‘Interest-only’ loan rush foreshadows a new phase

JAMES KIRBY
WEALTH EDITOR

About two years ago, I applied for a mortgage for an investment property and to my surprise they told me: “If you like you can make this interest-only … you won’t have to pay off the principal.”

Since I was fixing this loan for three years, I was puzzled for a moment at this offer to defer paying off the principal for years into the future.

And then I said: “Well, sure, let’s do that. I mean, why not?”

But here’s the thing: I thought this was a reward, a prize if you like, for my years of being a faithful client of this “big four” bank.

Moreover, since I’m in the finance media, I was pretty sure I’d got into a sort of club. I recalled that interest-only loans were a very small segment of the market.

Wrong! This week it was revealed that 40 per cent of all new mortgages — and a whopping 60 per cent of investor mortgages — are interest-only.

What’s more, the level of interest-only loans in the system has doubled in three years.

Crikey! I’m not in a minority, I’m in the majority — me and a horde of interest-only borrowers are now threatening the very market I’ve geared myself into.

Interest-only loans are not inherently dangerous — they will make sense to well-financed investors. But with 60 per cent of investors using them and a scary 20 per cent of owner-occupiers using them, the risks to the system are indisputable.

Now, there is always money to be made by someone somewhere in the property market — no doubt there are bargains in Perth and in selected mining towns. Wily investors will, for sure, make the occasional killing in “mezzanine” finance as developers race to finish apartment towers before the expected crunch in the inner-city market comes to pass.

But for the average investor entering the apartment market now (the traditional “first step” in property), the chances of getting healthy returns in the next few years are fading rapidly.

The mushrooming of interest-only loans is just another sign the market has moved into a “bubble” phase. The banks are being leaned on by all regulators to cool lending; lending rates are going up and steadily the supply of new apartments into the market is expected to at best flatten prices.

Of course, the tax benefits of negative gearing and capital gains tax allowances remain in place, but there is a very strong chance the government will lessen these privileges soon — it is rumoured, for example, that the government may reduce the capital gains tax discount you get after holding an asset for more than a year from 50 per cent to 40 per cent. This could be included in a wider package of measures to be announced in the federal budget on May 9.

Healthy returns in the next few years for the average investor entering the apartment market are fading rapidly

Shares attractive

Meanwhile, in contrast, the sharemarket is looking attractive. The returns — from both a price perspective and an income dimension — are healthy and the prospects are certainly more reliable than residential property.

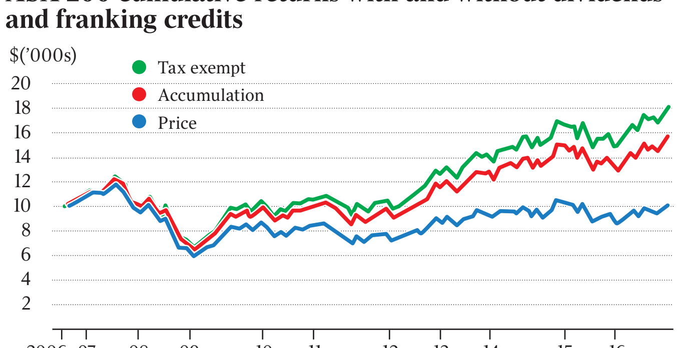
Separately, while investors in the property market are heavily mortgaged, very few private investors in the sharemarket take advantage of negative gearing. In fact, many people don’t realise negative gearing is not a “property only” tax shelter; it can be used for shares or managed funds as well.

We see so much attention paid to the Sydney residential market’s 19 per cent annual returns, but the portion of Australians who can access this market is limited; the sharemarket, on the other hand, has entry prices starting at $500 — the value of a minimum block of shares.

Better still, the strong returns in the sharemarket are available to everyone … wherever they live.

Don Hamson, the managing director of the Plato Investment Group, puts it this way: “We have a very reliable dividend stream in the market and it has meant total returns are more predictable than many investors might expect. It’s really when you work in the after-tax value of franked dividends that you see the full picture.”

ASX 200 cumulative returns with and without dividends and franking credits



Tracking back to 2011, when Hamson started his Plato Australian Shares Income Fund, the local market has offered a total average return a year of 12 per cent (including franking) — underpinning those returns has been a dividend yield of about 4.5 per cent that when “grossed up” — in other words, when the after-tax benefits of franking are taken into account — reaches about 6 per cent. So the sharemarket has been pumping out returns of 12 per cent each year, and half of that return is as reliable dividend payments.

As a fund manager, Hamson has had to clear a high hurdle to offer an above-average return but he has managed to get 14 per cent a year (after fees) through skilled use of buying high-dividend paying stocks, especially as they near the dividend payment date when they reach seasonal peaks.

Hamson is comfortable the patterns set in the past six years are sustainable — he can, of course, say such things knowing the local market is still well behind where it was 10 years ago — in mid-2007, the ASX was surging towards a peak of 6800. You have to doubt a property expert could offer a similar outlook.

Understanding your ‘total super balance’ crucial for DIY funds

MONICA RULE

As we move towards July 1 and the biggest suite of changes to superannuation rules that most advisers have ever seen, the term “total superannuation balance” is something that all superannuation fund members must come to understand.

Up until now, many articles have been written on the $1.6 million transfer balance cap. This is the total amount an SMSF member can have on the day they start their retirement pension account (from July 1).

Separately, a member’s total superannuation balance is also struck at a figure of $1.6m but is a rolling limit — it is to be assessed every year.

Here’s how it works: it is calculated by adding together their accumulation account balance, retirement pension account balance, and any money rolled into their SMSF that has not been allocated to either their accumulation or retirement accounts, and then subtracting any so-called “structured settlement contributions (compensation payments for personal injury)” received in their SMSF.

It will affect how much a person can contribute to their SMSF, whether they qualify for certain superannuation entitlements and which method their fund can use to determine tax-exempt income from July 1.

Crucially, a member’s total superannuation balance is important as it determines what a member is entitled to and what actions they are allowed to take. Here’s the main superannuation items and how they may be affected under the TSB.

- Non-concessional contributions: a member’s total superannuation balance must be below the general transfer balance cap, in order to make non-concessional contributions into their SMSF from July 1.

This means, if a member’s total superannuation balance is $1.6m (the general transfer balance cap for 2017-18) or above, they cannot make any further non-concessional contributions into their SMSF. The balance is measured at June 30 of the previous year in which the contribution is made and is tested each financial year. (This means, a member under the age of 65 will not be able to use any unused portion of their bring-forward non-concessional cap if their total balance is $1.6m or over. As the limit is tied and indexed to the general transfer balance cap, it will increase as the general transfer balance cap increases.)

- Spouse contribution tax offset: a spouse can claim a tax offset of up to $540 for making up to $3000 in non-concessional contributions for their low-income spouse. This is provided the low-income spouse’s total superannuation balance does not exceed the general transfer balance cap of $1.6m and their total non-concessional contributions received in the relevant financial year do not exceed the $100,000 annual limit. The low-income spouse must also be under the age of 70 and meet the part-time work test (40 hours over 30 consecutive days) if aged 65 to 69, both the contributing spouse and the low income spouse must be Australian residents for income tax purposes and not be living separately and apart on a permanent basis at the time the contribution is made. The income threshold for the low-income spouse must not exceed $40,000 from July 1.

- Catch-up concessional contributions: the new law allows any unused concessional contributions (the annual cap is $25,000) from July 1, 2018, to be carried forward for up to five consecutive years. This is provided the member’s total superannuation balance is less than $500,000. Only unused amounts accrued after July 1 next year will be eligible. Amounts carried forward that have not been used after five years will expire. It is important that members maintain accurate records of contributions made into their SMSF.

- Superannuation co-contributions: to be eligible for up to $500 of the government’s superannuation co-contribution, a member’s total superannuation balance must be less than the transfer balance cap of $1.6m on June 30 of the year before the relevant financial year. The member must also not have contributed more than the $100,000 non-concessional contributions cap, their total income must be below the higher income threshold ($51,021 for 2016-17), and 10 per cent of their total income is from employment-related activities, carrying on a business or a combination of both.

- Segregated assets method: from July 1, SMSFs will no longer be permitted to apply the “segregated assets method” to determine their tax-exempt income if any member has more than a $1.6m superannuation balance and the member is in pension phase.

There are 1 million SMSF members in Australia and they need to understand how their entitlements will be affected under the new “total superannuation balance” concept to not only avoid penalties but to also take advantage of opportunities to accumulate more for their retirement savings.

Monica Rule is an SMSF specialist at www.monicarule.com.au

An alternative path to property investment

ELIZABETH MORAN

The residential property merry-go-round is always good, until it stops. Just ask some Perth homeowners and investors where prices dropped sharply this year.

While the good times are well and truly over in the west, the hype around the Sydney and Melbourne housing markets seems to be more infectious than ever, creating an urgency to invest or miss out. But, if you stand back and assess residential property as just another investment, it doesn’t always stack up. Maintenance, real estate agent fees, stamp duty, rates, insurance, vacancy periods and changing property markets mean even with the best intentions, investing in physical property can result in an overall loss.

Rapidly rising property prices in Sydney and Melbourne have put pressure on rental yields, which are at record lows, according to CoreLogic. For a house in Sydney the gross yield excluding costs was 2.8 per cent in January, while in Melbourne it was 2.7 per cent, indicating investors are chasing capital growth. What happens if the market changes and prices go backwards?

Property bonds returns

COMPANY	MATURITY DATE	YIELD TO MATURITY	INCOME/RUNNING YIELD	MINIMUM FACE VALUE INVESTMENT
Mirvac	18/09/2023	3.74%	3.55%	$500,000
Mirvac	18/09/2020	3.06%	5.29%	$500,000
Stockland	23/11/2022	3.43%	4.27%	$10,000
Stockland	25/11/2020	3.14%	7.03%	$10,000
Sunland	25/11/2020	6.20%	7.24%	$10,000
W A Stockwell	29/06/2021	6.32%	7.49%	$10,000
Impact Group	12/02/2021	7.45%	8.26%	$10,000

Prices accurate as at 6 April but subject to change. Source: FIIG Securities

But investing in property doesn’t have to be such a gamble. There are two alternative paths into property you may not be aware of — investing in property bonds and residential mortgage backed securities (RMBS).

Property bonds

Many of Australia’s largest and medium-sized property companies issue bonds. The great advantage of bonds is that you know what your return will be and the date you can expect to be repaid the $100 face value of the bond, providing greater certainty than direct property investment. Yield to maturity ranges from 3.06 per cent for a Mirvac bond maturing in September 2020 to 7.45 per cent for an Impact bond maturing in February 2021.

It’s interesting to note that all of the yields available on property bonds are higher than the gross rental yields on Sydney and Melbourne houses. (Elsewhere in these pages Wealth editor James Kirby has also noted that the yield on average across Australian shares is also higher than rental yields).

Late last month, property company Villa World issued a $50 million simple corporate bond via the ASX, maturing in April 2022. This one is floating rate and priced at 90-day bank bill swap rate plus a margin of 4.75 per cent providing an initial yield of 6.55 per cent annualised for the first quarter.

RMBS

Residential Mortgage Backed Securities are issued by financial institutions to recapitalise their balance sheets. Hundreds and sometimes thousands of loans are pooled together via a trust. The trust breaks the combined pool into smaller, marketable classes (tranches), making the RMBS attractive to investors.

In this way, the tranches act like a normal company capital structure, where investors with the lowest risk appetite target the senior bonds (or in the case of RMBS, the highest rated tranches) and those with a higher risk appetite target the lower ranked capital, such as hybrids or shares (or in the case of RMBS, the lowest rated tranches).

Different tranches of RMBS offer a spectrum of risk although, given the structure, the majority are typically low risk due to high underwriting standards, conservative loan to value ratios (averaging about 70 per cent) and the fact that loans retain full recourse to the borrower if selling the property can’t recover the borrowed funds.

RMBS pass through the principal repayments from the pool of mortgages, unlike bonds that pay interest and principal at maturity, so RMBS terms can be quite short. Income is set up-front and is based on a margin over a benchmark, usually the BBSW.

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