

Motivations of investors in the private rental market

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EXECUTIVE SUMMARY

This study of the motivations of rental investors in Australia is being conducted collaboratively across five AHURI Research Centres, led by the AHURI Queensland Research Centre. Essentially, this is a qualitative study of rental investors, which aims to gain a better understanding of investors' experiences, motives and actions, as well as the perceptions of investors' behaviours among other key players in the rental sector. Some data regarding types of investments and investor characteristics will also be collected.

While our understanding of the private rental system has improved considerably over the last decade or so, most of the literature discussing investor motivations and landlord typologies dates back to, or is drawn from data relating to the 1980s or early 1990s. Gaps in our knowledge and understanding of the providers of rental housing remain, and an up-to-date analysis of investors operating in contemporary rental housing markets is required.

The present study seeks to address this research gap. The study is principally concerned with the motivations, expectations and experiences of rental property investors, and the implications of those investment motivations and behaviours for the future of lower rent housing.

The project aims to:

- explore the motivations, expectations and experiences of rental property investors;
- consider how these factors vary according to length and timing of investment, geography, cost segmentation, investor type and scale of holdings;
- assess how the motivations, expectations and experiences of rental property investors shape investor behaviour;
- explore the institutional context which generated the rapid growth in rental investment including the nature of new lending instruments; and
- examine the implications of investment motivations and behaviour for the future of lower rent housing and the stability of the private rental sector.

Traditional analysis of rental investors in Australia has stressed the significance of the small-scale, sometimes shorter term landlord, who owns one or two properties. Their main reasons for investing are connected to anticipated capital gains rather than rental income, and they are attracted by the capacity to negatively gear rental losses to reduce income tax. This study offers an important opportunity to test some of these impressions in a contemporary context. At the same time, previous research on landlords has tended to view economics as the main driver of rental investment, but in the absence of any formal framework for understanding investment behaviour. This research will seek to position investors' actions in appropriate behavioural models.

The study also represents exploratory research, which seeks to test a range of methodologies designed to ascertain the views of investors and other key agents at the rental sector coalface.

The findings from this study will provide rich material on the rationale, motivations and experiences of private rental investors, across factors such as time, investor type, and geography. The findings will enable governments and others to have a clearer understanding of current and potential investment in the rental sector, and will also inform discussion on policy interventions which could be utilised to preserve existing investments and to facilitate additional supply of lower priced rental property.

1 INTRODUCTION TO THE STUDY OF RENTAL INVESTORS

1.1 Background

This Positioning Paper is the first output of a research project examining the motivations, expectations and experiences of rental property investors, and analysing the implications of investment motivations and behaviours for the future of lower rent housing.

While the private rental sector has always been an important part of the Australian housing system, it has “often been considered the ‘lost child’ of ... Australian housing studies” (Beer 1999: 255). As Berry (2000: 661) argues, “the tenure still exudes a somewhat neglected air”. Our understanding of the private rental system has improved through research of the last decade (Yates 1996; Beer 1999; Berry 2000, Wulff Yates and Burke 2001; Yates et al 2004), and by a number of recent AHURI studies, but there are still important gaps in our knowledge of the rental housing system and of housing market dynamics.

The present study will fill one such research gap by investigating the motivations, expectations and experiences of investor, how these are affected by government policies such as negative gearing, and how they may vary according to length and timing of investment, geography, cost segmentation, investor type and scale of holdings. The focus of the study is direct investment by individual landlords and does not examine investment in the form of direct investment by institutions, or indirect investment by institutions or individuals through property trusts. The implications of investment motivations and behaviours for the future of lower rent housing is also an important consideration.

All of these issues will be researched from the perspective of rental property investors themselves, rental property managers, and other key agents directly involved in the private rental sector. Primarily this will be undertaken using qualitative research approaches, although some more quantitative data will be generated regarding the types of investment holdings, investor characteristics and other features of investment phenomena.

This Positioning Paper seeks to provide the background to the study, and outlines the research themes and questions to be pursued, and the methods employed, based on the original research proposal. The Paper also positions the study within specific housing policy, housing market, and housing research contexts.

1.2 Why understanding rental investors is important

Despite renewed interest in the private rental investors elsewhere (see for example, CMHC 1999; Rhodes and Bevan 2003; Saville-Smith and Fraser 2004), much of the Australian literature discussing investor motivations and landlord typologies dates back to the 1980s or early 1990s. This research provides an opportunity to conduct a contemporary analysis of the motivations, intentions and behaviour of rental investors, and to consider the implications for the future supply and management of private rental housing.

Housing policy in Australia relies heavily on many low-income households being able to access affordable rental housing in the private sector. This has become especially significant in view of the virtual halt in the expansion of social housing provision. The supply of housing at rents affordable for people on low incomes receiving Commonwealth Rent Assistance (CRA) is critical to reducing what might otherwise be higher demand for social housing. This project will examine one key factor in

determining the supply of such accommodation, namely: the motivations and behaviours of rental property investors.

Australia has recently experienced a significant surge in housing market activity, with investment in private rental property making up an important component of the boom. Although the peak of investment in both rental and owner-occupied property now appears to be subsiding (more so in some states than others), the longer term impacts of these phenomena on the affordability and availability of rental housing for tenants, the rates of return to investors, and effects on industry stability have yet to be assessed.

Allen and McDowell (1989: 45) have argued that, "Knowing what kinds of landlords there are in the market and how they are likely to act is a necessary prerequisite to an understanding of what is happening to the private rented housing market". There has been increasing interest in private rental market issues from the mid 1990s onwards. Research Berry, Beer, Yates and Wulff, and others have documented changes in supply, demand and prices in the private rental market. Other past research which has discussed investor motivations includes work by Allen and McDowell, Kleinman, and Whitehead in Britain, and Core Consultants, Paris, the NSW Department of Housing, Brian Elton and Associates, Mowbray, and Seelig in Australia.

More recent research for AHURI has suggested shifts in the supply of low cost and other rental housing, but has not sought to provide a detailed explanation for why such changes in supply might be occurring. In the context of the recent housing boom and surges in mortgage lending for residential property investment, understanding investment behaviour is crucial to estimating future supply trends, particularly at the lower cost end of the sector.

In general, it is widely recognised that our knowledge of the rental housing system remains constrained, and that more research is needed to inform policy and understanding (Berry 1998:14). One such research and knowledge gap relates to the motivations, expectations and experiences of rental property investors, and how these impact on investment behaviour in the supply of rental housing generally, and lower rent housing in particular. This research will provide an up-to-date insight into the motivations, behaviour and intentions of rental investors in the Australian context, and the implications for housing policy. The research is important in policy terms for several reasons.

Firstly, the private rental market presently houses around one-fifth of the population nationally; with much higher proportions in specific urban locations. The sector actually accommodates a greater number of lower income households than the public housing system, including the majority of those on social welfare benefits and pensions. Events in the private sector thus have implications for the demand for Commonwealth Rent Assistance and State/Territory provided private rental support programs.

Secondly, private rental market performance in providing affordable and stable housing can impact directly on tenants' well-being physically and psychologically (Morris et al 2005), and rental cost and supply may affect national and state social policy programs such as increased access to labour markets, spatially-specific employment generation, and reduced public expenditure on public housing.

Thirdly, the private rental market functions in a wider housing system context. What happens in private rental housing in terms of costs to tenants can have effects on entry to home ownership by influencing the capacity to save deposits, demand for public housing if conditions are not adequate or appropriate, and even levels of homelessness if people are excluded from private rental housing, for example via tenancy databases, without alternative options being available. The supply of lower cost private rental housing is important in the context of ongoing public housing reform agendas.

Finally, and significantly for this research, the private rental sector represents an investment opportunity to some 7% of adult population, and attracts some overseas investment in the domestic economy. The sector delivers investment returns to individuals and others, providing a means of wealth generation and financial planning for retirement. Perceptions and realities about the desirability and profitability of rental housing investment significantly affect the levels and location of supply, and the overall propensity to invest and provide rental housing. Private rental housing also acts as an important market for the development, construction, finance and real estate industries. Events in the sector can have important implications for the stability of the whole residential housing market.

1.3 Research themes and questions

This study has been conceived around four broad topics, as follows:

1.3.1 Investor motivations

- What motivations do investors identify as key factors in their investment decisions, and do those motivations change over time?
- How do investment motivations vary according to discrete groups or types of investors and scale of investment holdings?
- What role does location play in motivating rental investment within metropolitan areas and between metropolitan and regional areas? Do motivations of investors vary according to different types of housing market?
- Do particular groups or types of investors focus on specific cost segments of the market? Do any target their investments towards the lower cost end of the market? What are their main reasons for doing so or not doing so?
- Are there critical differences between post-2000 investors, and those who invested in earlier periods, including but not limited to those who have been investors for a longer period of time?
- Has the post-2000 boom in rental investment involved existing investors expanding their property portfolios, or has it attracted groups or individuals new to property investment? If the latter, what motivated them to choose to invest in residential property?
- What role do Government incentives (eg tax concessions and negative gearing) play in motivating investors to purchase properties for rental purposes compared to other potential factors?

1.3.2 Investor expectations and experiences

- What expectations do property investors have of rental returns, capital gains and other benefits? Do investors believe such expectations have been met, and how have they changed over time? Have expectations influenced their future investment intentions?
- What expectations do rental investors have of the costs associated with tenancy management? To what extent do investors use professional managers versus more informal management arrangements? What experiences have investors had of tenancy management in terms of professional property managers and tenants? Have these experiences influenced their future investment intentions?
- What sorts of legal and financial instruments have investors used to enter the rental market? What were their experiences of lending institutions and sales agents?

1.3.3 *Investor behaviour*

- How can we understand the behaviour of rental investors with reference to investment motivations, and to what extent is their behaviour influenced by initial expectations and ongoing perceptions and experiences?
- How do investors select the area and type of housing they invest in?
- What drives investment into or out of specific segments of the rental market?
- How has investor behaviour been impacted on by recent property cycles? How have these impacts varied across different types or groups of investors, cost segments and housing market location?

1.3.4 *Institutional context*

- What changes in the institutional environment helped to create the upsurge in private rental investment?
- What new lending products were created and how did these products work?
- What was the role of investment brokers and spruikers in shaping attitudes to residential investment?

The study also seeks to consider the policy implications of research findings and knowledge gained in respect of the above questions. In particular, the study aims to conclude with an analysis of the implications for the future supply and management of lower rent private housing, and the future prospects for lower cost rental investment, including the range of policy options which might exist for governments to preserve existing investment and/or attract new supply at the lower cost end.

There are certain methodological challenges associated with attempting to conduct primary research with individual investors, concerning the recruitment and willing involvement of participants. In testing out solutions to these challenges, the project will seek to apply a variety of research methods, and will adopt creative and experimental approaches to securing the direct involvement of investors. The study will concentrate on metropolitan and regional rental markets in five States: Queensland, NSW, Victoria, Tasmania and Western Australia.

1.4 Structure of the Paper

The remainder of the Positioning Paper has been structured as follows: Chapter 2 considers the policy and institutional context in which rental investment occurs, and analyses relevant housing policy considerations, taxation issues, the finance sector, and the impact of property and tenancy law on rental investors. Chapter 3 reviews previous research into rental investors / landlords, and looks specifically at what earlier studies have suggested about patterns of rental investment, the characteristics of rental investors and their reasons for investing in rental housing, before outlining previous taxonomies of landlords. Chapter 4 outlines some important issues regarding conceptualizing the investment behaviour of rental investors, and how we might better understand investor decision-making, before suggesting a theoretical framework for this. Chapter 5 concludes the Positioning Paper by explaining how the main part of the study will be conducted.

2 POLICY AND INSTITUTIONAL CONTEXT OF RENTAL INVESTMENT

2.1 Introduction

Before looking more systematically at landlords and their investment decision-making, it is important to review the policy and broader institutional environment in which rental investment occurs, and which investors must operate within. There are two key components of the institutional environment. The first is the policy context, embracing housing policy; taxation, charges and other costs; property law; finance provision issues; and planning. The second and interrelated one is that of the residential property market, and the drivers of demand and supply in the market.

2.2 Housing policy considerations

The private rental sector has always been a key tenure in the Australian housing system. While it did decline substantially in the post war years it never took on the marginal status of the UK or a number of European countries. As documented by Yates (1996), Beer (1999), and Berry (2000), the private rental sector has never fallen below 20 percent of the stock in the post war years despite a change in the nature of function over these years. For much of this period it was both a tenure of transition - a holding point for households waiting to move into ownership - and a tenure of last resort, housing the poor who could not get into the public housing sector (Yates 1996; Jones 1973). In the last decade or two, it has also become a long-term tenure for households unable or unwilling to access home ownership.

Today, the private rental market is a significant part of the Australian housing system. It is where the bulk of non-aged low to moderate income households reside, and is the largest single (and majority) source of households entering public housing. Traditionally, the private rental sector was viewed as a transitional tenure, but its nature and role has changed over time. A more complex array of 'housing pathways' (Clapham 2002) are now evident, involving transitions into and out of private rental housing, with significant proportions of tenants renting for extended periods. An increasing proportion of renters in the private rental market now see renting as their only option.

The Introductory chapter of this paper has already mentioned several of the key considerations regarding the policy implications of private rental sector phenomena. Perhaps the crucial point to re-emphasise is that federal and state housing policy is becoming ever more reliant on the private sector to provide housing for low-income consumers. This policy direction is being driven by a number of factors, including funding constraints for social housing, and also by assumptions about the capacity of the private rental sector. However, while the supply of rental stock *per se* appears quite healthy, there is evidence of significant market failure in the private rental sector, particularly around the supply of lower cost housing (Wulff et al 2001; Yates et al 2004; Morris et al, 2005). In examining the motivations and behaviours of rental property investors, this study may help in better understanding the factors which determine the supply of such accommodation.

2.3 Taxation and charges

There are three elements of taxation which impact directly on the rental investment environment: the ability to claim losses including interest on mortgage payments against income (negative gearing), capital gains tax, and depreciation on construction and improvements to a property. It should be noted that the two key income tax benefits, namely the concessional treatment of capital gains and negative gearing which are available to rental housing investors are not housing investment specific. They are also available, to varying degrees, to investors in equities and other forms of property. The general income tax concessions provide an opportunity for investors in rental property to 'reduce tax', albeit in a way that may distort investment allocation and relativities. Whether such access to the available tax benefits is a significant motivating factor for an individual to invest in rental residential property becomes an issue that has important policy implications for the provision of an adequate and affordable supply of housing.

In addition to these tax considerations, there are also several other costs and charges which rental investors will incur in the process of acquiring and owning residential rental property. A key question regarding these outlays concerns whether they act as a disincentive to providing rental housing, and/or whether they add significantly to the costs of rental housing provision, and thus represent a barrier to the provision of lower cost housing in particular.

2.3.1 *Taxation of capital gains*

Capital gains tax on rental investment applies to proceeds from the sale of the dwelling, and was introduced in 1985 to apply to properties purchased after that date. Up until July 2000, it was calculated at the effective marginal rate of tax in the year of sale, but was indexed so that tax only applies to real, that is post-inflationary, profits. By definition, capital gains will only be realised where property values increase, and where there is a market to sell to, so the proportion of investors who are liable for capital gains tax may vary according to market conditions.

Under the present tax arrangements, calculations for capital gains taxation have now changed. Where previously only real capital gains were taxed, for property acquired after 19 September 1985, individuals only pay tax on half of the nominal capital gain ('50% discount method'). The capital gain represents the difference between the selling price ('capital proceeds') and the cost ('cost base') provided that the property has been held for more than twelve months. This method of calculating the assessable capital gain was introduced on 21 September 1999 when the Government moved from a tax on the full real capital gain i.e. after allowing for the effects of inflation during the period the property was held ('indexation method'). The capital gains tax is payable only when the property is disposed of so that accrued capital gains represent untaxed gains, with 50% of the capital gain added to other assessable income in the year of realization and taxed at the applicable marginal income tax rate. Effectively, individuals pay capital gains tax at half the rate at which they pay income tax so that even for individual investors in the highest personal tax bracket, they will pay no more than 24.25% (including a 1.5% Medicare levy) in tax on their capital gain. Of course, during periods of high inflation taxpayers will be paying capital gains tax on nominal inflation growth rather than real growth such that the perceived advantage for investors of the 50% discount may become more apparent than real.

In a more limited range of circumstances there is a further capital gains tax concession that might be available to some investors, particularly those who are able and prepared to move away from their family home. The capital gains tax provisions provide a capital gains tax exemption where a taxpayer sells his or her family home ('the main residence exemption'). This exemption is extended to allow a taxpayer who ceases to occupy his

or her main residence to choose to continue to treat the home as their main residence even though it has ceased to be so, and irrespective of whether the property has been used to produce rental income (and qualify for offsetting deductions, including interest on borrowed funds) during their absence ('absence provision'). Where the house is used as a rental property it may continue to be treated as the taxpayer's main residence for a period of up to six years. The six-year exemption period need not be continuous and a person can have more than one six-year exemption in respect of the same main residence so long as the residence again becomes and ceases to be a person's main residence. Further, the election for the absence concession does not have to be made until the property is disposed of, even though the taxpayer has ceased to live there.

New South Wales Vendor Tax

A Vendor Tax was introduced in New South Wales in June 2004. The tax involved taxing the seller of investor properties 2.25 per cent of the selling price if the selling price exceeded the cost price by more than 12 per cent. The state government claimed that the tax would raise about \$690 million a year and make some contribution to alleviating the NSW government having to contribute \$3 billion of its GST revenue to other states (Wade and Davies 2005). Ultimately, due to the downturn in the property market, only twenty per cent of transfers were subject to vendor tax in the 14 months following its introduction and the actual revenue for the 2004/5 financial year was \$340 million (Chancellor 2005). After an enormous amount of pressure from the NSW Property Council, developers and private investors, the tax was scrapped at the beginning of August 2005 (Davies 2005).

2.3.2 Negative gearing

There are a number of key deductions allowed for rental property of which the interest costs of a debt-financed rental investment property regardless of the property against which the debt has been secured is the most important. Negative gearing occurs when the interest on the borrowings (together with other deductible property expenses) is greater than the rental income produced by the property. The resulting net rental loss can then be offset against income from any other source with a reduction in personal income tax payable on that other income.

Negative gearing in rental housing is linked to borrowings (gearing), and has a contentious history. In 1985, it was 'quarantined' for new investors, so that off-setting losses from interest payments was restricted to other rental housing costs alone (i.e., not against non-rental earnings). Concurrently, the tax on capital gains post 1985, including those from rental property, was introduced. The quarantining of negative gearing was in response to concerns that the system was open to exploitation. The ability to capitalise profits by off-setting rental losses brought about by high borrowing, but then to realise capital gains in the absence of taxation of such profits, was viewed as encouraging a tax shelter around rental housing investment, of greatest benefit to those on higher incomes (Paris 1985; 1993; Badcock and Browett 1991).

At the time, negative gearing was probably little more than "a relatively obscure tax avoidance measure" for the majority of investors in private rental residential housing (Hayward and Burke, 1988), although it was estimated that in 1982-83, just under 100,000 tax payers made use of negative gearing for rental properties generally (that is, residential and commercial combined) (Badcock and Browett, 1991). The policy of restricting the use of negative gearing was subsequently reversed in 1987 by the Federal government, anxious about the alleged adverse effects its quarantining was having on rental investment. However, capital gains tax remained to capture real appreciation in property investment values. The reinstatement of full negative gearing was a key promise during the national election that year, and as Hayward and Burke

(1988) and Badcock and Browett (1991) argue, this policy retreat was due more to successful political campaigning by the Real Estate Institutes of NSW and Australia, than to overwhelming evidence of disinvestment.

Unfortunately, the policy reversal that produced the reintroduction of negative gearing coincided almost exactly with the 1987 stock market 'crash', and resulted, initially at least, in a boom in residential property investment and property prices in Sydney (Hayward and Burke, 1989). In fact, the reality was that there was no obvious immediate reduction in investment that could not be explained by cyclical variations or other influences, and given the nature of the quarantining policy, nor should there have been (Hayward and Burke, 1988). Most industry analysis of the effects of negative gearing restrictions was also confined to Sydney, overlooking opposing trends occurring in other capital city rental sectors (Badcock and Browett 1991). The effect of the quarantining and the political campaign was to bring an awareness of the existence of this particular provision which it had never had before, and in the process it drew attention to rental investment for a wider range of potential investors.

Currently there are no restrictions on the application of negative gearing, notwithstanding the observation of the Reserve Bank (2003) that negatively geared rental properties will generally not become cash-flow positive for a number of years, if at all. Traditionally, property investors prefer fixed interest only loans to maximize tax deductible payments and a negative gearing strategy will be most tax-effective for investors paying the highest marginal rate of tax. Recent Australian Taxation Office (the ATO) data provides evidence of the increasing interest of investors in the rental property market. In an address on 28 February 2005 by the Second Commissioner, J. Grainger, it was advised that for the second successive year the ATO had seen year-to-date growth in net rental losses of 65%. For the 2003 financial year, over 1.3m taxpayers had declared rental income of \$13.7bn and claimed rental deductions of \$14.9bn. That trend had continued into the 2004 financial year with one million taxpayers already returning rental income of \$9.5bn while claiming \$11.8bn in rental deductions.

Many investors will surely still use negative provisions, even if it is merely to mitigate poor cash flow, while anticipated capital gains are accrued. Theoretically, negative gearing will be of greatest benefit to those on higher incomes references, as the offset discount on other income will be calculated at the rental investors marginal rate of taxation (Badcock and Browett 1991). Indeed, Wood and Watson (1999) argue investors with high marginal tax rates will tend to invest in higher cost dwellings to maximise taxation benefits of negative gearing. Thus, the higher the tax rate, the greater the advantage. ABS data suggest that negative gearing is the largest single factor taken into account by rental investors in the first year of investment¹, although it was not as prominent as a factor nominated by longer standing investors for why they had invested in private rental housing (ABS 1998b 8711.030.001).

Yates (1996: 39) claims that because negative gearing benefits are delivered through the income tax savings, they establish "an incentive for investment which varies more with the characteristics of the landlord than with the characteristics of the investment property". While perhaps an accurate assessment in terms of who *intends* to make use of negative gearing, this does not necessarily apply to who actually ends up making use of it. Historically, given the varied nature of rental investors and reasonable rates of capital gain, negative gearing may not have had a significant impact on investment levels. However, most analyses of negative gearing were conducted in the late 1980s and early 1990s. Little subsequent research into negative gearing has been undertaken, in part because of the inability to obtain data on the level and destination of the forgone taxation revenue.

¹ Speaking of the growing awareness of negative gearing, Yates (1996 p.45) has previously suggested that, "One plausible argument is that the furore over its temporary abolition in 1985 served to inform investors of the potential gains to be made."

Yates (1996: 45) also highlights, “concerns over whether negative gearing is a cost-effective method of increasing or sustaining the supply of low-cost rental housing”, and similar points are made by Badcock and Browett (1991). On the other hand, Paris, over the years, has consistently argued that negative gearing has, in fact, been central to the viability of private rental housing investment (1985: 12), and that “...If this tax break had not been available, then the supply of private rental accommodation may have been much less” (1993: 181-2).

In its Draft Report the Productivity Inquiry into First Home Ownership (2003, pages x and xxi) formed the view that the interaction of the concept of negative gearing and capital gains tax provisions, combined with high marginal tax rates, had encouraged the high recent (post 1996) investment demand for residential housing. Although these provisions are not necessarily housing specific, a discussion paper prepared by Applied Economics for the Association of Certified Practising Accountants (CPA) Australia concluded (2004: 11) that “...the way in which the provisions work and the special characteristics of the housing sector are such that the distortions appear to be significantly larger in the housing sector than in other sectors.”. The REIA however do not ascribe to these views and see the growth in rental investment explained by other factors (REIA 2004: 5).

For a negative gearing exercise to be successful in creating wealth the investor needs to achieve an after-tax capital growth in the property greater than the sum of the after-tax cost of the net rental losses incurred while holding the property.

2.3.3 *Depreciation and general tax charges and deductions*

In terms of the Goods and Services Act (GST), the rental of private residential properties is input taxed, meaning that GST is not charged on residential rents regardless of the registration status of the owner and regardless of whether the owner landlord owns multiple properties. The owner cannot claim any input tax credits for the GST paid on any taxable supplies acquired for the rental property (e.g. repairs and maintenance, agent commission etc.). Generally, the sale of residential premises is either input-taxed or not subject to GST as the owner vendor would not be required to be registered for GST.

Depreciation is probably of limited importance in the overall picture of rental investment economics as it only applies to new properties or ones where there is substantial improvement. Historically, most investors in Australia have purchased an established property for which capital works depreciation allowances are not relevant although the boom in new inner-city apartments in recent years has created the opportunity for more investors to receive this benefit.

The rules in this area are quite complex and relate to the timing of construction. Every income producing residential building where construction commenced after 17 July 1985 qualifies for a Division 40 or 43 capital works allowance. The amount of the allowance depends on the date construction commenced. Buildings where construction commenced between 18 July 1985 and 15 September 1987 are entitled to the 4% claim per annum with the claim being reduced to 2.5% for buildings that were constructed after 16 September 1987. The claim is allowable on the actual construction costs of the building not the actual purchase price and is variously estimated at between 10% to 20% of the value of the investment property. Because new property depreciation and capital works write-downs are non cash items investors are able to gain a tax deduction for money not actually outlaid other than that of purchase. Like negative gearing this is attractive to investors who are looking for tax deductions to minimise the amount of income tax that would otherwise be payable.

In addition to the interest on debt-financed rental properties, investors are entitled to deductions for certain expenses incurred for the period the property is rented or available for rent provided the expenses are not of a capital or private nature. Revenue expenses such as council rates, land tax, repairs and maintenance, real estate agent commission, travel costs to inspect the property etc. are potentially deductible.

Effective from 1 July 2001 deductions for depreciation fall under the Uniform Capital Allowances regime ('UCA'). Depreciating assets in a rental property are those assets that satisfy a separate functional test and are not regarded as part of the structure of the rental premises e.g. carpets, window treatments, hot water systems, furniture etc. Broadly, the deductions are based on the effective life of the asset and are calculated using either the prime cost or diminishing value method. Where the rental activities do not amount to the carrying on of a business an immediate deduction is available for depreciating assets costing \$300 or less.

2.3.4 Property transaction and ownership costs

In addition to these tax considerations, there are also other costs and charges which rental investors will incur in the process of acquiring and owning residential rental property.

In purposefully acquiring residential property for rental, rental investors will incur specific property transaction costs. The main taxes and charges are Stamp Duty (or its equivalent) on the purchase contract, and in some states Mortgage Duty and Land Titles fees. The largest of these is Stamp Duty (now officially known as 'Property Transfer Duty' or variations thereof in most states), which is calculated on the overall value of the property being purchased. Specific rates and policies vary between jurisdictions, but some example rates of duty in the five study states are provided in Table 2.1. As these data suggest, Stamp Duty is a relatively significant one-off cost, but is not exclusive to rental investment acquisitions; it is common to all residential property purchases. However, in the case of rental investors, it can be claimed as an expense for tax purposes.

Investors, in common with other purchasers, are likely to incur other, more minor costs associated with property acquisition, including conveyancing fees and other taxes, such as Mortgage Duty².

² Victoria has now abolished Mortgage Duty. NSW and Qld still apply Mortgage Duty, which would be approx \$2,000 on a \$500,000 mortgage.

Table 2.1: Examples of Property Transfer Tax/Duty applicable on residential property in NSW, Victoria, Queensland, WA and Tasmania

<i>Dwelling Value</i>	<i>\$150,000</i>	<i>\$250,000</i>	<i>\$500,000</i>
NSW	\$3,740	\$7,240	\$17,990
Vic	\$4,660	\$10,660	\$25,660
Qld	\$3,975	\$7,225	\$15,975
WA	\$3,200	\$8,200	\$20,700
Tas	\$3,175	\$7,550	\$17,550

In terms of ongoing expenses, as well as the cost of servicing a mortgage and budgeting for maintenance, rental investors must pay local government rates, and may also be liable for land tax and/or body corporate fees. Land Tax is levied on the estimated unimproved value of land holdings, and whilst there is usually an exemption for the principal place of residence, all other property holdings will count in assessing the applicable rate for a given year. A minimum threshold generally applies, which varies across jurisdictions (in Queensland for example, it was \$450,000 as at 30 June 2005, but a lower threshold applied in Victoria), and land values are normally averaged over more than one year, but values are treated cumulatively rather than individually, and the rate of land tax rises rapidly with higher combined values. Table 2.2 illustrates how land tax applies across different or cumulative land values.

Table 2.2: Example Annual Land Taxes in NSW, Victoria, Queensland, WA and Tasmania

Land Value (cumulative)	<i>\$150,000</i>	<i>\$250,000</i>	<i>\$500,000</i>	<i>\$1,000,000</i>	<i>\$1,500,000</i>
NSW	\$0	\$0	\$2,616	\$11,000	\$19,606
Vic	\$0	\$250	\$800	\$3,680	\$10,230
Qld	\$0	\$0	\$750	\$6,125	\$13,500
WA	\$0	\$180*	\$1,185*	\$6,360*	\$14,460*
Tas	\$600	\$1,287.50	\$4,387.50	\$16,082.50	\$28,587.50

* Plus 0.15% of the land value for the Metropolitan Region Improvement Tax in the case of WA metropolitan land.

NSW has some specific exemptions from Land Tax for Boarding Houses, and 'Low Cost Accommodation' – defined as a rental housing under a formal residential tenancy agreement where the rent was no more than \$165 for a 1 bedroom dwelling; \$221 for a 2 bedroom dwelling; \$276 for a 3+ bedroom dwelling.

Body corporate fees will be incurred in the case of dwellings in multiple occupancy structures, such as units, flats and apartments. These fees are intended to cover the costs of maintaining common areas, such as gardens and access-ways, and for major structural repairs to the building. In many instances, the annual charge is relatively modest, but in some, particularly recently-built inner city high rise apartments, fees are significant. They are also in addition to any on-site management fees which apply for separate tenancy and residence management.

As with property acquisition expenses, land tax and other ongoing charges can be claimed as deductions from other taxable income.

A key question regarding these initial or ongoing outlays concerns whether they act as a disincentive to providing rental housing, and/or whether they add significantly to the costs of rental housing provision, and thus represent a barrier to the provision of lower cost housing in particular. With Land Tax in particular, an additional question relates to whether the effects of the tax form either an incentive to invest in lower cost properties, or a disincentive to hold more than one or two properties (or this is largely shaped by other factors).

2.4 Financial regulation (and deregulation)

For the first eight decades of the 20th century, Australian governments were highly suspicious of the finance system. Their fears had been nurtured during the early 1890s and early 1930s when the economy was thrown into deep depression. Bit by bit, governments put in place an elaborate system of regulation that covered not only international exchange rates, but also what different types of financial institutions could and could not do, how much capital had to be kept in reserve in order to meet prudential requirements, and interest rate controls. As a consequence of this elaborate regulatory framework, by the early 1980s the Australian housing finance sectors had become largely insulated from the wholesale money markets.

A string of regulations governed how and at what price banks could raise and lend funds. In Australia, competition within the sector was restricted by the federal government's unwillingness to issue banking licences to foreign banks. Further, a legal distinction was made between trading and savings banks, and other financial institutions (such as merchant banks, building societies and cooperatives) were not covered by the Banking Act. Banks' assets and liabilities were governed by strict controls, they were not allowed to pay interest on overnight deposits or cheque accounts, and legal 'ceilings' prevented consumer and housing loans from exceeding a certain value. For investors, particularly the small investor, this regulated period meant that there was a very limited range of options for obtaining finance and what options there were, for example solicitors funds, were expensive and less secure. It is no surprise that in these years the level of investment in private rental was minimal, especially when compared to what occurred post deregulation.

Throughout the early 1980s the finance system was deregulated particularly on the retail side. By the 1990s the provision of finance for housing was deeply affected by what happened in other parts of the finance sector in general, with all institutions competing for deposits, and all borrowers – whether they be investors, home buyers or car buyers – effectively competing with one another for their share of the funds that are available via their ability and willingness to pay the prevailing rate of interest.

As with the provision of other forms of housing finance (National Housing Strategy 1991: 14-6; Berry et al 1999), competition in the 1990s between lenders, and a relative decline in households purchasing their homes (Yates 1999), has resulted in more choice and greater flexibility for investors around loan arrangements as financiers seek to maintain or secure greater market share. Aggressive marketing from smaller

financiers in the rental investment sector occurred in the mid 1990s (Seelig 2001), during which time banks lost their almost complete domination of the rental finance market for individual borrowers, falling from a share of almost 100% to just over 80% nationally (ABS 5643.0). The competition had many manifestations but can be categorised as ones of new provider and new products. New providers included:

- *'mortgage brokers'* whose task is to match potential borrowers with other financial institutions which have funds available to finance mortgages;
- *'Mortgage managers'* who do not just match borrowers and lenders, but actually go about managing mortgages issued to customers sourcing their funds from mortgage originators (see below) who tap directly into the wholesale money markets; and
- *'Mortgage originator's* who package up a number of mortgages – a process called 'securitisation' – and sell them to participants in the wholesale money markets such as superannuation funds and other fund managers.

As a result, there have been some specific innovations around rental investment finance (a trend also seen in the US; see Malpezzi 1998: 361). One of the banks' responses to competition was to remove the premium that rental investors used to be charged in addition to standard mortgage interest rates to reflect the perceived increased risk with rental investment (Burke 1999b; Seelig 2001). Partly to respond to new consumer needs and partly to compete with the new providers, bank and credit unions started to offer new products or more widely promote products which had been around previously but only available to a limited client groups. These products included:

- *Fixed rate loans.* These emerged to deal with concerns around the high level of interest rates between 1989 and 1991. At this time, the main worry for buyers was the impact on household budgets of an increase in mortgage costs as a consequence of an unforeseen increase in interest rates. The solution that banks offered was fixed interest loans, in which lenders paid a slightly higher rate of interest than traditional credit foncier loans but had the safety of knowing that their mortgage costs would not rise for the agreed period.
- *Flexible mortgages.* These are distinguished from a traditional credit foncier loan in that they may vary the rates of repayment (enabling loans to be paid off earlier) or be linked to other services, eg mortgage offset accounts, or redraw facilities.
- *Cocktail loans* These are loans are a mix of a fixed rate loan and a variable loan
- *Interest only loans.* Targeted at investors these offer finance where repayments are only of the interest not the principle so that for a given loan e.g. \$200000 repayments are less than they would with a conventional loan.
- *Deposit bonds.* These are a form of finance available to property investment intermediaries to facilitate a sale to the end consumer/investor. They enable the intermediary to buy a property under construction for one percent of the purchase price who then on sells the property. When on sold the full deposit is paid. This type of financial arrangement was used by property investor/advisers to sell investment advice services and property (often without disclosing the adviser was also the property owner).

The range of provider and products meant that small investors now have many more funding options. For rental investment loans, a specified percentage of the dwelling purchase price as a deposit will usually be required. The normal minimum level of equity is 20%, and as with other housing loans, loans in excess of 80% of the purchase

price require mortgage insurance³. However, rental investors can normally use equity they have in their own home as security for an investment loan on a second property. Such arrangements are made possible because most investors either own outright (46%) or are purchasing (30%) their own home (ABS 1998b 8711.030.001). The banks apply the principle of 'all equity against all debt', by combining existing and the proposed loans. For the lenders, this gives a high level of security, as mortgage agreements will normally act as a lien over both the investor's own occupied dwelling as well as the rented dwelling. For rental investors who are also home-owners, this means that a loan equaling the full value of the rental investment dwelling can be offered.

Equity requirements applied by the banks ensure that they are not exposing themselves to excessive risk. In most cases, they would not be lending beyond any estimated underlying value, so the banks' investment is sufficiently protected, and the individual borrower carries the major risk associated with over-priced housing. In his study of the private rental sector in Brisbane, Seelig (2001) analysed the provision of finance for rental investors in the late 1990s. He found that all the major banks claimed to scrutinise each proposed investment before an investment loan was approved. This meant inspection of the rental property, checking of vacancies in the area, reviewing the customer's profile, and valuation by an independent valuer. Providing security for the loan was determined as being sufficient to cover the assessed underlying value of the property, the loan would normally be offered. Whether these sorts of practices were followed in all cases in the mid to late 1990s, and more importantly during the subsequent boom in investment lending is open to question, and will be considered during the present study.

2.5 Property law

2.5.1 Residential Tenancy Legislation

Another important function of government in Australia as far as rental investment is concerned has been the facilitation of private property rights (Sandercock and Berry 1983; Burke 1999a). The ownership of housing provides certain legal rights in terms of dwelling usage and wider property relations (Ball 1983; Hayward 1992). In the case of private rental housing, the ownership of a rental investment property means owning a dwelling that becomes someone else's home. This can lead to tensions, conflict, and disputation between tenant and landlords. As National Shelter (1997b: 4) suggest,

Tenants seek lower rentals, security of tenure and good quality housing in specific locations. Landlords, however, are not primarily concerned with housing provision, but with returns on their investment. Thus their key concerns are likely to include minimising operating costs, flexibility in the use and disposal of their asset, and locating dwellings in areas of high capital gains.

Constitutionally, it is the States and Territories that are responsible for residential tenancy legislation. In most cases, landlord-tenant relations are prescribed under 'Residential Tenancies Acts', which regulate the basic rights and obligations of tenants and landlords. The various landlord-tenant laws in Australia were all originally inherited from the same source: the English law of the early 19th century. Government's main concern at the time was protecting legitimate rights to ownership and possession. Thus when Australia adapted English residential tenancy law for domestic use it was heavily weighted in the landlords favour. It was not until the 1970s that Australian tenancy laws were reviewed in the context of housing conditions and outcomes. Issues concerning the adequacy of landlord and tenant legislation were raised during the

³ While available for rental investment loans, insurance is not available for loans for the purchase of shares, and such loans are subsequently strictly limited to a maximum 80% of value, and often less.

Commission of Inquiry into Poverty in 1975 (Mowbray 1996), where poor conditions and the lack of tenure security were highlighted. However, in practice, it was only in the 1980s or 1990s that legislation was brought more up to date to reflect the changing housing and consumer right realities post the nineteenth century.

Despite the likely structural causes of tenancy disputes (Burke 1998), there is a heavy reliance on tenancy law to provide equity in landlord-tenant relations in Australia (Seelig 1997; 2001). Tenancy protection in Australia today is based on principles of basic health-related housing standards, minimum notice periods for 'no cause' eviction, and limits on the frequency of rent increases (Kennedy et al 1995). Residential tenancy law in Australia has invariably sought to 'balance the interests of tenants and landlords' rather than to provide strong rental consumer protection (Kennedy et al 1995; Seelig 1996). Consequently, arguments about broader legal protections have been limited, and arguably contemporary residential tenancy law is still weighted in the landlord's favour.

By international comparisons, tenants in Australia receive relatively little protection through tenancy law. In general, Australian tenancy legislation does not regulate the value of rent levels (as it does in many of the largest US cities experiencing housing stress) nor rent increases. It also does not provide security of tenure to periodic tenants. This is despite research into the nexus between tenancy law and investment in the private rental market, which suggests overall investment in the private rental sector is not necessarily affected by tenancy legislation (Paris et al 1991; Kennedy et al 1994). The vast majority of investors do not consider tenants' rights as something that impacts on their investment, because in the main, the scope and extent of legislation is such that landlords economic interests are not affected. However, this may depend on the type of rental investor is under consideration (Brian Elton and Associates 1991), and may reflect the kind of tenancy legislation currently enacted in Australia. Nevertheless, from the viewpoint of landlord investors this is a much more attractive policy environment than exists in other countries. Whether it is a policy environment now out of step with the nature of the private rental market is a different question.

One of the central characteristics of Australian property exchange is that established dwellings for sale are often placed into an open market, where current and aspiring owner-occupiers, and potential investors, are in direct competition with each other. During the life of a property, it may be consumed as both owner occupied and as private rental, and this has major legal implications for both owners and occupants of private rental housing. As Burke (1999b: 8) suggests,

.... this has required residential tenancy legislation in the various states to recognise the landlord's right to make decisions as to whether the property is to be used for owner-occupation or rental ... the landlord must have the right to sell the property as they please, whether as a rental property with tenant intact or as a potential owner-occupied property without the tenant.

The capacity of rental investors to sell a dwelling with vacant possession is therefore a significant component of private rental dwelling exchange processes (Mowbray, 1996: 272-3). Australia is not alone in this issue being of importance - (Ball (1983: 102), and Whitehead and Kleinman (1986: 73) all refer to the advantages to rental investors in the UK that flow from selling dwellings with vacant possession onto an open market, with every prospect that an owner-occupier will purchase the dwelling. Hamnett and Randolph (1988) in particular point to demand from home-owners, and rising house prices, as factors that have encouraged rental investors to sell with vacant possession to prospective owner-occupiers in Britain.

2.5.2 *Strata Titling legislation*

Strata title is a form of legal ownership of properties which enables a building to be subdivided into 'lots' held by a number of individual owners with owners sharing the rights and responsibilities of the common property, eg, stairs, driveways, etc, but with the freedom to use and dispose of their own lot as they please. It began to be introduced to residential property in the early 1960s progressively replacing company title where the title is in a company made up of the shareholders and collective owners. The latter required that permission to sell or rent out of a property had to be obtained from the company and the company could vet likely occupants. Strata leasehold is a more recent version (late 1980s) where the land may be owned by one owner and the individual properties have title to the properties but not the land.

Strata titling (or condominium legislation as it is known in North America and elsewhere) made investment in residential property ownership much easier. Where company share created restrictions that meant blocks of flats were either all rental (often owned by one or two people or companies) or all ownership, strata title enabled freedom of sale (and purchase) without constraint. Strata titling spread rapidly in Australia to the degree that in the seventies and early eighties there was considerable concern that strata titling was resulting in loss of rental stock as rental units were sold to owner occupiers. However, by the late 1980s this conversion process appeared to be causing less problems than thought and this concern faded away. Such was the acceptance and dominance of strata titling in Australia by the 1990s that it could be argued that the boom in inner-city apartment construction in that decade was one premised on strata titling. It enabled developers to pitch their market at anybody that was interested-not just landlords and not just owner-occupiers.

In the US, where condominium legislation was brought in at much the same time acceptance was slower (Weesup 1987). This of course means that the opportunities for individual investors to buy into a unit were more limited. Investors more often had to buy a whole block of apartments which means that the sector attracts more institutional investors and individual investors.

Thirty to forty years on new strata title issues are emerging which may be shaping the current or future investment decisions of landlords. In a strata arrangements many, perhaps most owners will not see their occupancy of the building as a lifetime commitment and will be reluctant to make, or will defer, any financial contribution other than basic maintenance for upgrading of the property, eg replacement of rooves or plumbing. The result is that many older strata titled building, eg, 1960s 'six packs' are in decline and with little capacity within the bodies-corporate which have to manage them to muster the resources to turn them around. This problem has meant that organisations such as the Property Council of Australia (2003) believe there should be compulsory maintenance plans for strata titled residential buildings to address the problem. As awareness of this problem increases, it will be interesting to see how it affects residential investment decision-making.

The other potential strata title problem relates to new rather than older dwellings rather than old and most notably to the higher rise inner-city apartments. While there is no systematic research around this problem there is anecdotal evidence of an emerging concern which characterised the US condominium industry in its early years and was part of its slow take up (Weesup 1987) and this is the problem of owners, including investors, being met with body corporate fees of a scale disproportionate to the level of investment or the level of rental income.

To what degree investors are aware of either of the above problems will be tested by this research.

2.6 Planning, urban development, and rental investment

Investment can only take place if there is somewhere to invest. In part the boom in investment in the last ten years was enabled by a supply side growth in the apartment sector. Historically planning legislation inhibited multi unit development at least subsequent to the flat boom of the 1960s and 1970s, which resulted in a regulatory backlash with local governments around Australia, exercising greater control through amendment to or interpretation of planning acts. Beginning in the late 1980s and accelerating in the 1990s, some level of deregulation of planning systems took place, much of it premised on the need to provide more multi unit housing.

The actual form of deregulation has varied from state to state, but typically has meant moving from prescription of what could be done to more performance based processes with performance around areas such as streetscape, density, overshadowing, and parking. So long as properties could demonstrate performance they could be built hence the new systems allowed for new forms of multi unit accommodation (specifically the high rise) and more of it.

Planning reforms were not the only reason for the growth in multi unit accommodation in the inner city in the 1990s, market processes were probably more important. They did, however, make it easier for the market to accommodate the growing demand. A growth in multi unit dwellings does not necessarily mean more investment properties (they could be purchased for owner occupation) but combined with the fact that virtually all of the new units were strata titled or strata leasehold the opportunity was there. In the 1990s, the Federal and several state governments facilitated the redevelopment of inner-city areas through the Building Better Cities program. This was presented as a major opportunity to revitalise inner city areas and slow down urban sprawl.

Subsequent apartment development orientated towards small private investors has occurred in various inner city parts of several capital cities. In Sydney, such developments have been dominated by the Meriton group, Australia's largest builder of residential apartments. A key feature of Meriton's marketing is that it offers attractive financial assistance to would-be small investors – "Our offer is a 3 year interest only loan at competitive Meriton interest rates coupled with no valuations or valuation fees, no brokerage fees, no early payout fees" (Meriton Website). Since the success of the Pymont Ultimo development, Meriton has built several thousand more apartments in Sydney's inner city, many of which been purchased by smaller investors using Meriton's financing scheme.

2.7 The Market environment

The housing market and the policy environment are interdependent. However, the market still has drivers which operate separately from the policy environment, including underlying household demand, changes in households' income and wealth (the latter related to property values), the creation of new building and financial products, and changing consumer values and expectations as to property investment versus other forms of investment or savings.. How the market is performing, and the signals that it gives out, will affect the decision making of residential property investors.

Since the late 1990s, Australia has experienced a significant boom in housing market activity symbolised by:

- An increase in real house prices between June 1999 and June 2004 ranging between 98% for Brisbane and 11.8% for Darwin (REIA Property Market Indicators Table 3.7).
- An increase in average residential property loan repayments between June 1999 and June 2004 of 62%. ABS Cat. No. 5609.0, Table 10b).

- An increase in the number of new houses commencements between 1998/99 and December 2004 by 21% (ABS Cat. No. 8750.0, Table 5).
- An increase in the total number of dwellings financed between 1998/99 and December 2004 by 14% (ABS Cat. No. 5609.0, Table 1).
- An increase in the total value of loans (in real terms) between 1998/99 and 2003/2004 of 45% (ABS Cat. No. 5671.0).

This boom peaked in late 2004 and has subsequently stabilised, although as of early 2006 there is some national variation, with Western Australia still sustaining price growth and strong activity, whilst New South Wales, for example, has seen price falls and much more subdued rates of construction and borrowing. Significantly, investment in private rental property made up an important component of the boom. The scale of investment in the sector was unparalleled since the late 1960s, when a huge construction boom in flats in Australia's metropolitan cities took place (Archer 1980).

Although the peak of investment in both rental and owner-occupied property now appears to be subsiding (more so in some states than others), the impacts of these phenomena on issues such as long term housing industry stability and the ability to provide affordable and sustainable dwellings for current and future tenants has not been evaluated. The end of the boom has also created some uncertainty as to the future direction of the property market and this is a factor that no doubt existing and future investors are factoring into current decision-making as to the direction and timing of investment decisions.

2.8 Summary comments about the rental investment context

As this Chapter has indicated, the institutional environment for rental housing investment encompasses the policy contexts and the broader residential property markets in which private rental housing provision occurs.

Whilst the private rental sector is important in housing policy terms, there is little in the way of direct formal housing policy, other than through housing assistance to tenants (CRA). However, rental investment is clearly impacted by other, more 'housing-related' (Paris 1993) economic policy, such as taxation, property and planning laws, and the provision of finance. Taxation in particular is traditionally seen as having a major impact on investors both in terms of being a key driver for investment, and also as an influence on investment outcomes. At the same time, changes to the regulation of the financial sector, and the expansion in lending products has made it easier than ever to secure funds for rental investment.

In summary, it could be fairly said that the institutional environment for rental housing investment is a very positive one in the sense that there are few legal or policy barriers for investors, particularly household-based investors. Over the last few years, Australia has seen a significant boom in such investment, particularly in the inner urban areas of the capital cities, driven seemingly by both increased demand for rental housing, but also high demand for rental investment opportunities.

Before considering more theoretically what might be driving such investment motivations and behaviour, and how this study will seek to pursue those issues, it is worth examining what previous research and analysis has indicated about the characteristics of rental investors in Australia.

3 PREVIOUS RESEARCH INTO RENTAL INVESTMENT⁴

3.1 Overview

To further understand the issues which impact on landlords and the supply of lower cost housing, Chapter 3 of the paper considers previous research into rental investment, and the characteristics of those engaging in private rental housing provision.

A number of earlier studies have suggested that there are several quite distinct types of rental investors (Paris 1984; Paris 1985; Allen and McDowell 1989; NSWDH 1990; Brian Elton and Associates 1991). Their nominated reasons for investment are also varied (ABS 1994 8711.0) and probably dependent on their 'investor type'. Much of the investment in private rental housing is by individual, small time rental investors owning one property (ABS 1994 8711.0). Yates sees this as one reason why the Australian private rental market has remained "robust" in contrast to many European rental sectors (1996: 35), whereas Burke suggests that this is also problematic because it creates difficulties with security of tenure, poor management skills, reduced property standards and levels of maintenance, and a barrier to targeted investment assistance (1998:3-4). As Chapter 2 has highlighted, the policy environment over the years has been largely favourable to small scale investment.

There is no conclusive knowledge of the form or scale of private rental housing investment in Australia (Paris 1984; 1993; Mowbray 1996; Berry, 2000). From past studies, it seems pretty clear that investment has been sustained by individual households rather than by institutional investment. However, small family based partnership and smaller companies are thought to have accounted for around 40 percent of ownership in the early nineties (Yates 1996), and in New South Wales for example, it is presently estimated that small investors account for 80% of NSW's landlords (Needham 2005). There are both practical and methodological problems with identifying landlords and matching them with the dwellings they own. An understanding of the nature of rental investment is therefore constrained by a lack of data, and will at best be based on the impressions that can be assembled from what data, analysis, and theoretical research does exist.

In 1988, private consultants on behalf of the NSW Department of Housing, conducted a survey of private rental investors in that State (NSWDH 1990). Much of this material was also used to inform the work by Brian Elton and Associates (1991) for the National Housing Strategy. This second piece of research sought to extrapolate the NSW data into a national picture of investment in the private rental sector, via industry consultations in capital cities.

More recently, the Australian Bureau of Statistics has conducted two specific surveys of rental investors (ABS 1994 8711.0; ABS 1998a 8711.0), each being part of wider population surveys. This has meant that ABS sample sizes have tended to be small, making it difficult to drill down into the data beyond the national, aggregated level.⁵ Mowbray (1996) has conducted survey research into the nature of landlordism in NSW, using Rental Bond Board and registered property titles data as a sampling frame.

The ABS surveys of rental investors have enabled excellent exploratory work in this area, notably Yates (1996), Beer (1999), Berry (2000) and Seelig (2001). However, the findings of the later survey are now almost a decade old, and may not represent the present reality. Since the mid 1990s Australia has experienced a significant surge in housing market activity, with investment in private rental property making up an

⁴ Parts of this Chapter draw on previous analysis of unpublished unit record file data from the 1997 ABS Survey of Rental Investors ((ABS, 1998b 8711.030.001), conducted by Seelig (2001).

⁵ The 1997 rental investors' survey has a national sample of just 2,249 cases of investment property owners.

important component of the boom and in the process achieving a scale of investment in the private rental market, unparalleled since the late 1960s when there was a huge construction boom on flats in Australia's metropolitan cities (Archer 1980).

3.2 Patterns of rental investment behaviour among landlords

Data from both ABS surveys of rental investors (1994; 1998a), and the NSW Department of Housing study (1990), highlight the relative overall importance of the individual investor and the single rental property owner, although the precise proportions vary in each study, as different methodologies and data were utilised. The relatively low level of corporate investment is, by implication, also highlighted by these data, and the dominance of 'small-time' investment is the traditional delineation projected within recent rental housing literature (Paris 1984: 1993; Yates 1996).

The ABS (1998a 8711.0) found that, in 1997, the vast majority (some 76%) of investors owned just one rental dwelling, and 92.5% owned no more than two. A mere 3.5% of all investors were found to own more than five dwellings in 1993 (ABS 1994 8711.0). Accentuating this picture, the 1988 NSW study had previously found that 82.6% of investors owned just one property. It also reported that individuals represented 64% of all investors, with partnerships making up a further 29%, and companies constituting a mere 6% of private rental housing providers (NSWDH 1990). These data certainly appear to justify a picture of low key investment patterns in private rental housing.

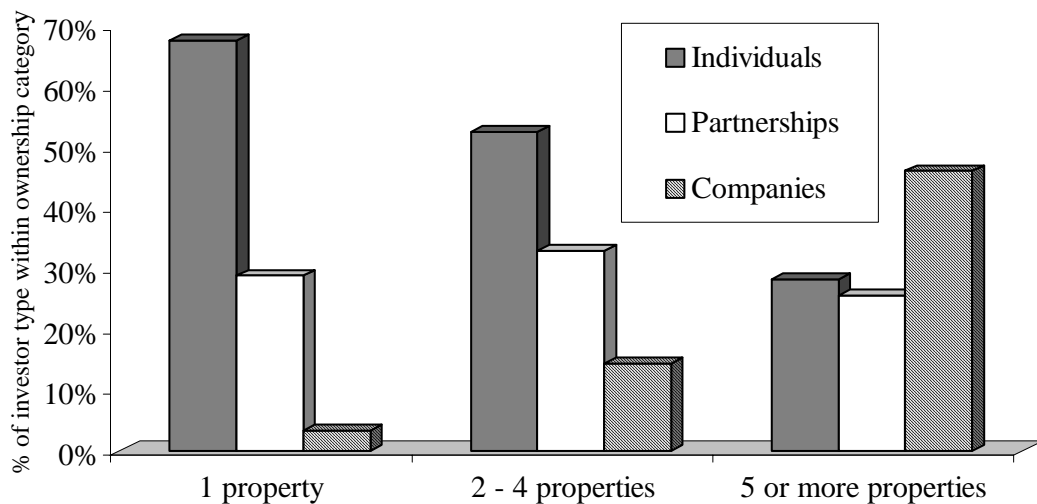
In 1993, the likelihood of owning more than one rental property increased with income (ABS 1994 8711.0), although the data indicated that the increase was slight. More recent data also indicate that the propensity to own more than one dwelling increases with the age of the investor until 65 years of age is reached, when this trend reverses (ABS 1998a 8711.0), suggesting rental investment is as much about benefits while of working age, than it is about income in retirement. Generally, the ABS data suggest that the propensity to own more than one investment dwelling also increases with rent charged on the landlord's first rental property (ABS 1998a 8711.0). Rental investors owning low cost (sub-\$100 per week) rental properties were more likely to own only one dwelling than investors generally. In fact, 85% of 'low cost landlords' owned a single rental property, although the proportion owning one or two dwellings was the same across other rent cost segments other than the highest \$200+ per week bracket (ABS 1998b 8711.030.001).

In terms of the legal ownership arrangements for rental investment dwellings (first investment property owned by reference person), the 1997 ABS survey of investors suggests that most household investors do not operate as formal businesses. Nearly half (46.3%) of landlords operated as an 'Individual', with 35.8% operating in association 'With your spouse/partner'. A further 11.5% did so with another relative. Only 2.9% of landlords operated as a Principal in a company or trust (ABS 1998b 8711.030.001).

Kemp (1988a: 243) refers to "petty landlordism" to describe investment activity in the English private rental market, a description echoed by Berry (2000) with reference to the Australian experience. Overall, this is probably a fair term for the nature and scale of rental investment in Australia, although the existence of some small scale corporate landlords cannot be completely discounted. Berry (2000: 664) asserts that individual rental investors now hold around 60% of total private rental stock, with the balance being held by "small (especially family-based) partnerships and small companies". This still might only portray part of the reality of investment activity in Australian cities, and hidden behind the dominance of the small investor is some evidence of some larger holdings, and limited but discrete minor-corporate property owning, particularly in the city areas (Brian Elton and Associates 1991).

The NSW study found that although individual investors and single property owners were both more numerous than other investors, the proportion of properties they own is less significant. Just over half of the total number of dwellings (55%) were owned by individuals, and a similar proportion of properties were held by investors with only one rental property (NSWDH 1990). In other words, nearly 45% of all rental dwellings were owned by an investor holding more than one property; 20% by those owning five or more properties. Figure 3.1 shows how the total number of properties owned by rental investors divided by investor types and by the size of their investment holdings, suggested by the NSW research, potentially represents a quite different kind of investor in terms of size of holdings. Further, while companies constituted 6% of all private rental housing providers in NSW in the late 1980s, they owned 16% of all properties, and their significance leapt in the 'five or more properties held' bracket, where they owned 50% of the relevant stock and made up almost half of all investors (NSWDH, 1990). The actual size of these companies was not known, and other research has suggested that the very large national and multinational corporations are not prominent amongst rental housing investors (Brian Elton and Associates 1991; Yates 1996; Berry 1999; 2000).

Figure 3.1: Number of properties owned by rental investors, by investment holding size, NSW 1988



Source: NSWDH 1990

There has been little follow-up research since the NSW study into the issue of corporate investment in private rental housing, making it impossible to know the situation regarding the breakdown of investors almost two decades later either on a national level, or in specific cities and regions. This is a pity, as it would appear for example, that companies do indeed represent a different kind of investment player, more interested in larger property holdings. Unfortunately, it is also beyond the scope of the present study, which is focussing on individual investor motivations and behaviour from a qualitative perspective.

Berry has been one researcher who has pursued the issue, and he argues that institutional investors are "largely absent" (2000: 668) from the rental market. Similarly, Yates (1996: 48) has argued that the private rental sector in Australia "... has not been supported by the actions of corporate or institutional investors". Berry claims that the Australian situation is in contrast to many other industrialised countries, although van der Heijden and Boelhouwer (1996) highlight the decline in the individual rental investor, and the greater role that corporate and other larger entities can play in European private rental markets, and Crook (1998) makes reference to the dominance of small scale landlordism in Canada. England is one exception to this (van der

Heijden and Boelhouwer 1996: 24), where 60% of lettings in the early 1990s were owned by investors with five or more rental dwellings (Crook and Kemp 1996).

Berry (2000; see also Berry 2001) examines some of the barriers to institutional investment in Australia, and lists six main barriers that mitigate against institutional equity investment in private rental housing in Australia. These are low returns, high risks, high management costs, illiquidity, poor market information, and a lack of track record (Berry 2000: 672-4). Burke (1999a) argues that the growth of strata titling has provided a barrier to institutional investment by virtue of limiting the capacity of institutional investors to control any one property and therefore impacting on risk and management costs. Berry explains that, despite a number of previous attempts to initiate institutional investment in private or social housing (Yates 1997; Berry 2000; 2001), little movement has been achieved in securing the large corporate dollar into either rental sectors.

3.3 Characteristics of rental investors

The personal characteristics of rental investors in Australia have been identified in several pieces of research which have drawn on or supplemented ABS survey data (Yates 1996; Dalton and Maher 1996; Mowbray 1996).

Analysis of the Australian Bureau of Statistics surveys of rental investors (ABS 1994; 1998a 8711.0) reveals the types of person (household or income unit) that has invested in private rental housing. According to the more recent data, 144,000 Queensland income units, or 9% of all income units in the State, owned investment properties in 1997. This is the highest rate of any State, and is significantly more than the corresponding rates of 5.2% in NSW and 6% in Victoria.

ABS data from the last rental investors survey (1998a 8711.0) indicate the vast majority of investors live in couple-based households, and investment rates peak in middle age, although landlords are distributed throughout adult age cohorts. The age pattern of investors as a whole differs quite dramatically from the age spectrum of the general adult population, with investment peaking in the 45-54 age category (ABS 1998a 8711.0). Across age cohorts, the age distribution of low cost landlords is not hugely dissimilar to that for other rental investors, although there is a very small bias among low cost landlords towards older age (ABS 1998b 8711.030.001). Most investors (71%) were born in Australia (ABS 1994 8711.0).

The main source of income for two-thirds of investors was wages and salaries from an employer. However, for landlords of low cost housing, the rate was lower at just over 50%. Income from own business or partnership was a significant principal source of earnings for low cost investors, and income from rental investments may account for much of this. Greater proportions of such landlords were also reliant on superannuation or annuities. Not surprisingly, lower cost investors were thus more likely than other landlords to be outside of the labour force, although 80% of all low cost providers were actually in employment (ABS 1998b 8711.030.001).

According to the 1994 ABS rental investor data, nearly one quarter of investors earned less than \$240 a week, 44% had a weekly income below \$480, and just under two thirds of all investors earned less than \$37,500 per annum (ABS 1994 8711.0; NB nominal dollars). This material suggested that a significant proportion of lessors were on low to middle incomes. However, the more recent data from the 1997 survey suggested a quite different picture of investor income levels. Focussing on gross income ranges, broken down according to quintile groupings, the data indicated a far more even distribution of investor incomes across all quintiles, and that 70% of investors nationally earned more than \$44,876 per annum (ABS 1998b 8711.030.001;

NB nominal dollars). This suggests that many investors' incomes are higher than previously thought.⁶

As Table 3.1 indicates, most landlords bought their first property purposefully as an investment, with almost 60% doing so through a mortgage or loan, and a further 10% purchasing outright. However, a quarter of landlords used their previous home, and a small percentage inherited the premises being rented out. The same data (ABS, 1998b 8711.030.001) suggests that low cost landlords were more likely to have inherited the dwelling than investors in general. They were also nearly twice as likely to have purchased the rental investment dwelling outright than other landlords.

Table 3-1: How principal dwelling originally acquired

Previous own home, now rented	25.1%
Bought with mortgage/loan	59.4%
Bought outright	10.4%
Inherited	3.7%
Other	1.4%

Source: ABS, 1998b 8711.030.001

Just under half of all rental investors were situated relatively close geographically (in the same Statistical Local Area of Statistical Subdivision) to their rental dwellings. Only 11.5% of property investors nationally owned dwellings that were situated in another state (ABS, 1998b 8711.030.001).

It should be noted that because neither the 1994 nor the 1998 surveys of rental investors have attempted to identify the characteristics of corporations that are residential landlords, the demographic material above relates to individuals and income units who are rental investors. Such material tells us nothing about companies and corporations that may own or manage private rental housing portfolios.

3.4 Reasons for investing in rental housing and factors considered

The previous analysis may, inadvertently, have implied that the actions of landlords are all based on conscious decisions to invest in rental property, or to become the providers of private rental housing. However, Core Consultants (1983), Paris (1984), the NSW Department of Housing (1990) and Brian Elton and Associates (1991) have all drawn attention to the unintentional or temporary nature of some rental investment. Some private rental housing providers could be considered as 'accidental landlords' in that they become landlords by means other than deliberate and intended entry into the rental sector. Brian Elton and Associates (1991: 85-6), for example, argued that,

... rental investors are a highly heterogenous group. Their motives for investment and withdrawal from rental investment are sometimes economically logical and rational, but often they are not. A large proportion do not take a conscious investment decision, but become landlords by reason of personal circumstances.

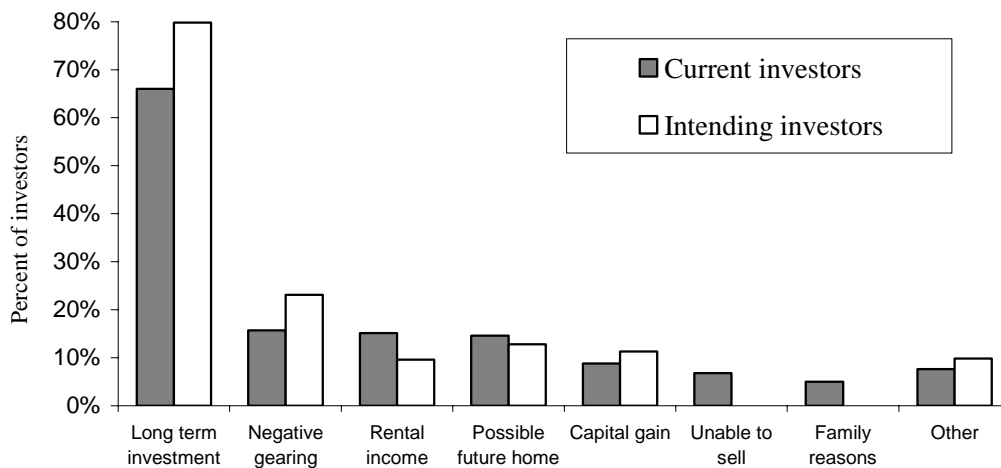
⁶ The accuracy of investor income information is tempered somewhat by the high levels (almost a quarter) of 'not stated' type responses. Nevertheless, this is a significant and noteworthy change from earlier data that cannot be explained by wage inflation alone, and indicates that investor incomes overall are likely to be higher than previously thought.

Previous studies of rental investors (NSWDH, 1990; Brian Elton and Associates, 1991) have identified distinct economic factors connected to the ongoing supply of formal private rental housing. These include cash-flow benefits flowing from rental income, capital gains from property values increasing over time, 'equity' profits derived from attaining substantial or outright ownership of the property, and taxation benefits from off-setting rental losses or reducing other taxable income through negative gearing and depreciation. In their surveys of rental investors, the ABS has also identified a number of different financial reasons for why people invest in rental properties.

Yates argues that "Investment in rental housing has been undertaken by (most) investors because they believe it to be a long-term, secure investment which supplements their investment in owner-occupied housing" (1996: 48). This is clearly borne out in the ABS data. As Figure 3.2 shows, in terms of motivational factors, return over the longer term is clearly of greatest importance to rental investors. 'Long term investment' was nominated by almost two-thirds of current rental investors, and 80% of intending investors when surveyed in 1997. Although "potential for capital gain" is only directly nominated by 12% of investors, long term investment clearly implies making a profit upon sale of the dwelling, and this is usually achieved by the capital gains made, further emphasising the property value aspect of investment over an income stream. "Income from rent" does not feature highly as a significant reason for investment, representing 15% of current investors and only 9.6% of those intending to invest (ABS 1998b 8711.030.001). While less than 16% of existing investors in 1997 cited "negative gearing" as a reason for investment, representing a slight increase over the previous survey data, close to one quarter of intending investors nominated this as a consideration (ABS 1998b 8711.030.001).

One of the problems in analysing these ABS data is the interpretation of choices investors were offered in the survey, and the structure of the actual question. For example, what does 'long term' mean to investors, and are 'negative gearing', 'income from rent' and capital gains equivalent investment categories that can be included in the same question as long terms investment? It could be argued that there has been a conflation of objectives and causes of rental investment motivations, which limits the capacity to adequately understand those motivations.

Figure 3.2: Reasons for rental housing investment: existing and intending investors 1998

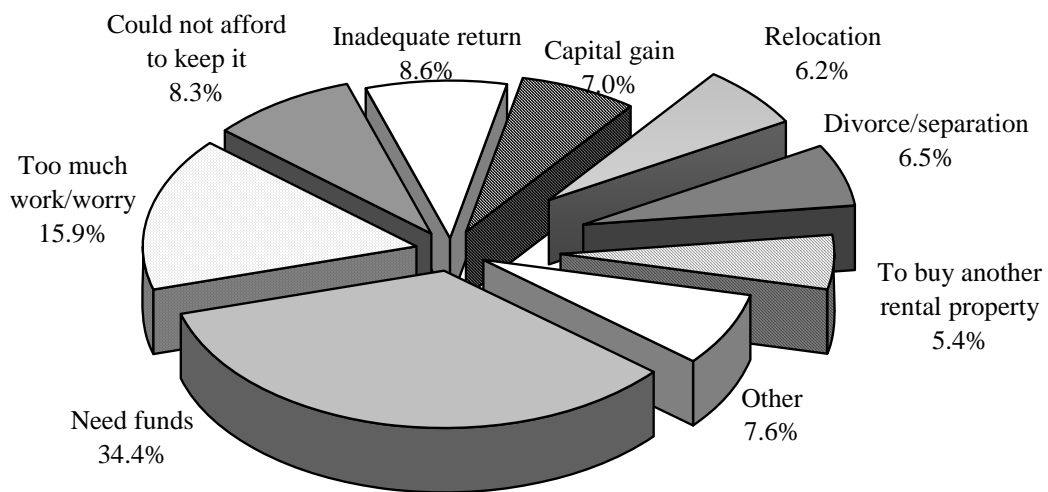


Source: ABS 1998a 8711.0

Note that totals will add up to more than 100% as multiple answers provided

ABS rental investment data do not reveal how long rental investors hold onto their property investments, although some information on when properties, available for rent in June 1997, were first acquired is provided (ABS 1998a 8711.0). Across all investors, the majority of properties (53%) were acquired within the last 3 years from the date of survey, and length of ownership declines as the length of time from June 1997 extended. This implies a very high rate of turnover. In June 1997, 201,100 investors had sold their rental properties in the preceding 2 years (ABS 1998a), although during the same survey just under 204,000 income units indicated their intentions to invest in private rental housing.⁷ The need for funds was the largest single reasons private rental housing providers provided to the ABS for selling their investment property in 1997. As Figure 3.3 indicates, aside from this reason, a plethora of other factors were nominated by selling investors, including “inadequate return”, which accounted for 8.8%.

Figure 3.3: Main reason for sale of rental property, investors who sold over 2 years from June 1997, Australia



Source: ABS 1998a 8711.0

Low cost private rental housing providers were less likely to have disposed of rental investment dwellings than other landlords (6.7% of low cost landlords had done so, compared to 10.6% overall (ABS 1998b 8711.030.001)). However, such landlords were much more inclined to sell their first investment property in the following two years from 1997. Of rental investors overall, 68% had no intention to sell, with 16% having such intentions, and a similar proportion undecided. As Table 3-2 illustrates, 21% of low cost landlords had clear intentions to dispose of their rental investment dwelling, and a further 14% were undecided.

⁷ Such a balance of acquisitions and sales will be sensitive to the prevailing conditions in the housing market and wider economy, and what may have been the case in 1997 cannot be assumed to always be so in other times, past or future.

Table 3-2: Intentions to sell first investment property in next 2 years (1997)

	\$1-99	\$100-149	\$149-199	\$200+
Intends to sell property	21.3%	15.8%	17.4%	12.7%
Doesn't intend to sell property	64.4%	67.1%	67.2%	72.5%
Unknown/maybe	14.3%	17.0%	15.4%	14.9%
Total	100%	100%	100%	100%

Note Reference person only

Source: ABS 1998b 8711.030.001

While low cost landlords identified a number of factors for wanting to sell, some of which were shared in similar proportions by other rental investors, one stand-out issue was “Too much work/worry”. One third of low cost landlords intending to sell nominated this as the main reason, whereas a mere 13% of investors overall saw this as the key factor (ABS 1998b 8711.030.001). The ABS rental investors data highlights that low cost private rental housing providers were also less likely to buy investment property in the following two years from 1997 (ABS 1998b 8711.030.001).

3.5 Taxonomy of landlords and the role of purposeful investment

There have been a number of attempts to categorise rental investors in Australia and elsewhere. Previous examples include work by Allen and McDowell (1989), Kleinman and Whitehead (1988), and Whitehead and Kleinman (1988) in Britain, and by Core Consultants (1983), Paris (1984; 1987), the NSW Department of Housing (NSWDH 1990), Brian Elton and Associates (1991), Mowbray (1996), and Seelig (2001) in Australia. All of these studies have suggested there are several quite distinct types of rental investors.

The first significant effort to categorise rental providers in Australia was put together by Core Consultants (1983: 21-4), who constructed three ideal types: Small scale landlords, which incorporated temporary and accidental, and both amateur investors and more-informed investors; Medium scale landlords, representing professional investors with moderate holdings, and Large scale landlords, capturing developers and commercial investors.

Allen and McDowell (1989), using previous work originally by Allen published in 1983, analysed landlord typologies in the UK (Allen and McDowell 1989: 41-5). They provided a critique of taxonomies based on the scale of investment holdings, claiming these are arbitrary and of limited use. Allen and McDowell argued that the motivations of landlords and their investment behaviour and characteristics are much more important. They developed a typology of six groups based on Traditional landlords, Employer landlords, Informal landlords, Investor landlords, Commercial landlords, and Financial landlords (Allen and McDowell 1989: 49-57). Traditional landlords include longstanding private rental housing providers, some charitable institutions and the Church of England. Investor landlords are made up of small scale individuals and partnerships with emotional attachment to their dwellings. Commercial landlords are small scale individuals, partnerships, and companies more detached from the dwelling, and more rational in their investment actions. Larger companies and financial institutions comprise the Financial landlord group.

Subsequently, Paris (1984: 15-18; see also Paris 1987) modified the Allen and McDowell UK-oriented approach, to develop a taxonomy of seven groups for the Australian context. Paris categorised four as 'Landlords', and included Temporary, Employer, Other institutional, and Informal groups separately as such. He describes the remaining groups as Individual investors, Corporate investors, and Owner managers. Later, Paris restricted his original list and argues that the formal private rental sector is made up of "Temporary Landlords, Individual investors, Corporate investors, and Owner managers" (1987: 158).

When research was conducted in NSW to test hypothesised classifications for landlord type and investment patterns (NSWDH 1990), the NSW Department of Housing took a different tack from the earlier approaches, and distinguished between 'unintentional landlords', and a range of different financial investment-driven players, as shown in Table 3-3. Brian Elton and Associates (1991: 50-3) adapted the NSW study taxonomy for the National Housing Strategy, and argued that the private rental sector comprised Informal landlords, Unintentional landlords, Equity-driven landlords, Tax reducers, and Renovators/traders.

Table 3-3: Summary of formal landlord typology from 1988 NSW Study

<i>Investor Type</i>	<i>Key defining characteristics</i>
Unintentional landlord	Persons who have come to own a rental property by chance or through circumstance, rather than by deliberate acquisition
Security investors	Investors who are primarily seeking to receive rental income returns
Tax reducers	Investors who are primarily seeking to reduce other taxable income whilst receiving other returns
Capital accumulators	Investors who are primarily seeking to make capital gains
Rental property owners	Investment company or institution which may be a tax reducer, capital accumulator, or security investor
Renovator/ Trader	Persons who renovate or buy a property to sell on, but who rent out in the first instance

Source: material from NSWDH 1990.

The Elton and NSW studies both emphasise the level of investment diversity in private rental housing. However, one limitation with them is that they tend to focus on the *original* reason or cause for investing, rather than the ongoing motivation for remaining in the private rental investment sector. Berry (2000: 666) points out that it cannot be assumed that so-called unintentional rental investors, estimated variously to represent some 20-25% of all landlords (NSWDH 1990; Brian Elton and Associates 1991), are not affected by the economics of private rental housing, as their choice to remain in the sector may in part be connected to financial considerations. Concurrently, as Chapter 4 will discuss, we cannot automatically assume that all investors act in an economically rational manner or make informed or rational economic decisions (Kemp 1988a: 244). As Brian Elton and Associates (1991: 86) say, "Investors' reactions to changing economic, fiscal and regulatory circumstance are also unpredictable. Actual behaviour does not always match anticipated behaviour."

Yates (1996) correctly highlights that it is the small rental investor that has supported and maintained the size of the Australian private rental sector. Such landlords have a tendency to be less economically rational than other investors in their investment decisions. Financial ambivalence or economic irrationality can mean ongoing supply when objectively it might not be expected:

A significant proportion of individual investors have shown a long-term commitment to investment in illiquid residential property yielding variable but steady long term returns. Institutional investors, however, have been unwilling to invest in residential property on the same terms and conditions. (Yates 1996: 47)

This suggests that it is difficult and perhaps meaningless to analyse landlord motivations or behaviour solely in terms of economics, and landlord typologies primarily based on economic considerations are unlikely to be of much assistance in understanding key cleavages in private rental sector investment. At the same time, the notion of 'accidental landlords' is also problematic, and size of holdings alone is also not sufficient to explain rental investor activity and behaviour.

What is needed is for the actual investment behaviour of landlords to be placed into a broader theoretical context, which accounts for social, economic and organisational factors. A simplified taxonomy of private rental housing providers is essentially required. In the context of Elton's comment, it is possible to build on the work of Core Consultants (1983), Paris (1984; 1987) and the NSW study (NSWDH 1990) to conceptualise the classification of formal landlords and their motivations and investment behaviour.

In his analysis of the private rental sector, Seelig (2001) proposes a simplified taxonomy of rental investors, based around three fundamental groupings⁸: 'Short term or temporary landlords', 'Small-scale private investors', and 'Professional and minor-commercial investors'. Their characteristics are broadly as follows:

- *Short term or temporary landlords* - These will be short term, small scale investors, and they may or may not act according to financial considerations. They will include those aiming to return to the property, and those wanting to sell in the near future.
- *Small-scale private investors* - These will be small to medium scale investors. They will nearly always act according to perceived financial advantages from private rental housing investment, although the specific factors can change over time and location. Although intending to invest for the medium to long term, it cannot be assumed that their economic perceptions or expectations are 'objective' or realised.
- *Professional and minor-commercial investors* - These may range from small to larger scale investors. They will always act according to perceived financial considerations, and are likely to apply more objective viability tests on private rental housing investment in relation to other investments (Seelig 2001).

In many ways, this simplified taxonomy returns to the Core Consultants' (1993) original classifications, except that it separates out the temporary and longer term forms of small scale landlords, and collapses medium and large scale landlords into one category of 'Professional and minor-commercial investors'. It also has much in common with Paris' (1987) refined list of formal private rental sector players. The main perceived financial considerations for each of these three groups will vary considerably, but are likely to be capital gain or rental income, and there are likely to be examples of rental investors seeking one or other form of economic return within each group. However, all may also seek to use negative gearing during their investment phase.

⁸ These specifically exclude variants of 'informal' landlords.

Seelig (2001) also considered where providers of low cost private rental housing might fit into this simplified taxonomy. Based on analysis of the ABS investors' data, he concluded that low cost private rental housing providers are not a homogenous group of investors. In summary, low cost landlords are *more likely* than other investors to own just one dwelling; to be more reliant on income from investment and business sources but to have lower levels of income and to be retired; to have purchased the dwelling outright or to have inherited; to own older dwellings; to self-manage the rental dwelling; to have been a landlord for longer; and to be residual providers in that they would like to get out of the sector but cannot sell. They are *less likely* than other investors to have an investment mortgage; to be interested in long term investment; and to seek further investment acquisitions. While this suggests that some low cost landlords display characteristics and investment behaviour that sets them statistically apart from other rental investors, several of the differences are small. In many other senses, low cost landlords do not stand out from the mass of investors. In terms of the simplified taxonomy of rental investors, it may be hypothesised that low cost landlords would be drawn from both 'Short term or temporary landlords', and 'Small-scale private investors'.

3.6 Other features of investment: management arrangements, mortgages and profitability

ABS Rental investors survey data indicate that across all investors in 1997, more than 60% of dwellings covered by the data were managed by an estate agent. In about 35% of tenancies, the landlord managed the property themselves (ABS 1998a 8711.0). While self-management is of less importance in the private rental sector overall, landlords of lower cost housing are more likely to take on property management themselves, rather than use an estate agent (ABS 1998b 8711.030.001).

The ABS data also indicate that the propensity to use another party to manage a rental investment dwelling is connected to the proximity of investors to their rental properties. Quite logically, landlords are more likely to utilise the services of real estate agents to conduct the rental management the further they themselves are from the rental premises. One side-effect of greater professionalism is higher management fees and charges (author's interviews with estate agents). Some of this additional cost may be absorbed into the investors' overheads, to be claimed as tax deductions, and some or all of it may be passed on in higher rents.

Surveying rental investors in 1997, the ABS found mixed profitability from private rental housing. Of those investors able to report for a complete financial year⁹, 34.3% of investors reported a profit, 12.8% broke even, and 41.8% reported a loss (ABS 1998b 8711.030.001). Some 9.5% of landlords in 1997 made no statement about the profitability of their rental investment. These rates were fairly consistent across rent cost segments. However, they represent an important variation from the (often-quoted) 1993 data, which suggested the following pattern of return for the most recently acquired rental property: a similar proportion of investors reported negative returns (22.3%), positive returns (20.7%) and breaking even (21.1%) (ABS 1994)¹⁰. However, in the previous 1993 survey, just under 36% of investors claimed they did not know what sort of return they had made.

The existence of a mortgage has a significant bearing on whether profits or losses were made by investors in 1997 (ABS 1998b 8711.030.001). Those investors not paying off a mortgage on the rental property were four times more likely to report a

⁹ 14.1% of all investors were not asked about return because their property has been purchased after the start of 1996/97 financial year (ABS, 1998 8711.030.001)

¹⁰ In 1993, three-quarters of investors reporting negative returns indicated that the range of losses lay between \$1 and a little over \$4,000 (ABS, 1994 8711.0).

positive return than those with a mortgage. Indeed, the two key economic variables in rental investment are dwelling prices and rents.

3.7 Summary comments about the rental investor characteristics

There have been a number of attempts at developing typologies of rental investors, both in Australia and elsewhere. While approaches have varied across the examples, the dominance and significance of the individual, smaller-scale rental investor is clear. Some of this investment is for the longer term, based around anticipated capital gains, while some is for the shorter term. In terms of characteristics of household-based investors, the ability to afford the purchase of an investment property appears to be the only prerequisite for deliberate entry into the private rental sector as an investor. Most of these investors are not professional landlords, who receive the main income from investments.

Some analysts have argued that it is precisely these sorts of characteristics of investors, and features of rental investment, which have sustained the Australian private rental sector over the last two decades or so, and which facilitated the investment boom in rental housing more recently. While the sector has grown significantly as a whole, the prospects at the bottom end of the market seem less positive. Investors in lower cost housing are seemingly not 'niche' landlords, who represent a different approach to rental investment. As the Industry Commission (1993: 51) acknowledged, "The market for rental housing that is affordable to low-income people is a residual one. Housing in this market typically 'trickles down' from other uses. Consequently, supply responses are restricted."

While previous surveys and studies are helpful in suggesting some of the key motivating factors for rental investment, they tend to assume rational investment behaviour, or at least they have to take, at face value, how investors themselves view their own investment strategies. While the present study will largely have to do the same, the views and perspectives of the participants ought to be placed within a clear conceptual framework for investment behaviour. Accordingly, Chapter 4 will briefly consider behavioural investment theory may assist in this endeavour.

4 THEORISING RENTAL INVESTOR BEHAVIOUR

4.1 Introduction

In principle, property investment is just one subset of investment generally yet academic texts on investment pay very little attention to property investment, or in some cases provide no mention of it at all (Sharpe, Alexander and Bailey 2001; Bodie et al 2002). Any mentions of property investment usually relate to unit trusts. Direct investment simply is not taken into account, which is perhaps just as well given the abstract utility maximising, perfectly competitive market assumptions and models that underpin investment texts. That direct property investment does not approximate the investment behaviours theorised in the texts is possibly the reason they are excluded from analysis! The lack of academic texts on property investment is, however, more than matched by the vast range of popularist 'how to get rich' texts by non academics. These vary greatly in level of sophistication and detail but all essentially carry the common message that residential property is the best investment, and many gloss over the problems of the sector.

There are specialist academic publications on property investment, such as the *Journal of Property Research* and the *Journal of Property and Investment Finance*, but historically these largely focused on researching observed property market outcomes including price movements and differentials, and coming up with better trend forecasting models, commonly based on rational market behaviour as an underlying condition of the market, and assuming that actors are well informed and that prices send clear messages enabling participants to read the market.

There is, however, an emerging literature on behavioural economics and finance. Some of the concepts and understanding from this literature is slowly filtering through to investment decision making generally and property investment specifically, but with only limited applications to residential property investment. This research has been labelled 'behavioural property research' by its most active proponent (Diaz 1999), although to date the bulk of the small amount of research in this area (largely published in the above journals) has been about valuers not investors.

The below analysis is drawn from both the limited property investment research and more general research and analysis of investment behaviour. This analysis has helped guide the design of the interview schedules that form a major part of the methodology.

4.2 Understanding investor decision making

4.2.1 Rational decision making

Investment literature on decision-making tends to categorise the decision making as a set of logical sequential stages. These stages typically are:

1. *Setting an investment strategy.* This involves the investor determining the objectives for their investment and the amount of wealth/borrowing to be set aside for investment,
2. *Investigating alternative investment opportunities.* This stage involves the investor examining the alternative investment opportunities eg stocks and shares, for current and future price movements, and or actual and anticipated returns over time (in the literature generally represented as the present value of the anticipated cash flows).
3. *Choosing specific investments or portfolio.* This stage of the decision making process involves identification of the specific investment one wants to make taking into account such facts as anticipated risk, the respective tax advantages, and the timing of likely returns

4. *Investment revision.* This is a stage which is essentially one of periodic review or repetition of the previous steps and leading to an investor selling out of his or her investments, adding more of the same investment switching to other investments to changing the conditions under which the existing investments are financed.

This is a useful way to understand the basic mechanics of the residential property investment decision-making process, even if the principles and practices which sit behind each of these tasks may not approximate those of the texts. As indicated earlier the broad principles assumed in the texts are that of profit maximisation and the practices are those of a very technical or formalised nature which are consistent with mathematical formulation or modelling. Residential property decision making however does not lend itself to analysis by such practices raising the relevance of the concept of bounded rationality.

4.2.2 *Bounded rationality*

Bounded rationality is an economic concept that emerged in the late 1960s in recognition that in certain spheres of economic behaviour, the individual utility maximising behaviour assumption of economics does not hold (Matthias and Esther-Mirjaim 2005). Bounded rationality theory, as the name suggests, recognises that while maximising might be the objective of decision making, the actual reality of achieving a maximising outcome is limited or 'bounded' by social norms or group thinking, lack of information or even disinformation, uncertainty, cognitive abilities (the way people think about problems), or emotion. In this understanding, it is theorised that the bounded rationality decision-maker adapts more quickly than objective or quasi scientific modes of decision-making generated by environments of uncertainty and chaos (Krabuanrat and Phelps 1998) It is therefore not necessarily irrational behaviour, but one which aims at a 'satisficing' outcome – one based on their most important current needs rather than a longer term 'rational' outcome - given all the boundaries around decision-making.

Residential property investment is one of those areas where the concept of bounded rationality has considerable relevance and research potential. In this context, rationality of decision-making under the sequential decision-making process outlined above is bounded by both insufficient domain knowledge (market information), and inability to fully comprehend what domain knowledge there is (associated with the difficulties of cognitive decision making in certain areas) (Dianz and Hansz 1997).

In market theory, perfect information is a key assumption yet information provision for residential housing is quite poor, for reasons outlined in the next section. Moreover, many residential property investors may be conditioned by social norms and value, for example "bricks and mortar is the best investment", herding behaviour (the fashion of following the crowd), market sentiment, or cognitive constraints, simply because of the complexity and diversity of housing markets.

Bounded rationality does not mean that residential property investors do not follow some broad decision-making process as outlined above, but that the specific decisions at each stage require a more intuitive and perhaps simpler process than might be predicted by the utility maximizing formal models of the economist's ideal world, or the financial analysis of the academic texts. This was broadly the conclusion of a small study of investment decision making by small property investment companies in the UK (Gallimore Hansz and Gray 2000), and this by companies that were both property specialists and investors in the more stable less complex commercial property market. What then is bounded rationality likely to mean for the small scale largely unprofessional investor in residential property in Australia?

Kindleburger (1996) has noted that 'mob psychology' or hysteria is a well established deviation from rational behaviour. Herding can be seen as a subset of bounded rationality or an alternative decision-making model. It is the decision-making process whereby by people make investment decisions based on what every body else is doing, and while it might be rational and 'safe' from the individual's perspective, the sum of the group behaviour (such as over investment in a particular area), my turn out to be 'irrational'.

4.2.3 *Rental investor behaviour and rental market assumptions*

The previous section suggested that investor behaviour for residential property may be very different than for other investment areas. This raises the question of why residential property investment decision-making may diverge from formal theory. These are all essentially variations on the concept of informational imperfections but with specific twists.

Perfect market theory including investment theory assumes that all economic agents have access to the same information at the same time. In the real world we know that access to information is very unevenly distributed and particularly in the area of property investment. Compared to equities and bonds, key property data (namely prices, rents and yields) is extremely poor. There is no one nationally uniform residential property data base, nor is there any agreement as to the best methodology for measuring prices, rents and yield The data sources that are available are limited (often no more than medians) normally with considerable time lags, and not controlled for the other variables on prices or rents e.g. changes in quality. Even data purchased from financial advisors (major sources of information for other investment sectors) is little more than reworked secondary data, and in many cases reworked into material to sell properties or finance under spruiker exercises rather than providing objective information.

In an adaptation of Gallimore and Gray's (2000) typology of investment information sources, four sources of potential information to assist residential investment decision making can be identified:

- *Public information, widely available to all interested parties* - Free via print media,(for example, the Australian Financial Review), property section and auction results in daily newspapers, or web sites; or purchased via investment magazines e.g. Australian Property Investor, web sites, Valuer Generals Property Sales data, 'How to get rich' books.
- *Private information, not widely available or available only at relatively high cost* - bought from financial advisors, e.g. Henry Kaye; or bought from private data bases e.g. Real Estate Institute of Australia *Market Facts*, BIS Shrapnel *Residential Property Prospects*.
- *Information obtained through investors personal network or contacts* - the process of networking with those people who are participants in the market and may have access to investment information. This category includes real estate agents.
- *Personal Feel and Market Sentiment* - Information acquired consciously or subconsciously by a range of processes and which structures a market view for the individual.

In both the private and public information categories, the sources for residential property investment are very limited and often accompanied by analysis, text, or sales pitch to guide investors toward a particular direction rather than an objective analysis. Generally, they are not in a form which allows for independent objective analysis. Private information providers themselves are as much handicapped by the information

problems around residential housing as the investor. Most value add to existing data bases or in some cases undertake their own surveys, e.g. REIV *Australian Property Market indicators* but the outcomes are data which is still very limited compared to what is available for other investment sectors.

Personal networks and contacts particularly of estate agents are potentially a key information source for many investors, but the degree to which they provide good overall market information as distinct from good property specific advice is unclear. Estate agents are not without a vested interest in a sale, and their knowledge of market trends is based on past performance rather than any detailed analysis of market fundamentals and what they might suggest for the future. Personal feel is even less a scientific source of market decision making, but given the importance of bricks and mortar to Australians and the role of property as a base for day to day conversation, it is a significant one in decision-making.

Market sentiment is the process of relying on indirect signals for market information, particularly published market analysis or commentaries which in the wider financial market are seen to lead to sub-optimal behaviour (Gallimore and Gray 2002). Relying on market sentiment such as those reflected in the property sections of daily newspapers or the specialist magazines such as the Australian Property Investor is arguably a response to the lack of more formal and objective information on property market fundamentals. Gallimore and Gray (2002) in a study of 983 individuals investing in property in the UK found that investor sentiment is a major factor in property decision-making, and was closely aligned to personal networks as a source of information. One of the problems of relying on market sentiment for residential property may be the fact that, in the case of residential property investment (unlike most other areas of investment), much of the print media are not neutral observers. They secure a sizeable proportion of their revenue from advertisements on residential property and have a vested interest in talking up the market and sales turnover.

Property is also unusual in comparison to virtually any other sort of investment as there is a tangible and visible product: buildings. And this very visibility could be a factor in shaping market sentiment. An expanding skyline of new apartments (as per inner city Australian in the last decade) can reinforce views about the safeness of property or provide tangible evidence of demand. The fact that they may not be let or yielding returns that are poor by the standard of other investments may be less visible.

One of the other important concepts relevant to understanding residential property decision-making is the concept of 'awareness space'. This concept was first used in the 1970s to help explain residential mobility decision-making. In recognition that most people moved to dwellings relatively short distances from where they lived, and that if they moved longer distances, it was normally to a location that people had some familiarity with, sociologists created the term 'awareness space' to recognize that there were areas or housing submarkets for which people had greater perceptiveness or awareness as to the attributes of those areas including housing form, quality, price and amenity. This is because of direct contact, i.e. living in them or traveling through them, or indirect awareness via information sources such as newspapers and estate agents (Knox and Pinch 2000).

While initially used as a concept related to the dwelling choices of owner occupiers and renter households it is likely to have relevance for small scale landlord/investors of the type that characterise Australia. There are myriad housing submarkets in Australia so how does an investor choose which to invest in? Investors are likely to feel safer about investing in areas of awareness as they feel they have more knowledge about these areas so awareness space becomes a key factor in narrowing choice.

One of the problems therefore for regional centres, which tend to have major rental stock shortfalls, is the limited awareness of these regions by investors. Conversely, inner cities which for one reason or another are part of most peoples awareness space,

including the aforementioned visibility of the product, may end up with over investment as a result of people investing in areas of awareness rather than those which may promise the best returns.

4.3 Developing a theoretical framework for understanding investor decision making

In short, the above discussion highlights that any research into the motivations of investors must be aware that investor behaviour is unlikely to follow the principle of profit, or utility maximising behaviour that characterise the academic texts. Behaviour may still be rational but it is a 'very bounded rationality' as investors cope with informational difficulties and the complexity of housing markets.

Table 4.1 takes the investment decision making stages identified in section 4.2 and outlines the decision making elements, constraints, and likely behavioural responses in a way which provides a framework for ordering the questions that will be asked of rental investors.

Table 4.1: Understanding Investor Decision Making Processes - a framework for analysis

Investment stages	The decision making elements	Decision making constraints	Likely behavioural responses	Type of Research issues
Setting an investment strategy	The decision to invest at all. Determining the objectives for any investment Deciding how much to invest? Long terms or short term?	Unfamiliarity with investment scene. Lack of knowledge Lack of investment experience Lack of confidence	Sentimentality	Why did you decide to invest your savings rather than consume or put in bank? What is your previous investment history
Investigating alternative investment opportunities	Examining alternative investment opportunities from; <ul style="list-style-type: none"> • Stock and shares • Residential Property Trusts • Other property Trusts • Bonds 	Lack of awareness of alternatives. Over awareness of property. Lack of experience in evaluating investment alternatives. Lack of market information Lack of faith in funds managers	Herding. Sentimentality. Gathering market information. Seeking out formal investment advisors. Avoidance of other investment sectors.	What was your major sources of information of alternatives? What alternatives did you consider? Why did you reject the alternatives?
Choosing specific investments or portfolio	Identify specific property. Evaluate anticipated risk, tax advantages, the timing of likely yields	Lack of specific knowledge about changes in actual investments over time and within local areas. Lack of specific range of skills to implement decisions.	Investing in awareness space. Personal feel Collection of data on rents, prices,	What did you invest in? What specific factors made you chose this investment?

Investment stages	The decision making elements	Decision making constraints	Likely behavioural responses	Type of Research issues
Investment revision.	Review investment portfolio. Sell Purchase more of same. Switching to another investments Changing investment conditions eg refinance	Unfamiliarity with investment scene. Lack of investment experience Lack of confidence. Lack of knowledge	Retain old investment, Seek new market information, Sell old property.	What are your future intentions? What is affecting them? What could change your intentions?

4.4 Summary comments about investment behaviour theories

Given the risk, the uncertainty, the illiquidity and the poor market information, understanding the motivations of residential property investors is both an interesting and challenging task for which existing investment theory is poorly equipped to assist us. As this Chapter has suggested, it is important that the study is not limited by pre-conceived assumptions about how rental markets work, nor by how rental investors ought to be behave, according to standard investment models.

The main part of the study, which involves interviewing rental investors, property managers and other relevant stakeholders, will therefore be guided by consideration of the decision- making elements, constraints, and likely behavioural responses which might be observed among rental investors.

The final Chapter of this paper will outline how the remainder of this research will be undertaken.

5 NEXT STAGES IN THE RESEARCH

5.1 Review of what the PP has highlighted

Much of the Australian literature discussing investor motivations and landlord typologies dates back to the 1980s or early 1990s. This research provides an opportunity to conduct a contemporary analysis of the motivations, intentions and behaviour of rental investors, and to consider the implications for the future supply and management of private rental housing.

It also provides the foundations for examining options for state and federal government policies and programs targeted at the private rental sector. Improved knowledge of contemporary investment motivations, behaviour and intentions of rental investors will help identify the forms of policy interventions which could be utilised to preserve existing investments, or to encourage/facilitate new supply across the sector and at the lower cost end.

It is important to point out that this study is only about direct residential property investment by individual landlords. As far as possible, the aim will be to include only those investors who have undertaken purposeful investment in rental properties, rather than those who may be renting out dwellings they have previously occupied themselves.

It is also important to note that investors are effectively investing in local or regionally based markets, rather than a single, national rental market. It is entirely possible that different types of responses, and patterns of investment behaviour will be observed in different locations.

5.2 Conducting the main part of the study

The original brief for this research specified that the study should employ qualitative methodologies. Accordingly, the study has been designed principally around such research approaches, in particular in depth, semi-structured interviews with individual investors, property managers, and others in the sector. However, the study will also involve the collection of some more quantitative material, which will assist in contextualising or disaggregating some of the interview response themes.

Investors are not easily identifiable in the general population, and property and rental bond data administration practices, which provide possible avenues for recruitment, vary significantly across States, as do interpretations of privacy laws. While there are considerable challenges in attempting to research residential property investors, preferred approaches have been identified for how to target and involve investors' participation in this research. Essentially, the research represents an exploratory approach to researching the motivations and behaviour of rental investors, testing out methods and approaches, and uncovering issues which can be applied more systematically, and potentially more quantitatively, in the future.

5.2.1 Primary research phases

The main phases of research for this study are as follows:

1. Semi-structured interviews with key informants in the rental industry, including representatives from the Real Estate Institutes and Property Owners' Associations in Queensland, Victoria, NSW, Tasmania and Western Australia, and their national offices, plus representatives of property investment finance lenders and residential finance journalists from the Australian Financial Review, Australian, and Business Review Weekly.

2. A series of semi-structured interviews with leading rental property managers in a number of metropolitan and regional areas, namely:
 - Queensland (Brisbane and Toowoomba)
 - Victoria (Melbourne, Dalysford and Surfcoast)
 - NSW (Sydney and Coffs Harbour);
 - Tasmania (Hobart and Launceston); and
 - Western Australia (Kalgoorlie/Boulder).

Approximately 10 interviews will be conducted in each jurisdiction.

3. In-depth face-to-face or telephone-based interviews with individual rental investors, selected to represent a broad cross-section of rental property owners in the areas listed above to address the key research questions. It is envisaged that 30-40 interviews would be conducted in each of Queensland, NSW and Victoria. In Hobart/Launceston and Kalgoorlie/Boulder, it is hoped that up to 20 investors would participate. Prior to, or at the commencement of the interviews, participants will also be asked to complete a short questionnaire.
4. Interview materials will be systematically transcribed, and then coded and analysed thematically using the NVivo software program. Questionnaire materials, meanwhile will be both analysed quantitatively in SPSS or Stata, and integrated into the NVivo responses. This will be followed by an in-depth analysis of the responses by senior team members.

5.2.2 *Recruitment approaches*

As discussed, recruitment of individual investors presents certain challenges for this study. A range of options exist for achieving the participation targets, which include:

- Using referrals from those estate agents and Property Owners' Associations interviewed;
- Use of RPData residential database via customized extraction or through direct access, to compile a list of rental property addresses and registered owner or purchaser addresses;
- Use of rental bond databases in Queensland and NSW (NB in Victoria, it is not possible to use rental bond data in this way, and in WA and Tasmania such options may not exist); and
- Using other property sector or related networks, and if necessary through newspaper advertisements, represent additional options.

5.3 Pilot stage for recruitment and questions

A series of questions have now been developed for use with individual investors and other participants. It is proposed that investors be asked to complete some initial questions prior to interview. These questions have been laid out in a more quantitative-style survey format, where it is believed the range of potential answers are more predictable, and/or more amenable to rapid data entry and analysis. The more open-ended questions for investors will then be posed during face to face or telephone interviews. A copy of these questions is included in Appendix 1 to this paper.

To test out the utility and usability of these questions, and to trial some of the recruitment approaches, the research team intends to conduct a limited piloting exercise. This will involve seeking some interviews with estate agents in two or three States, and then attempting to use those contacts to interview a small number of individual investors. Some preliminary examination of the RPData residential database will also be undertaken.

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