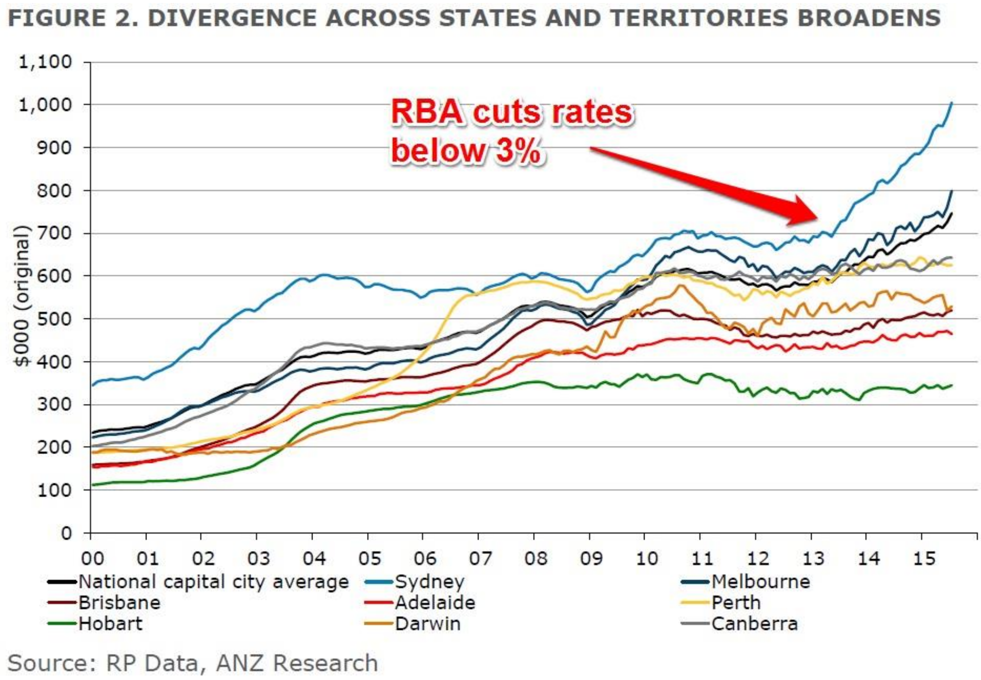


Chart 3

For the remainder of this paper I will use the following data:

Data Assumptions	Value
Average Price 2016	$1.03M
Average Price 2006	$580k
Average Price 2004	$600k
Optimistic Rental Assumption	3.5%
Realistic Rental Assumption	2.9%

Table 1

You can see in Chart 3 above, and with reference to table 1, that in 2006 the Sydney house price average was approximately $580,000; today it is a little over a million dollars at $1,030,000. This is a total return of 77.5% or 5.9% per annum for the last decade.

Again, like the share chart, this is just a price chart and does not include income, or rent. This data is not broadly available and very property specific so we will have to construct a proxy. A $1M house will rent at approximately 3.5% gross *at best*, or $35,000 per annum or about $29,000 after land and water rates, building insurance and $1,500 for miscellaneous repairs and other costs such as vacancy, leasing fees etc. A more realistic gross rent is 2.9%. Property receives no franking credits.

This brings the accumulation return to about 8.8%, representing income plus capital, or 8.1% if you use a realistic gross rent.

8.8% per annum

This number doesn't tell the whole story. There has been no allowance for painting, carpets and some provision for renovations of kitchen and bathrooms etc.

The statistic for housing is constructed from an average selling price. The statisticians can ONLY look at the contract sale prices therefore does not include capital deductions for renovations, additions, or in extreme examples knock downs and rebuilds. There is no data on this as it is devilishly hard to gather, so whilst we can amortise some larger maintenance costs for the kitchens, bathrooms and carpets, estimating the capital injection over the life of the "average dwelling" to deduct from the "average sales price" is very subjective however conservative assumptions will be used. Please also refer to section two for more discussion on this subject.

Lastly when looking at investments logically, you need to consider lifecycle costs. This includes therefore trading costs. Everybody knows about the dreaded stamp duty, agents' fees on sale and transaction costs. In our example a $580,000 residence would cost you a little over $21,000 in stamp duty and a million dollar residence about the same to sell. "I won't sell" I hear you say, well your kids probably will so it will cost the family somewhere someday. Allowing for $20,000 in major expenses over 10 years (kitchen, carpet, bathroom, gutters etc.) or only $2,000 p.a., brings us to $62,000 including agent's fees and stamp duty or about 0.7% per annum.

This brings our housing result down to about 8.1% if we **ignore** knockdowns, rebuilds and significant improvements. Without an optimistic rental assumption, which includes no vacancies for 10 years it falls to 7.5%.

E fpadmin@nac.com.au
W www.lifestylewealthpartners.com.au

Making Sense of it all

So, in summary housing has been a better investment than shares by about 2.6% p.a. for the last 10 years, or 2.0% for a more realistic rental assumption. This is a significant outperformance if it could be maintained for the longer term, you can't however just focus on the good times for housing, equities or any other asset for that matter. You must look at performance through the full cycle. The current housing cycle started in 2004, refer Chart 3, our 8.1% for housing drops to 6.8% over this time period. Furthermore, our accumulation equity return rises from 5.5% to around 10.5%, or an outperformance of ***equities over property*** by 4.7%, or 5.2% with a more realistic rental assumption.

This in a period of very strong growth and too many headlines to remember in favour of residential property and including the losses of the GFC. Again please refer to Section Two for more detail.

In this 12 year period, according to conventional wisdom, residential real estate has clearly outperformed shares…. not according to the maths it hasn't!!

So would I ever invest in residential real estate?

Of course, just not at these prices. One of our core beliefs is that the biggest determinant of long term returns is the price you PAY for the asset. If residential real estate fell by 30-40% I would almost certainly have it as part of an investment portfolio and a 20% fall would certainly have me looking.

Can't happen you say! Outside of New Zealand, Canada and Australia it has happened to almost every western country. Australia has record high personal debt COMBINED with record high house prices AND record low interest rates. Will the sharp increase in debt crash the market?

There has been a very strong rise in total debt, Australia is leading global private debt tables. Will there be a big debt crunch? Well thankfully many Australians, despite gearing themselves heavily, have also been building a buffer to protect themselves.

Chart 4 shows that despite a strong rise in debt, net debt (the red line) is still at around 2004 levels. As interest rates have fallen many borrowers have maintained their repayments into offset accounts and increased their defences. This is a VERY good thing to do.

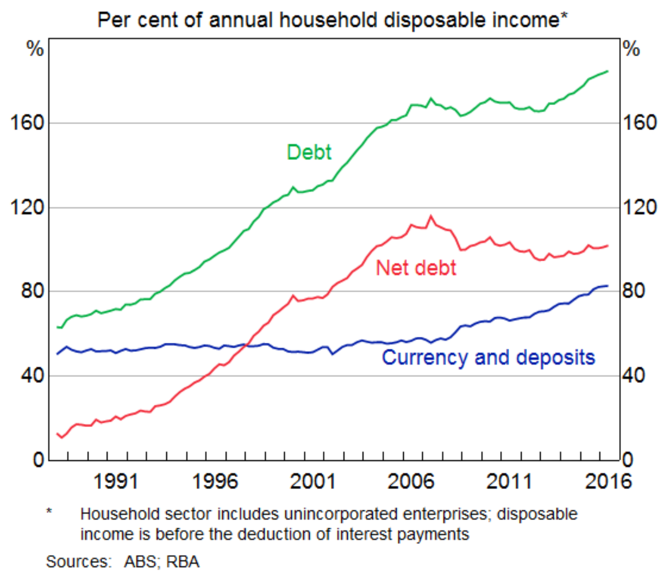


Chart 4

There will be individual borrowers that will suffer greatly if there is a rate rise of even as little as 0.5 - 1.0%. The net debt position however is currently holding stable and I would not expect the trauma to be widespread.

So in summary whilst debt is not totally out of control I would be pretty confident we are ***not*** positioned at the *bottom* of the next great bull market in residential property.

So put all our money in shares? Well....errrrmm...no. Australian shares represent reasonable value, after a rubbish decade they should! My concern relates to earnings growth, the ability of companies in Australia to grow their revenues and profit, or their earnings.

Global shares are a mixed bag, Europe is OK with better earnings prospects, Asia is good value but sentiment remains strongly against Asian equities and the Trump trade headwinds remains a real concern for investors. The US equity market is very expensive. Only ever more expensive at two times in history, just before the crash of 1929 and just before the tech wreck crash in 2001[1].

Interest rates in the US are at an all time record low making shares somewhat palatable at higher prices, but not at this extreme level of high prices for me to want to invest large portions of a portfolio there.

So the real strategy here must be diversification. Nothing is great, many options are not terrible, and there are very few, if any, great options. Term deposits are poor but they remain an option to buy future assets at cheaper prices, this of course means property or shares have to fall first!

Diversification provides investors, especially those that are retired or about to retire, the best option to preserve their capital as best as possible and still be in a position to invest when the tide turns. They do however mean lower returns in the short term. The tide will turn, but my view is you need to be prepared for a longer than normal wait.

We remain vigilant, cautious and careful but also remain invested. We can't afford to be out of the markets as that too can be extraordinarily costly. We are managing the risks posed by a very challenging investment environment, one that will continue, whilst driving as much income and growth as possible into portfolios.

If you would like to discuss this paper or any other matter please do not hesitate to contact us at fpadmin@nac.com.au or (02) 9984 7774.

Kind Regards

David Lunn
GDFP, MBA, SSA
Authorised Representative No: .239790

[1] Schiller CAPE (Cyclically Adjusted Price to Earnings ratio)

Section 2 – Statistics and Lies

Lies, Damn Lies and Statistics

I was forced into another round of quotes, there are just so many good ones!

Cognitive psychology tells us that the unaided human mind is vulnerable to many fallacies and illusions because of its reliance on its memory for vivid anecdotes rather than systematic statistics.
Steven Pinker

Statistics show that of those who contract the habit of eating, very few survive.
George Bernard Shaw

I only believe in statistics that I doctored myself
Winston S. Churchill

Statistics are used much like a drunk uses a lamppost: for support, not illumination.
Vin Scully

In ancient times they had no statistics so they had to fall back on lies.
Stephen Leacock

I alluded earlier to the issues surrounding the quality of data that statisticians, or more importantly the users of statistics, use when constructing "facts". It comes down to the writer and their bias. I have tried to be incredibly sympathetic on any assumptions or interpretations as I too could be accused of bias, I would happily discuss my interpretations with any reader of this paper.

When proper due diligence is undertaken in evaluating investments it is imperative that you not only analyse the data to find the correct answers but analyse the quality of the data that you are using to identify the "correct" answer.

The problem comes from several sources and there are many more than those listed:

1. Lack of available data or errors in the interpretation of data.
2. Bias of the provider and a truly objective assessment of the relative merits of investment options.
3. Bias of the recipient of the information.
4. Convenient timescales
5. Mathematical Complexity

Let's look at them in turn:

1. Lack of Available Data or Interpretation of data

There is no available data set, reliable or dodgy, for contributed capital to maintain a dwelling. This would include carpet, kitchen or bathroom renovations, painting or gutter replacement for example. It also includes knock downs and rebuilds or improvements like extensions or pools.

I will therefore have to unfortunately resort to assertions. The best example is right here in Dee Why in the unit market. I haven't seen very recent data but unit prices in Dee Why were cited to have returned about 10% p.a. for the last 5 years or so excluding rents. Very attractive indeed and well above the broader market.

Why is this the case?

This is where the statistics get in the way of the truth but make a great headline. This increase refers the average sale price. This is constructed from the following formula:

$$= \frac{\sum_{Q}^{i=1} P_i}{Q}$$

Where:	Pi	sale price of each property
	Q	the number of properties sold

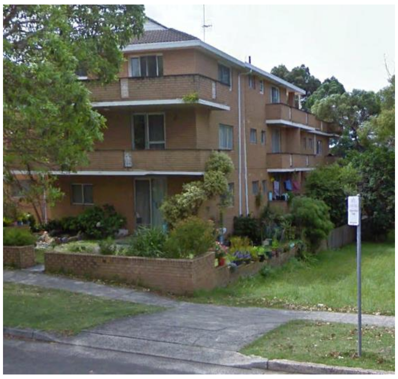
It's a mathematical way of saying the sum total of all property sales divided by the number of properties sold, or a simple average.

E fpadmin@nac.com.au
W www.lifestylewealthpartners.com.au

Why is this average formula important?

It is heavily impacted by the data put into the formula. You need to examine how data became P_i, or the price of property that was sold and Q_i, how many were sold at that price.

Refer by way of illustration below.



Many existing unit investors in Dee Why 5 or more years ago had a property like this one:

But after lots of this on adjacent sites

We now have lots of these

Note: All of these are actual properties in Dee Why.

What is the impact of these changes for the different owners?

Just a question to ponder…. if you look at total sales of how many of the first property type (old ones) were sold versus the number of the second property type (new ones) were sold in the last five years? My contention would be many more of the latter, or many more new properties were sold at a higher price.

If you then think of the "average" formula previously provided the result is clear. It would have risen steeply. The price of the new units AND the volume of new sales to existing would also be higher. The fact the new units had an extra bedroom, undercover parking not a car space, more developed gardens, lifts, a pool perhaps and maybe even a gym in the bigger developments, is also missed when calculating the average price. We are now not actually comparing apples with apples anymore – the new properties are, well new, larger, have more features and are visually more attractive.

One thing I can be sure of though is the owner of the old property did NOT experience the "average" rise, in fact their rises would have been limited by newer and more desirable, albeit more expensive, properties just next door.

Secondly, the developer may have done alright, as this is where the **real** property profit margins lay, but the purchaser has obviously not made this return money either.

The big issue in this is that the average formula makes absolutely ZERO allowance for the COST of the building the new units, just the average price goes up according to the media – more on the media below.

The result: NOBODY likely receives the "average" price rise.

2. Bias of the provider of data

With reference to Winston Churchill's quote above there is so much bias in the media these days, often due to complex ownership or commercial deals, bias of the author, or simply to sell distribution, advertising or even web 'clicks'!

By way of example. One of the biggest promoters of real estate stories is the Sydney Morning Herald (SMH). Domain.com.au is owned by Fairfax which also owns the SMH. It is therefore in the papers best interests to stoke fires of perception over reality as it will drive volume through its sister business, Domain. That's why when house prices fell 8-10%, or stagnated with a ZERO return for **5 years** (refer chart 3) there were no stories in the paper on this, other more important things were published, like a cat up a tree or something.

Another example was last year. Corelogic, a provider of data to our own Reserve Bank of Australia, was sacked by the RBA in 2016 after they were challenged on their continued publication of rising house prices even though any brief and amateurish analysis of the raw data showed prices were in fact FALLING. They sheepishly admitted they had "changed their formula" and proceeded to tell no one. This is ridiculous. Refer HERE for the article on the ABC site explaining this farce. Needless to say prior to this SMH kept running rising price stories on the back of CoreLogic's flawed analysis when the opposite was in fact true and further stoking perception over reality.

3. Bias of the recipient of data

Behavioural Finance experts (the study of human psychology and financial decisions) have highlighted "Confirmation Bias" as a key failing for investors. This occurs when an individual will justify either a transaction they have completed, or an inviolable belief in the supremacy of one type of asset, only regards information that backs their view and discounts any information that contradicts their view.

Everybody has their own biases, preferences etc. however there is NEVER only one way to invest money and NEVER only one 'best' solution that always provides superior investment returns. If this mythical perfect investment did exist, it would soon be bought (price would go up) by selling other assets down (those prices would fall) and future returns would normalise between investment options again.

There are also inadvertent biases. For example people forget to deduct negative gearing losses, value of personal labour cleaning or making repairs. This can dramatically reduce the actual return received but is rarely measured by the investor.

4. Convenient time scales

Again with reference to Winston's quote, and point 2 above, be very careful of chosen time scales in any examples. I demonstrated this clearly in the analysis in Section One by comparing the last 10 years showing property was of course the winner but over 12 years it was beaten by a bigger margin by Australian shares.

The other trick in this area to watch out for is to check the scale on a graph, if you see a rapidly rising chart, check the scale on the side and a very long term chart of the same measurement. By adjusting the scale, perceptions can be created that diverge significantly from reality.

5. Mathematical complexity

Being an ex-engineer, I love maths. It can reveal so many things and is absolute; there are no subjective measurements in classical mathematics. Of course, as previously mentioned, if your data is dodgy then the maths can't help.

Nevertheless, even simple financial mathematical calculations are not taught in our education system to any great degree. Again by way of example, someone mentioned to me today that their parents' property was bought for $650,000 and it's now on the market 15 years later for $1.3M, what a great investment. Well…compared to what?

The annual return on this is 4.7%, sounds better the other way doesn't it?

If we include stamp duty and sales commission, it drops to 4.4%. I have also made no allowance for rates, strata fees and insurance. Say an average of $8,000 per annum, the return drops to 3.7%!

I have also yet to deduct any renovations, painting, carpets etc. Let's pretend they don't exist!

Term deposits over this period probably averaged around 5% despite the recent much lower rates. 5% for 15 years on $650,000 would have grown to $1.351M. This compared to $1.18M after deducting the holding costs of $8,000 p.a. The difference is a whopping $170,000 worse off than term deposits!

It sounds even better when you say you bought for $650k and sold for $1.3M than "I earned a solid 3.7% and less than term deposit" now doesn't it!

Furthermore, I have been guilty of making simplistic assumptions in the numbers I presented. For example I used a realised dividend and franking chart for Australian Shares, this I believe to be pretty accurate.

However in my rental assumptions I assumed $29,000 gross rent or 2.9%. I multiplied this by 10 to give the rental for the decade. The problem with this assumption was that I should have used about 3.9% 10 years ago, or about $22,620 gross rent. This is because yields were close to 3.9% 10 years ago but the property was worth $580,000, not $1.03M.

What I should have done was used a discounted cashflow analysis. This would have lowered the realised rental amount and therefore total return of property. Nevertheless the magnitude of the differences between property and shares was well demonstrated with the 10 and 12 year comparison.

CONCLUSION

As ex British PM, Benjamin Disraeli, once said "There are three kinds of lies: lies, damn lies and statistics". What I have presented on statistics, and their application to investment decisions, is that sound investment judgement is very much based on running the numbers and making objective assessments.

Just who's numbers and who's assessments is the hard question sometimes and the difficulty becomes learning to tell the difference.