POUND COST AVERAGING – WITH PROPERTY!

WHY BUYING MORE PROPERTY IS A BETTER STRATEGY THAN REPAYING YOUR MORTGAGES

By specialist property accountant Stephen Fay ACA

Once interest rates return to normal levels, some investors will find themselves with an unsustainable negative-cashflow portfolio. While it is tempting to start repaying mortgages, another strategy to ensure long-term survival is to buy MORE income-generating property at today's lower prices.

Buying assets continuously through the peaks and troughs of the market cycle is known as 'pound cost averaging' (the phrase is adapted from the US term 'dollar cost averaging) – this article explains how this strategy can protect a portfolio.

What is 'pound cost averaging'?

Pound Cost Averaging (PCA) is an investment strategy that entails investing equal-ish amounts regularly over the long-term. This strategy is normally associated with investing in shares, and enables the high and lows of the market cycle to be averaged out. When asset prices are low, the invested cash buys more property than when prices are higher.

Many investors built their portfolio in times of higher property prices. If these investors stop investing when prices fall, their **average** property purchase price will remain high – whereas if they continue to purchase property at today's lower prices, their **average** property purchase price will actually fall.

For example:

Mr Small bought 5 properties between 2006 – 2008 at an average purchase price of £120k, and then stopped buying.

Mr Small's average purchase price is £120k.

Whereas ...

Mr Big also bought 3 properties between 2006 – 2008 at an average purchase price of £120k, but continued to buy a further 3 properties for £80k between 2009 – 2011.

Mr Big's average property price – across all properties - is now just £95k.

PCA investing works well for property as it is a slower-moving asset class than shares.

This means the professional investor can take advantage of falling prices to buy bargain properties and drive hard bargains.

This is the basis for the phrase 'when there is blood on the streets, buy property'.

Why debt repayment has a limited effect on overall profitability

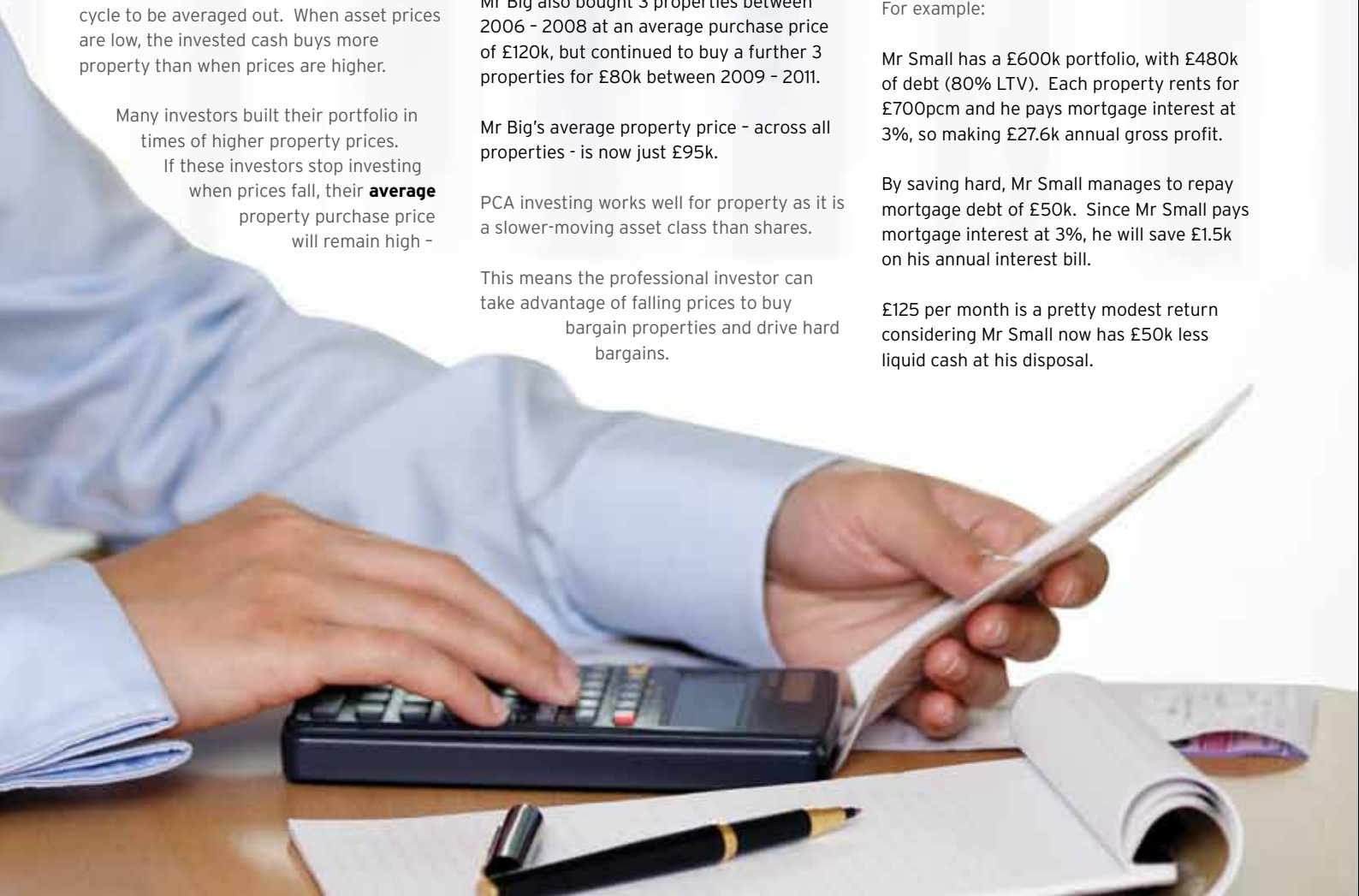
The sheer size of mortgage debt that many investors are carrying means that putting a meaningful dent in that debt is a tall order. How many investors have 6-figure incomes that mean they can repay significant chunks of debt?

For example:

Mr Small has a £600k portfolio, with £480k of debt (80% LTV). Each property rents for £700pcm and he pays mortgage interest at 3%, so making £27.6k annual gross profit.

By saving hard, Mr Small manages to repay mortgage debt of £50k. Since Mr Small pays mortgage interest at 3%, he will save £1.5k on his annual interest bill.

£125 per month is a pretty modest return considering Mr Small now has £50k less liquid cash at his disposal.



Why buying more property at cheap prices increases net income more than repaying debt

Buying more cashflow-positive property is often a better strategy to increase portfolio income than repaying debt. Pound Cost Averaging means that during downturns, the savvy investor will buy bargains that may not be possible in the good times – and that can mean a better balanced, and better-performing, portfolio.

For example:

Mr Big spends his £50k on his additional 3 bargain properties at £80k each, plus closing costs, using 80% LTV mortgages. He rents these properties at £700pcm each, as these are similar to his other properties, and while prices have dropped, rents haven't.

Although Mr Big is paying 5% on his new mortgages, compared to just 3% on his old mortgages, his gross rental profit increases by £13.2k.

Compare a gross return of £13.2k for Mr Big, due to buying more income-producing property, to the £1.5k that Mr Small has made by repaying £50k of cheap mortgage debt – almost a 9-fold improvement in gross profit.

Mr Small Vs Mr Big – breakeven comparison

Of course, as well as finance costs there are also letting costs. If we assume that letting costs are 20% of gross rent, the break-even point – the finance % pay-rate at which each portfolio would go into negative cashflow - would be as follows:

Mr Small and Mr Big (originally) = 7%

Mr Small (after repaying £50k mortgage debt) = 7.3%

Mr Big (after buying 3 profitable bargain properties) = 8.0%

So, Mr Big is now significantly better protected against rising interest rates than Mr Small, as a result of his PCA strategy.

In fact, since the Bank of England base rate typically moves in increments of 0.25%, Mr Big could withstand almost 3 additional Base Rate rises than Mr Small.

Bear in mind that this effect came from buying only 3 more properties. Across a portfolio, this 'beefing up' of the overall profitability can have a dramatic effect on the breakeven 'safety point'.

A final point ...

As well as being better-protected against rising interest rates, Mr Big has also increased his portfolio size by 3 units (60%), and so all things being equal when the market cycle swings upwards, as it inevitably will, Mr Big will make a further 60% profit than Mr Small – and all the while having far better cashflow.

Summary

It may seem counter-intuitive to keep buying property when the market is falling – but savvy purchases during downturns means that the average portfolio purchase price is lower, and rents and profits are higher. This has a protective effect on a portfolio & is often a better use of limited cash resources than repaying debt.

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