What others say about this book...

“Perfect timing for property advice

The timing of this very valuable book couldn’t have been better, or of more use. The public at large are getting many, many messages in regard to the current property market and the doomsayers keep adding to the pessimism.

These highly qualified authors have put together a very interesting and I think valuable suite of thinking that anyone can benefit from, given the present state of play in the property market.

I’d especially recommend this to the real estate industry and those in search of enlightened, thoughtful advice based on expertise and experience. — *Hawkes Bay Today* ”

“Gloomy outlook need not be end

Investors should be focusing on making sure they have strong enough foundations to survive a falling property market, reckons author Peter Aranyi.

How To Survive and Prosper in a Falling Property Market ... doesn’t try to predict a collapse of property prices, but concludes there are some pretty staunch indicators which should warn investors to take care for tough times ahead.

That message is needed because there are still plenty of spruikers continuing to predict high returns on property despite today’s sky-high prices.

Aranyi said the book was in part designed as ‘an antidote’ to what he calls ‘the foolhardy and frankly deceptive sales spiel of property spruikers of all shades.’ Investors need to shock-proof their property portfolios. — *Sunday Star Times* ”

About the authors — investors teaching investors

Andrew King is the author of two best-selling books, *Create Wealth: The Complete Guide to Residential Property Investment* and *Planning for Property Success*. As a long-time officeholder in various property investor associations, Andrew is a high-profile and respected media spokesman on residential property.

Mike McCombie has 25 years of hands-on experience as a residential and commercial property investor. Mike has been involved in virtually every facet of commercial property investment and development. He has taught principles of successful investment at training courses on both sides of the Tasman and recorded a popular DVD video programme *Proven Formulas for Success in Commercial Real Estate*.

Mark Withers is a specialist property accountant, advisor, residential and commercial investor and the author of *Property Tax*. Mark's practical and plain-talking advice is based on years of experience dealing with thousands of transactions for his clients and his own investment property portfolio.

Tony Steindle is a lawyer whose practice covers all aspects of real estate law. His clients include investors of all sorts, as well as developers and commercial landlords. Tony is the author of *Property Law* and a sought-after advisor and speaker on legal issues affecting property investors.

Peter Aranyi is the author of *Commercial Real Estate Investor's Guide* and editor of several best-selling books on property investment. His training company Empower Education is a trusted source of practical and impartial information — and part of the success of thousands of property investors throughout Australasia.

Read more from these authors at **www.EmpowerEducation.com**

How to Survive and Prosper in a Falling Property Market

… and other vital secrets to building wealth through real estate

Edited by Peter Aranyi

EMPOWER LEADERS PUBLISHING

To Pearl, Amelia and Kit — the A team

First published 2008, revised and reprinted 2008 (twice)
Compiled and edited by Peter Aranyi
Book design and production by Peter Aranyi
Cover design by Jon Evans, Critical Mass Communications
Printed by Publishing Press

National Library of New Zealand Cataloguing-in-Publication Data

How to survive and prosper in a falling property market : and
other vital secrets to building wealth through real estate / edited
by Peter Aranyi. 1st ed.
Includes index.
ISBN 978-0-9582307-5-9
1. Real estate investment—New Zealand. 2. Real estate
business—New Zealand. 3. Finance, Personal—New Zealand.
4. Recessions—New Zealand. I. Aranyi, Peter, 1958-
332.63240993—dc 22

EMPOWER
LEADERS™

Empower Leaders Publishing Ltd
PO Box 38 226 Howick, Auckland 2145, New Zealand
in association with Empower Education Ltd
+64 9 535 2415 • www.EmpowerLeaders.co.nz

Contents

Why this book?

The purpose of this book is to share experience with you in the hope that you can learn from lessons others have learned the hard way. This is not a book of 'predictions', nor does it warn of an impending crash or meltdown … except to point out that there is a pattern in the property cycle. This pattern repeats. It's not exactly the same every time, but significant changes occur in the market and they tend to do so in a form that resembles previous changes.

It's worth being aware of the pattern and knowing how resulting pressures affect various players in the market. In the past people have been financially burned as a result of their ignorance of the changing cycle and its flow-on effects.

Unfortunately, there's no fun way to pass on some of the negative things that can and do happen to property owners, investors and businesses. Nor is there any point glossing over the turmoil that occurs from time to time in the property and financial markets. People suffer from these changes. Our aim in this book is take a good hard look at the downside as well as the upside — and to identify ways you can firstly protect yourself and secondly be in a position to make the most of the opportunities that inevitably arise.

It doesn't matter whether you think the market is hot, cold or indifferent as you read this. We've done our best to produce a useful handbook with principles that apply *throughout* the cycle. This is not your 'complete guide to success' in property, nor do we say it's the only book you should read (see recommended reading). In part, we've also worked to offer an antidote to some of the foolhardy and frankly deceptive sales spiel of property spruikers of all shades. There's an old saying: 'Never ask an encyclopaedia salesman if it's a good time to buy an encyclopaedia.' The answer will always be 'yes'. Too many investors and home buyers seek advice solely from those who would benefit directly from the transaction. People who act in this way are the traditional losers or victims of the property cycle. Do not copy them.

Get professional legal, financial and tax advice on your own situation and any proposed course of action. A useful strategy for success is to seek a range of sources of neutral, impartial information from people with *relevant* experience.

This book is a start.

1

Introduction

Moving forward as an investor by regarding the past

> **cycle** *noun*
> [often with adj.] a series of events that are regularly repeated in the same order: *the boom and slump periods of a trade cycle.*
>
> — Concise Oxford Dictionary

'The property cycle' is the name we give to a model which describes the variations in the state of the real estate market. At its purest, the cycle rotates through boom, slump, bust, recovery. These stages can be reported as a 'strong', 'firm' or 'hot' market on the upswing and a 'weak', 'soft' or 'cooling' market on the downswing.

Fundamentally, the property cycle is concerned with supply and demand. When there are more buyers than there are properties for sale ('a seller's market'), prices and values rise. When buyers are scarce and the amount of stock for sale grows to the level of oversupply ('a buyer's market'), prices remain static or fall.

In a boom, desperate buyers can pay too much — and in a slump, desperate sellers sell too cheaply. Most buyers don't have to buy and most sellers don't have to sell. They can ride this part of the cycle out. The pressure comes on when someone is in a forced situation — e.g. an owner needs to sell to take up a job transfer or an investor must reduce debt.

Trend lines

When considering a market and its variations, one of the most useful things you can look at is a trend line — often drawn as an average through a set of points on a graph (see example below).

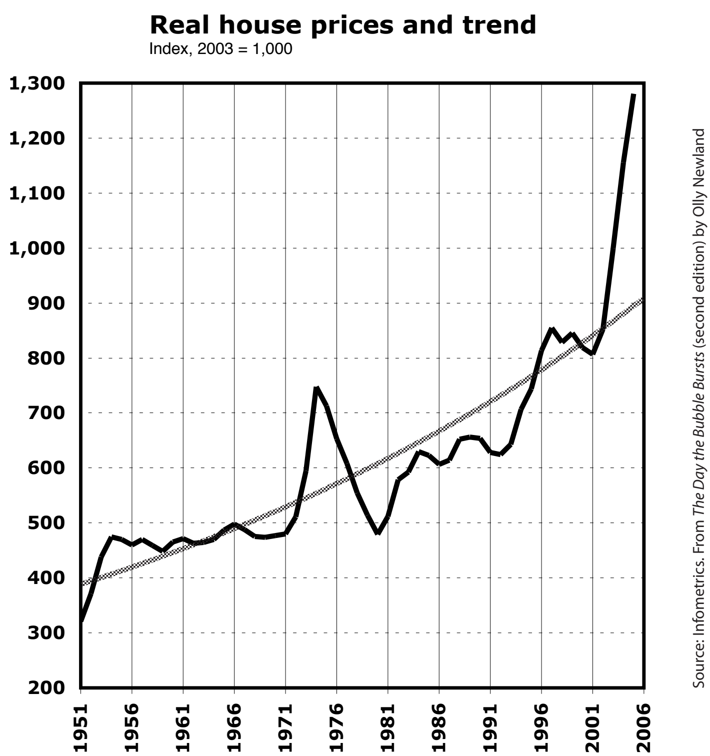

Figure 1.1 Example of price data and trend line

Statisticians and economists favour trend lines because they imply a general course or demonstrate a tendency, in some cases even pointing to a vaguely stable equilibrium.

In the case of real estate, for instance, economists might say that over time, property prices rise at 'about the rate of general inflation'. Alternatively, they might try to reference this price growth to GDP (Gross Domestic Product) growth … or to net population growth … or any other index or 'X factor' they've identified. Market values, prices, volumes, interest rates, etc, can all be analysed and plotted, then identified as presently above or below the trend line. The expectation is that any outstanding rise above the trend line (or fall below it) will be *temporary* and that the values will revert to the trend line — usually through a 'correction' in the appropriate direction.

History and experience tells us that a period of exceptional price growth or high level of activity in a market is usually followed by an adjustment — a drop-off in price growth and activity, and sometimes by a time of stagnant or negative growth. The high is followed by a low. A hot market cools. The boom turns into a slump.

A general rule is that the larger the rise, the sharper the fall that follows. This is not true in all cases. Yes, the property market changes, but not every cyclic fluctuation is characterised by a raging boom followed by a crash. Just as some parties are more fun than others, market variations differ in nature and intensity. Markets can crash, or they can soften gradually or stagnate. They can also undergo a long gentle rise — not every upswing of the cycle leads to a boom. As we'll see, the energy that sometimes turns a boom into an over-heated bubble is a mass over-confidence. Sometimes called market hysteria, this super-positive view of a commodity actually becomes both a cause and an effect.

When property (or a property sector) becomes a fad or flavour of the month, when everyone is doing it or enthusiastically talking about it in the same way as sharemarket mania, that's when the property market will, sooner or later, be in line for a correction.

Not just 'one' cycle

The property cycle is always turning. The market isn't the same for long. It's also splintered and fragmented. The market in a region, even a town, can be independently going through its own cycle — rising or falling due to factors affecting local supply and demand. Further, segments of a market (e.g. apartments, rental areas, commercial, industrial, retail, office) can have their own cycle and rhythm.

Certain types of investments can become fashionable — remember supply and demand — sometimes for reasons which are quite out of the ordinary. For instance, the childcare industry and eldercare industry have both in recent years been the target of efforts to consolidate ownership. For a time, larger overseas companies had their chequebooks out trying to buy up any reasonable childcare centre or retirement village on the market. This buying activity tended to create a seller's market and prices increased. Any local buyers had to outbid the offshore buyers. The same temporary effect happened in the funeral home business, and some years earlier in the office products/retail stationery business as national chains were created by amalgamating small independent operations. Staying close to your market and knowing what's happening in it is your best defence against mistakes and can alert you to opportunities.

However, the increased speed of communication (the global village) and the funds circulating the planet looking for higher yields mean that in the larger picture, individual markets are less isolated … and more interconnected. A decision by the US Federal Reserve to raise or lower interest rates can quickly affect the financial markets in Australia and

New Zealand. A decision made by a bank board in Geneva, London or Sydney (influenced at least in part by local market conditions, or global sentiment and events) can flow through to lending policies throughout Australia and New Zealand — depressing a small local or regional market because of factors that, on the surface, have nothing whatsoever to do with local conditions.

A correction, when it comes, can be national, regional or local. There's often a time lag as effects roll out, and some areas can remain stagnant — like rock pools: still full of water although the tide has gone out.

The cycle is neutral — neither 'good' nor 'bad'

Despite the pejorative language some people use to describe the market at any time (strong/weak, positive/negative, good/bad, hot/cold, active/slow, etc) the market is no more good or bad than any natural cycle. Like the weather or the tides, there's no part of this cycle that is wrong. It just is.

As you'll read, Mike McCombie's suggestion to consider your digestive cycle is highly relevant: which segment of this quintessentially natural cycle should you try to avoid? Eating? Digesting? Excreting? The answer is, none of the above. Each part of the digestive cycle is crucial.

As an investor, it's your job to tailor your decision-making and actions to be *appropriate* to the market — for instance, as Mike says, don't buy vacant commercial buildings at the bottom of the cycle unless you have a fairly solid plan for turning that situation around. Trying to lease vacant commercial space in a flat or depressed economy can be a recipe for struggle. (However, if you have a prospective tenant, or a plan to, for example, change the property's use to something that is in demand, then the investment has possibilities). Or, as Andrew King points out, there comes a time when it's more useful for a residential investor to target 'do-up' properties where value can be fairly easily added, rather than struggling to find a rental property that meets your investment criteria.

Interestingly, often the 'right' or useful action to take will be the exact opposite of what the majority does — a counter-cyclical approach. As Warren Buffett says, "We simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful."

Likewise, don't waste time trying to make banks and lenders 'wrong' or 'bad' for protecting their self-interests by changing their rules. Lenders are, first and foremost, in the business of staying in business. Protect your own interests — particularly from them!

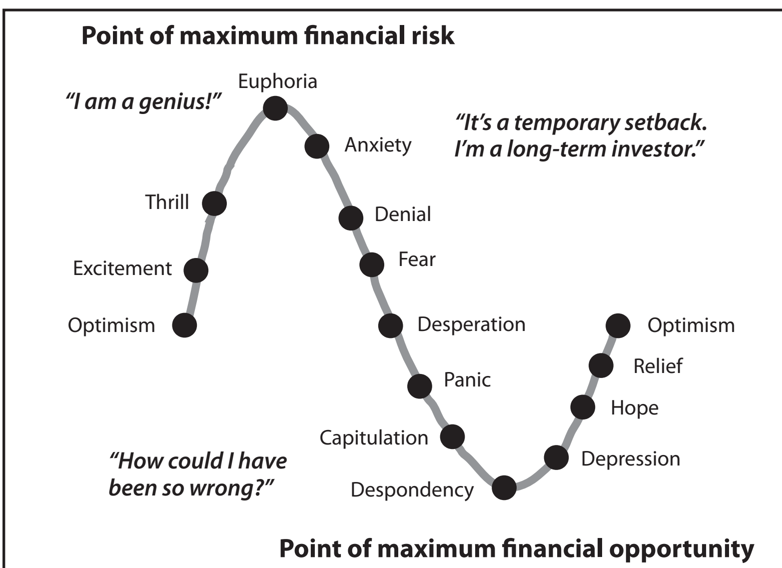

Figure 1.2 The cycle of market emotions

Most often quoted by advisors in the sharemarket, this classic representation of the stages of market confidence can also apply to real estate. When confidence plummets, experienced investors start looking for bargains.

The real driver: market confidence or 'social mood'

As we stated in *Commercial Real Estate Investor's Guide*, the property market is driven by **emotion** and **sentiment**. Many of the so-called 'drivers' quoted (really market indicators in our view) like household head count and number of listings are just reflections of the real driver: market confidence. Identify the level of market confidence at any given time and you'll be close to the market.

Some market observers label this phenomenon 'social mood' and note that it reflects the human tendency for herding behaviour. Social mood can change, quickly, and with it the idea of what a smart investment is in a given market. When market confidence is high (i.e. the social mood is positive and optimistic) people, companies and institutions take on risks or debt they may not really be able to afford. Their optimism leads them to enter into transactions with very poor fundamentals — or blinds them to the riskiness of their position. When the social mood turns from positive to negative, fear replaces greed, and people begin to see these risky behaviours or positions more accurately.

In a rapidly rising housing market the belief that property prices 'can only increase' is all-pervasive. A stall in price growth, or a reversal, or a series of negative market events like company collapses, can change that belief (and sometimes it's stubbornly-held) before being widely acknowledged.

Experienced investors have seen these market corrections before. They know they are just part of how things work. In his book *The Bubble of American Supremacy*, financier George Soros explains how a market 'bubble' comes about:

> The process begins when a *prevailing trend* and a *prevailing bias* reinforce each other. As the bias becomes more pronounced, it becomes vulnerable to being corrected by the evidence. As long as the trend survives the test, it serves

> to reinforce the bias so that the bias can become quite far removed from reality. Eventually, there arrives a moment of truth, when participants become aware of *the gap that separates their views from reality.* A twilight period, when the trend is no longer reinforced by the belief, ensues. In due course the trend is also reversed and *a self-correcting process is set in motion in the opposite direction.* Depending on how far a boom-bust process has carried, the reversal can be quite catastrophic, similar to a bubble's bursting. [emphasis added]

Adopting Soros's language, in a hot real estate market the prevailing trend = 'property prices rising', and the prevailing bias = 'property prices can only rise'.

These two factors can combine to create a period of market exuberance, in some cases over-exuberance, which must ultimately correct. That's the market cycle in action. What's unfortunate is that it is often the new players or late entrants to the market who pay the price in a downwards correction. As veteran commercial real estate agent Tim Julian says:

> To some extent the length of a short cycle is determined by *the period it takes to forget the pain of the last adjustment from market over-exuberance.* This is achieved in the overall market by new decision-makers emerging who either were not around during the last cycle or were so junior or simple that the events made little impact on them. [emphasis added]

On the late entrants being the biggest losers, Warren Buffett puts it this way:

> It's like most trends: At the beginning, it's driven by fundamentals, then speculation takes over. As the old saying goes, what the wise man does in the beginning, fools do in the end. With any asset class that has a big move, first the fundamentals attract speculation, then the speculation becomes dominant. Once a price history develops, and people hear that their neighbour made a lot of money on

> something, that impulse takes over. ... Orgies tend to be wildest toward the end. It's like being Cinderella at the ball. You know that at midnight everything's going to turn back to pumpkins and mice. But you look around and say, 'one more dance,' and so does everyone else. The party does get to be more fun — and besides, there are no clocks on the wall. And then suddenly the clock strikes 12, and everything turns back to pumpkins and mice.
> [CNN *Money* magazine May 2006]

Being merely a summation of human decisions, markets are almost by definition uncertain. As Buffett said, there are no clocks on the wall. There's no timer on the scoreboard counting down the time remaining before the sports teams are to change ends. To keep themselves safe, investors must exercise vigilance. Watch the market. ***Watch its mood.***

By all means, look at the statistics and the economic analysis. They do tell a story too, but, as we've discussed, they're generally not very predictive. It's not the statistics themselves, but rather the market's reaction to them, which is important. Sometimes markets can shrug off bad news, at other times confidence can slump, even crash.

Beware pseudo-science

Be wary of pseudo-academic discussion and analysis around 'drivers' and 'influencers' of the property cycle. Some amateur economists and self-proclaimed property investment experts are, sadly, 'gums for hire' — and their services are used as bait by property promoters.

On the other hand, many genuinely qualified, professional economists are fine people, but, with respect, *they* sometimes appear to forget economics is a social science (not one of the 'hard' sciences like physics). They also seem fond of over-complicating things, being dutifully rigorous with statistics and mathematics when the numbers they're working with remain fairly nebulous.

No amount of bamboozle factor with statistics ("Oh, look, business confidence has fallen 2.6% this month!") can make up for the hazy nature of this type of 'data'. Let's make a distinction between *hard historical data* and the 'opinion', 'intentions' or 'confidence' measures favoured by the media.

Sometimes the sample size for such so-called statistics is so small (or self-referencing) it makes variations irrelevant. At others the opinion questionnaire basis for the data ('Is this a good time to buy?' or 'Do you expect business will be better next year?') is woolly or indistinct. While there is value in examining a *trend* in this sort of data, it's dubious to regard individual samples, swings or data points as trustworthy, despite their ready acceptance by a hungry news media.

On factors such as exchange rate variations, income levels, household or business sector debt, consumer spending, export figures and interest rates (hard historical data), economists and analysts can be a *great* source of information and interpretation. And this type of data can be very illuminating, sometimes even useful, to you as an investor.

Some of the brains looking at the market are the best in the business and can identify what's been going on (hindsight) in terms of investment fundamentals, taking into account inflation, mortgage interest rates, rents received and tax rates. From experience, however, many of their 'predictions' can turn on a dime — the analysts change their forecasts with great alacrity. And you can't blame them for this. "When the facts change, I change my mind. What do you do, sir?" economist John Maynard Keynes once famously responded to a charge of inconsistency.

In many cases, such commentary is little more than hindsight — some of it practised by self-appointed experts. A wise investor sees this as 'noise' and looks for real-world, specific data *for their specific market* — 'hard' factors such as up-to-date comparative sales prices and rents/leases being received.

Another trap for amateur economists is mixing up causes and effects. For example, the average number of days to sell a property varies depending on the strength of the market, which it *reflects*. It seems faintly absurd to describe this measure as a *driver* of the market. Similarly, rental levels can be seen as an indicator of market supply and demand not a driver of it. (Of course, investors will make decisions based on rental levels and factor in their effect on return on investment — but these are the tail, not the dog.)

There's value in considering these factors, their trends, and being aware of market commentary, but it's *not* just arithmetic. Market sentiment and confidence — optimism and pessimism — are the indicators we observe most closely.

It is difficult to improve on Olly Newland's evaluation from *The Day the Bubble Bursts*:

> It would be easy to spend several lifetimes 'analysing', in a rigorous statistical fashion, the factors that drive the Economic or Property Clock. Pointy-heads can and do bury themselves in statistics, rows of data, multicoloured charts and graphs, finally emerging triumphant at having weighed all the macro-economic factors (interest rates, money supply, immigration, etc) and coming up with a theory to 'explain' what happens as the cycle moves around the clock. (But always after the fact. With very few exceptions, their self-serving 'predictions' aren't worth a tinker's cuss.)
>
> But the real driver is emotion or 'market sentiment'. What emerges in markets is a scaled-up version of 'group think', where the pervasive mood switches (and I mean switches) from negative to positive, then gradually becomes super-positive and hyped-up. In other words, hysterical.
>
> Unfortunately, the reversal of sentiment happens a lot more suddenly. There's an old saying from the sharemarket: 'The bull climbs up the stairs, but the bear jumps out the window.' (And I've lived it.) The climb towards high market mania happens regularly.

The cycle is not *completely* predictable — nor is it signposted

There's another old stockmarket saying, 'No-one rings a bell at the top or bottom of the market'.

Hearing about the property cycle, its repetitive pattern, the drivers and indicators that routinely sweep through the market and economy, and its overall rhythm, less-experienced investors can imagine that the cycle operates like a set of traffic lights — perfectly synchronised, orderly and with clear indications for all sides to see. Actually, this is not the case. It's the very lack of precise predictability and clarity that causes many of the casualties (and opportunities).

The phases of the property cycle are not signposted like rural towns. You won't see a banner that states 'Welcome to the slump' or 'You are now entering a commercial rent downturn' or 'Farewell from stagnant house price growth. Invest safely. Come back soon.' If only it were that simple.

In fact the market is beset with false starts and lulls, in the same way a faulty automatic gearbox sometimes 'hunts' for the right gear to engage when the car is driven uphill. As you'll see later in this book, inexperience, bad advice, and fear (fear of missing out and, later, fear of loss) can lead people to make unfavourable buying, selling and investing decisions. Some investors can sound like impatient children (*'Are we there yet? Are we there yet?'*).

Things are always so much clearer in hindsight. Take some advice from Olly Newland who advocates patience:

> Real estate is all about timing.
> Write it on your forehead and never forget it.

The purpose of this book is not to scare or to depress you. Rather, we've aimed to share the experience of those who have been through the cycle to help you stay safe and prosper. Use this first to raise your awareness. Then by taking some of the steps outlined here, you can build your financial strength to withstand the pressures and make the most of opportunities that present themselves.

As you read, look out for themes. Often when introducing one of our seminars or training courses, I stress that we don't shrink from repetition; in fact we welcome it.

If you read the same piece of advice (or different facets of it) from several of the contributors to this book, that's a *good* thing. The emphasis means it's important! If you read investor Mike McCombie's warning about a trap based on his hard experience, then see it reinforced by lawyer Tony Steindle who's seen that particular trap hurt a few of his clients, perhaps you will get the message that they're trying to share a *vital* piece of advice. A point like 'Always get your agreements in writing' is stressed repeatedly, so take the hint. It may be of use to you. We hope so, and wish you well.

— Peter Aranyi, *editor*.