NEXT HOME BUYER MANUAL

SEVEN STRATEGIES FOR BUYING YOUR NEXT HOME IN NSW

Strategy 6. Retain home as an investment property

JR MORTGAGES

John Ruddick's seven strategies for buying your next home in NSW.

Strategy 6. Retain home as an investment property

PREFACE

If you need to borrow money to buy a residential property in New South Wales, I want to be your mortgage broker.

This manual is written for those of you who are 'next home buyers' in NSW. That is, you currently own a property, and want to buy your next owner-occupied property.

You may be selling your existing home, or retaining it as an investment property. But in either case, this manual assumes you need to borrow money for that 'next home' purchase.

There are countless reasons why you might want to move home. Your family may be growing—or shrinking. Your financial circumstances may have changed. You may want to live closer to a school or workplace. Or you might simply want a change of scenery or new neighbours.

Next home buying is the most common property transaction. But the process does have some complexity, and without a clear strategy it can become a frustrating experience.

This manual spells out the process, along with the advantages and disadvantages of seven different strategies to buying your next home. Adopting the right strategy helps eliminate risk and increases your chances of buying the right property at a good price—and with less stress.

Every individual and every mortgage application is unique. Since 2001 my passion has been to help borrowers properly structure their mortgage debt and, just as importantly, help them understand the strategy behind the structure.

A good way to start is to contact my office and make an appointment to discuss your circumstances. Even if you think you won't be buying for a year or more, it's still worth having a general discussion now.

The first step is to map out a plan, and then get pre-approval for finance around that plan. Once the finance is in place, you can begin the journey from your current home to your new home.

To apply for pre-approval, you can either contact a lender directly or speak to a mortgage broker. In recent years, more than half of all Australian mortgages have been taken out with the help of mortgage brokers.

Being a broker means I'm a mortgage specialist who can introduce you to products from many lenders, including all the major banks. And, like most mortgage brokers, I typically won't charge you any fees.

Feel free to get in touch with me:

- by phone: (02) 9955 1176 or 0412 129512
- by email: john@jrhl.com
- at my office: 10/50 Margaret Street Sydney NSW 2000.

Sound preparation

Over the years I've worked closely with several hundred next home buyers. And in that time I've learned that following these guidelines will put you in a much stronger position.

- Wear out some shoe leather looking at properties in the suburbs you're thinking of buying in. The more you look, the sharper you eye will be, and the better you can gauge a fair value for a property.
- Make sure you haven't been late for any mortgage repayments in the past year. If you have, it will make lenders more hesitant in approving your next mortgage.
- If you need to sell your existing property, it's important to get the best possible sale price. It may be worth getting quotes on what improvements you can make to increase its value, and what they will cost. Putting in a new bathroom, a new kitchen or even some new carpet or paint may increase your home's sale price by more than what you spend. And if you're planning to convert your existing home into an investment property, these improvements will probably increase your rental return.
- Think about the timing of your sale. The property market is typically busier in spring and summer than in winter. But that is not always the case—the winter of 2015 was as busy as any spring.
- If you're selling and buying, be selective about the conveyancer/lawyer you engage. The transaction will be more complicated than when you bought your first home, and so will require more sound legal advice.
- When you bought your first home, you probably dealt with the vendor's real estate agent. But if you're going to sell your current property you need to choose your own real estate agent. It's worthwhile inviting three or four agents around so you can discuss your plans and see which one is best suited to sell your property. While experience is usually a positive attribute, agents with less experience can sometimes bring more enthusiasm to the sales process and deliver a better result.

> Every person who invests in well-selected real estate in a growing section of a prosperous community adopts the surest and safest method of becoming independent, for real estate is the basis of wealth.
>
> **Theodore Roosevelt**

STRATEGY 6

Retain home as an investment property

Many first home buyers aspire to buy a bigger home one day, and convert their first property into a long-term investment property.

While this can be an effective wealth-building strategy, it needs careful planning. Too many people buy their second property, only to find out their first home isn't a suitable investment property. Not because there's anything wrong with it, but rather because of its mortgage structure.

A lot of borrowers get caught in this trap—especially those with excellent debt repayment records.

If you plan on buying a bigger home and converting your first home into an investment property you may want to pay interest-only repayments on your first home from the moment you buy the property.

This may seem counter-intuitive, but you can effectively pay off the debt by building up cash in your offset account.

An offset account is like a normal everyday bank account except:

- the balance of funds in the offset account is assumed to be deducted from your loan balance each day
- you are only charged interest on the loan balance minus the offset balance.

If someone has a debt of $900,000, but also has $400,000 in an offset account, they are only charged interest on $500,000 each day. Paying interest only (and not making any lump sum payments into the mortgage) won't *officially* reduce your debt. But it will *effectively* reduce your debt because you're increasing the cash in your offset.

And when you're ready to buy your bigger home you'll have a big cash deposit, which means the future home will have a lower debt against it.

Let's imagine Emma has just bought her first home for $500,000, having borrowed $450,000 from XYZ Bank. She's happy to live there for the moment, but plans on buying another property for $1,000,000 in five years' time, moving into the new property, and turning her current home into a long-term investment property.

Option one

Emma makes principal and interest repayments on her mortgage, and deposits lump sum payments into the mortgage when she gets her annual bonus. After five years she reduces her home loan to $100,000, but has no cash savings.

She then buys her next home for $1,000,000. Because she doesn't have any saving she uses the equity in her former home (now an investment property) to borrow the entire purchase price plus the costs. Her new home loan has a balance of $1,045,000, which on top of her $100,000 'investment debt' means she has a total debt of $1,145,000.

At some point Emma (or her accountant) will realise she's better off selling the investment property, clearing the debt, and using the substantial remaining funds to reduce her home loan. And if she still wants to own an investment property, she'll need to borrow 100% of the purchase price plus costs.

Option two

After buying her first home, Emma pays interest-only repayments on the mortgage and puts all the money she would have paid on the mortgage into an offset account. After five years she still has a home loan debt of $500,000 … but having $400,000 in cash in her offset account means she's only paying interest on $100,000.

When Emma buys the bigger home, she uses the $400,000 in cash for the deposit and costs, and so only needs to borrow $645,000. She still has a total debt of $1,145,000 ($500,000 + $645,000). But there's a much greater proportion of investment debt ($500,000) and a much lower proportion of home loan debt ($645,000).

At first, it may seem like both options deliver the same outcome. But option two is a much better option because Emma can claim the interest she pays on her investment debt as a tax deduction.

Important note: This strategy can only work if you maintain a strict financial discipline. If you're an impulsive spender, or don't keep credit card debt cleared, this may not be a good option for you.

Why? Because chances are you'll spend the money accumulating in the offset account. And if that's the case, you're better off paying your first home loan with the usual principal and interest repayments than making interest-only payments but ending up with little savings to show for it.

JR

JR MORTGAGES