

Why aiming for a 10% rental yield is dumb

Many investors are fixated with getting a 10% rental return when researching their next target. But as *Paul Do* explains, this goal is not only flawed but may also be hazardous to your wealth



Many real estate authors and pundits claim that the secret to making money in real estate is to buy properties with rental yields of at least 10%. They might express this in a roundabout way, by saying “the price in thousands of dollars should not be more than half of the rent per week”. For example, if the rent on an investment property is \$300 per week, you will only make money on it if you pay \$150,000 (or less) for it. How do we know this? Half of \$300 is \$150. Then multiply that by 1,000 to get \$150,000.

The rental yield of a property is defined as the annual rent divided by the price of the property (rental yield = annual rent/property price). In

the example above, the rental yield is $\$300 \times 52 / \$150,000 = 10.4\%$, which is more than our magic 10%. Rental yield is used as a measure of value: the higher it is, the better value for money you’re getting. Note that when we talk about rental yield, we mean the gross rental yield before vacancies and what I call ‘holding costs’. If you get a change of tenant during the year, then you will usually incur two or more weeks of vacancy costs, with one week being the property manager’s reletting fee. In addition, there are holding costs of up to 30% or more of the gross rental yield – such as the property manager’s fee of 5–8% of the gross rent, council and water rates, maintenance costs,

insurance premiums, and possibly land tax (some of these costs are included in the strata levy for apartments).

There are no absolutes

The 10% rental yield rule of thumb is not only dumb – it can also be hazardous to your wealth! To see why, we need to look at the rental yields of houses and apartments in each of the capital cities over the last thirty years (see Figure 1 on page 55). In the graph for each capital city there are three lines. The top red line, which appears in all of the graphs, shows the standard variable interest rate (which is a proxy for the average mortgage rate). The blue line shows the rental yield for median three-bedroom houses, and the green line shows the gross rental yield for median two-bedroom apartments.

Firstly, you will notice that over the last thirty years, apart from some of the capital cities in the early 1980s and Perth in 1987 (with the defence of the America’s Cup), rental yields on median three-bedroom houses and two-bedroom apartments have never reached 10%. More recently, they have only been around 5% or half of the ‘rule of thumb’. Sure, these are median or ‘middle’ figures. There will be properties with higher rental yields, and there will be properties with lower rental yields. But investors chase the properties with the high rental yields and push up the prices on these properties, which drive rental yields down to median levels. Similarly, they avoid the properties with the low rental yields, which pushes down the price on these properties and drive rental yields up to median levels.

Secondly, the graphs show that rental yields move roughly in line with interest rates. The fall in interest rates from the teens in the 1980s to about 6–8% over the last decade has been matched by the fall in rental yields from around 8% to 4%. More recently, the rise in interest rates in the current

decade has been matched by increases in rental yields in most capital cities, including the sharp rise in 2008. Fortunately, the sharp fall in interest rates in 2009 hasn't been met with a drop off in rental yields, thanks to the shortage of supply of rental properties.

Why is this rule of thumb dumb?

It is dumb because rental yield is an absolute measure and doesn't take into account the level of interest rates, which is the major cost of holding real estate. And don't forget that even if you pay cash for the property, interest rates still measure the opportunity cost of investing in the property. So while rental yields are now only about 5%, interest rates are not much more. This represents great value in the property market. In the last few months, the gap between rental yields and interest rates has closed significantly in each capital city. The last time this occurred was in the late 1990s and early 2000s. If you strictly follow the 10% rental yield rule of thumb, then you would be standing aside now and waiting until rental yields doubled. But you could be waiting a very long time for this to happen. In fact, it might never happen again. The Australian economy has moved into a period of low inflation over the last 17 to 18 years. Apart from the smaller capital cities, interest rates are between 6-8% and rental yields are below 6%.

Why can it be hazardous to your wealth?

Because the last time rental yields were around 10% in some of the capital cities, interest rates were in their teens and rising. If you had followed the rule of thumb and bought then, you would have struggled to service the property. You might have even been forced to sell the property in the short term, losing money on your purchase – as well as incurring significant transaction costs. Don't look at rental yields in isolation.

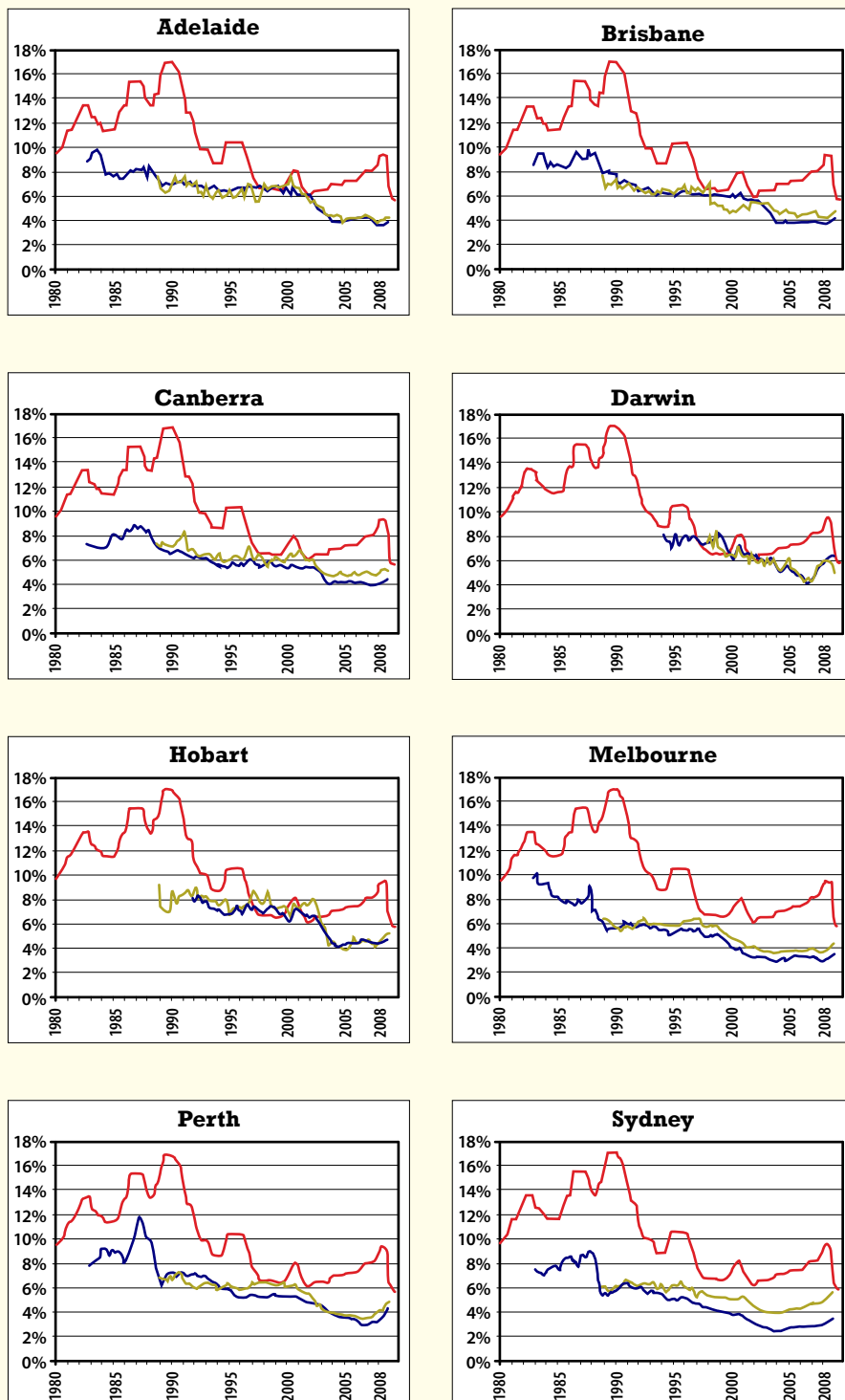
Value over time

A better measure of value is the relative rental yield. The relative rental yield of a property is defined as the rental yield divided by the level of interest rates (relative rental yield = rental yield/interest rates). For convenience, I've used the standard variable interest rate as a proxy for interest rates. Note that



Figure 1: Rental yields of houses and apartments

Houses — Apartments — Standard variable rate —

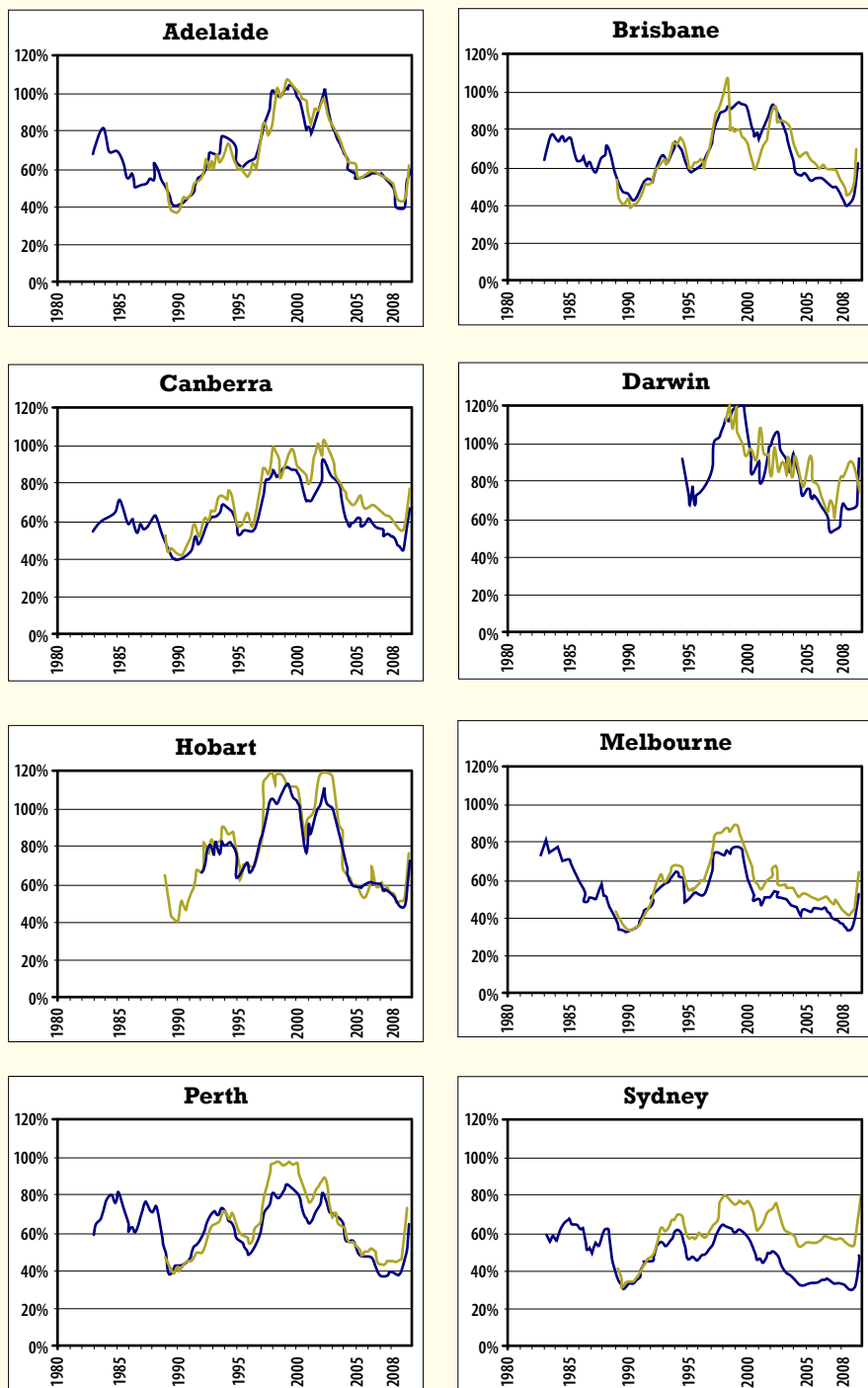


Source: Real Estate Institute of Australia, Reserve Bank of Australia



Figure 2: Relative rental yields of houses and apartments

Houses — Apartments —



no one pays the standard variable rate anymore, with most mortgages at a 0.5–0.7% discount to the standard variable rate. The relative rental yield is a better measure of value because:

- It is a relative measure of value by comparing the rental income yield on a property against the main holding cost of the property (or the opportunity cost of investing in the property), and
- it measures value over time.

The drawback of the 10% rental yield rule of thumb is that it only measures:

- Absolute value,
- and only at a point in time.

We have already seen how an absolute measure can cause you to stand aside when there is good value in the market, but jump in at the wrong time. But there is also another problem. If you only measure value at a point in time, then you are basically assuming that any time is a good time to buy property. Unfortunately, this is not the case. There is a right time and a wrong time to buy property, and the difference can mean having a profitable portfolio of properties working for you compared to struggling to hold and service an overpriced property.

To see why, we need to compare the rental yields with the relative rental yields of houses and apartments in each of the capital cities over the last thirty years. Take Sydney houses for example. In 1989, 2004 and 2008 the rental yields were around 6%, 2% and 3% respectively (see Figure 1 on page 55). However, the relative rental yields during these periods were just above 30% (See Figure 2, left). So despite the rental yield in 2004 being one third of that in 1989, they were the same from a value perspective. Similarly, despite the rental yield in 2008 being half of that in 1989, they were the same from a value perspective. Another way of looking at this is that even though the rental yield in 1989 was triple of that in 2004 and double of that in 2008, the property market did not provide any better value. Therefore, it doesn't make sense to buy property based on rental yields. You should use the relative rental yield as the criterion instead.

If you take a step back and look at the graphs over the long term, you will