ABC BULLION | EDUCATION

Physical gold vs. real estate and why I'm not buying the 'booming' Australian housing market

With the recent weakness in gold prices, and the resurgence in Australian home values, the never-ending gold vs. real estate argument has taken a turn back towards bricks and mortar, at least in the mainstream financial media, who are heavily talking up the latest property price movements.

But which is the better investment?

Both are 'real assets' and are limited in supply. Both should, at least theoretically, protect purchasing power over the long run, in that housing also has a strong track record of maintaining its value versus inflation over the centuries, a feat that physical bullion has also managed to perform very well.

For me personally, I'll be sticking with bullion for a number of reasons which I'll outline below, and the recent correction has only encouraged me to top up my gold and silver holdings, at a discount to boot.

The first reason I prefer bullion is liquidity. Gold and silver are highly liquid, with tens of billions of dollars per day traded around the world.

The bullion that I own (and that you own, should you choose too) is easy to sell when and if I either need to or want to, and is the same for any investor.

The second reason is transaction costs. Yes, there is a transaction cost to purchasing and selling physical bullion, in that you pay slightly more than the spot price to purchase, and receive slightly less than the spot price when you sell your bullion. Provided you shop around though, these premiums are quite small, as gold is highly liquid, so there is no need to pay sky high margins to enter and exit a position.

The transaction costs of buying and selling bullion pales into comparison versus the stamp duty, legal and agency fees required to buy a property, as well as the fees to a sales agent you'll pay when and if you sell.

The table below highlights the stamp duty, mortgage registration fees and transfer fees you'll pay on a $500k home (which is the average national home price now) in the various states and territories, and shows this as a percentage of the purchase cost.

Location	Stamp Duty	Mortgage Registration	Transfer Fee	Total Fee	Percentage Fee
NSW	17,990	105	209	18,304	**3.66%**
VIC	25,070	108	1,361	26,539	**5.31%**
QLD	15,925	157	1,111	17,193	**3.44%**
SA	21,330	148	3,560	25,038	**5.01%**
WA	17,765	160	250	18,175	**3.64%**
TAS	18,248	125	191	18,564	**3.71%**
ACT	17,100	121	134	17,455	**3.49%**
NT	23,929	133	133	24,195	**4.84%**
Average	19,669	132	881	20,682	**4.14%**

**note these fees were calculated assuming it was an investment property buying an established home.*

Data courtesy of InfoChoice available at
http://www.infochoice.com.au/calculators/stamp-duty-calculator/

On top of that, when you sell a property, you'll pay an agency fee. Whilst this will vary, the national average is around 2.26% plus GST.

Let's assume your home went up by 10% per year for 2 years, which is basically in line with gold's long-term price appreciation.

A $605,000 price tag will set you back $15,040.30 in sales fees when you're looking to get out of that property. Ouch!

The third reason I prefer bullion is ongoing management/maintenance. Gold is exceptionally cheap to store and requires essentially no ongoing maintenance

You can store it for next to nothing (free if it's in unallocated form with the right dealer) or you can access a private safety deposit box for a couple of hundred dollars a year.

Property needs constant attention. It needs painting, the garden needs upkeep, the appliances need repair and replacement and you have to pay council rates and property rates every year. If it's tenanted, you've got people to manage, or a property agent who'll take a decent clip of the rent to remove that headache for you.

The fourth advantage of bullion is leverage, or the lack of it required when choosing to invest in bullion. Physical gold can, and typically is bought without leverage.

Prices can go down, but you can't lose more than your original investment, and over the long run gold is the only asset no one has ever lost money in.

For most property investors, you can only access property with excessive leverage (something that will be worrying the RBA right now with the latest news that over 30% of Australian mortgages being written today have loan to value ratios of over 80%).

For those investors, if the home value drops only 20%, and they are forced to sell, they'll end up with less than zero.

That's something property spruikers don't spend much time talking about to investors, especially those encouraging people to set up a SMSF these days so they can go 'all-in' on an investment property.

The fifth advantage of bullion is diversification, which is sensibly one of the key tenets of a long-term wealth creation and preservation program.

If you have a $500k portfolio, you could easily have say 25% of your portfolio in gold, cash, shares and bonds.

If you don't like one asset class any more, or you want to rebalance your allocations between these assets classes, it's easy to sell out of one or adjust your portfolio in order with your preferences.

In the case of property, the chances are that your $500k portfolio is just one illiquid asset. If you decide you only want $400k in property, you can't very well sell off one bedroom or the kitchen.

Diversification is nigh on impossible.

All of those reasons are strong enough reasons to prefer physical gold to property in my opinion, but there are two further reasons, which are particularly relevant for Australian investors.

The first is that the family home will, in all likelihood, be the major asset that most Australians buy throughout their life. As such, as a general rule, residential real estate is already going to be the major investment most Australians make in their lives.

Therefore, Australians should be wary about investing more in property outside of the family home, as the idea of concentrating more capital (and risk) into a single asset class is one people should approach with appropriate caution.

But the final reason for being wary about investing in Australian homes, and preferring physical gold instead, is relative valuations at this point in the cycle.

Property has been in an incredible bull market for over 30 years, and prices on a national basis are at a new all time high. As a general rule, if an asset has gone up for 30 years almost uninterrupted, ask hard questions before throwing your money at it.

A second, general rule is that asset markets at all time highs are terrific markets – for sellers – not buyers, something that has relevance when looking at equity and bond markets around the globe too.

We've all heard the saying about the sky being darkest before the dawn, but in this case it's worth reminding readers that a star burns brightest just before it bursts.

That could well be where we are now with the Australian residential real estate market, as this bull market in property has taken it to truly historic valuations, well above long-term averages versus national incomes or versus rental yields.

In the last decade alone, house prices have gone from merely 4 times the average annual income to over 7 times. They're closer to 10 times the median income!

Not surprisingly, the huge increase in valuations relative to incomes means that Australians are so far in debt today, that even with interest rates at record lows, we are paying more as a percentage of our disposable income to service our mortgages than what we were back in the early 1990s when interest rates were over 15%!

For a quick illustration of how expensive our housing market is, consider the following table, compiled by The Economist, which shows that Australian homes are overvalued by some 46% relative to rental yields, and by 24% relative to disposable incomes in the nation.

The Economist house-price indicators

	Latest, % change		Under(-)/over(+) valued, against*:	
	on a year earlier	since Q1 2008	rents	income†
Hong Kong	18.4	90.9	84	*na*
United States	12.1	-8.2	2	-12
India	11.9	*na*	*na*	*na*
Brazil	11.8	*na*	*na*	*na*
South Africa	9.8	19.4	*na*	3
New Zealand	7.2	6.0	68	24
China	6.5	20.9	8	-36
Germany	5.1	20.5	-15	-18
Australia	5.1	14.1	46	24
Britain	3.9	-6.7	20	14
Sweden	3.0	10.6	32	19
Ireland	2.3	-49.0	-6	-8
Canada	1.9	20.0	74	30
France	-1.5	0.7	36	31
Japan	-2.2	-14.9	-37	-37
Italy	-5.7	-10.9	-2	11
Spain	-8.2	-30.3	12	12
Netherlands	-8.5	-19.0	6	21

*Relative to long-run average †Disposable income per person
Sources: Haver Analytics; Hong Kong RV; National Housing Bank; Nationwide; OECD; Teranet and National Bank; Thomson Reuters; *The Economist*

These are the kinds of statistics you don't hear the big four banks talk about often.

It's highly unlikey that a new house price boom will be sustainable, or will run for many years when it's starting at such high valuation levels already.

Furthermore, one of the major arguments from property spruikers, and our banking industry (but then I repeat myself) as to why property prices will always rise is our supposed housing shortage.

Before you accept that one hook, line and sinker, google the ABS Housing and Occupancy Costs report released this year.

It shows over 75% of Australians reporting they have **at least 1 spare bedroom in their home**. With roughly 8 million households in the nation, that's the better part of 6 million spare bedrooms already.

As times get tougher (and they are when you consider the unemployment rate is rising, as well as skyrocketing costs for utilities, insurances, health care and childcare etc.), Australians are going to come to the realization they don't need all those spare rooms. And they're going to economize.

Maybe it's a young family thinking they'll only have one child, hence they'll only need a two-bedroom house.

Perhaps it's a graduating university student thinking they can stay with Mum and Dad for a couple more years after finishing university so they can save some rent money, or a couple of friends sharing a three-bedroom house thinking that it might make sense to have another person move in to help save on rent money.

Either way, there's huge scope for Australians to use our existing home stock more efficiently. And that's exactly what we saw happen with the last census data, which showed that, for the first time in 100 years, the number of Australians living in each and every house actually increased between 2006-2011.

That's a trend worth paying attention too, and it will prove a headwind for house prices in the years ahead.

Yet another reason to be cautious about property as an investment right now is the sheer volume of advertising by large financial players talking about the 'opportunity' for Australians should they choose to invest in housing, and the number of 'experts' stressing that there is definitely no bubble in Australian housing, just like 'experts' in the US, the UK and Spain in the 12-24 months before their respective housing markets imploded.

This is, in many ways, evidence of what might be called the 'taxi driver' effect, whereby you know it's time to sell an asset class when even taxi drivers are telling you that 'you can't go wrong' in that particular investment.

Consider the following two advertisements recently taken within a couple of hundred meters of each other on a major Sydney street:
The first one is from Commonwealth Bank, and as you can see, apparently borrowing

$700k to buy one Sydney investment property isn't enough, smart investors (with highly questionable dress sense), should instead go $1.4 million into debt and buy two.

The second is from AMP, and is an advertisement 'encouraging' people to set up a self-managed super fund and buy property, something that will no doubt require the use of significant leverage.

As a final comment on this phenomenon, only this week I went to my bank to withdraw some money from the ATM and had to quietly chuckle when all 4 ads scrolling across the ATM screen were related to investing in property, including 'how much you can borrow', 'property profile reports', and 'be ready to pay on the day'.

There's a famous saying that 'when everybody is thinking the same thing, no-one is thinking much at all'.

All the big boys are saying you can't go wrong in property.

Fair warning indeed!

Last, but not least, when it comes to why I'd be cautious about buying into this housing market is the impact of demographics.

The one thing you never hear property analysts talk about is the role of the ageing population in the future trajectory of house prices. As it stands, the baby boomer generation, who now represent 25% of the Australian population, control 50% of the nation's housing stock. Not only that, but their investment in housing is by far their major asset, underpinning their net worth.

Unfortunately, most are unprepared financially for retirement, with ASFA data indicating that a couple aged between 61-64 would have only around $300k in retirement assets today.

Even if they were to earn 8% per annum (which won't be easy considering the risks in the market right now), this money would run out within 7-8 years based on them spending around $55k a year (which is the ASFA estimate of requirements for a 'comfortable' retirement).

As a result, many are going to have no choice but to sell their homes, so that they can unlock their existing equity in order to pay for their lifestyles.

The bottom line is that in the decade ahead there are going to be more and more baby boomers needing to sell, coupled with fewer Gen Ys and Gen Xs willing and able to buy.

The laws of supply and demand are not to be trifled with, and it's hard to see prices rising sustainably with these dynamics in play.

How about gold?

Unlike housing, on almost any metric you care to mention, physical gold on the other hand is ‘cheap’.

Whether you compare it to inflation, the global money supply, as a percentage of global financial assets or relative to the stock and bond markets, gold is still hugely undervalued.

On top of that, with interest rates either at or below zero in real terms (i.e. after inflation) all around the world, and with central banks continuing to print money, we are still in the perfect macroeconomic environment for gold.

This bullish outlook for precious metals is only enhanced by the fact that developing market nations like China, Brazil, Russia, India are all voraciously buying physical gold as a way of balancing out their foreign exchange reserves at the sovereign level, and as a form of wealth protection for the ‘man on the street’.

Therefore, despite the discomfort the current volatility in precious metal prices is causing some investors, in all likelihood, physical gold and silver prices are headed much higher in the years ahead.

Indeed, one final point with regards to the merits of investing in gold in comparison to the merits of investing in housing is worth mentioning today.

In Australia, over the last 130 years, there have been 3 major cycles in valuations between gold and house prices, where the relative value of each has swung drastically.

At each peak in gold (relative to housing), you’ve been able to buy an entire house in Sydney for approximately 100 ounces of physical gold.

At the time of writing, Tuesday October 8th 2013, 100 ounces of gold will set you back just over $140k AUD ($140,464 to be precise using a USD gold price of $1326.40 and an AUD/USD exchange rate of 0.9443).

$140,464 is barely enough to put down a 20% deposit on the average Sydney home which is in the $700k range today.

This perhaps more than anything indicates how undervalued gold still is today, or how overvalued property is, at least in a relative sense.

If history is any guide though (and I know of no closer thing to a crystal ball), those 100 ounces of gold will appreciate far more rapidly than the average house price in the years to come, narrowing the gap between the two.

Each and every investor needs to make their own decisions, but market cycles, if they don’t repeat, certainly do rhyme.

For me, personally, I am going to continue investing and saving my wealth in physical gold instead of housing, for the time being.

One day, when the market is willing to pay considerably higher prices for that physical gold and silver (as history suggests it will) it will no doubt make sense to divest a portion of those investments, but in all likelihood it won't be for quite some time.

But the most precious commodity of all, time, is on my side as the Rolling Stones said, and it's a commodity that every precious metal investor can use to their advantage in the years ahead.

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