CAPITAL ACCUMULATION

REAL ESTATE

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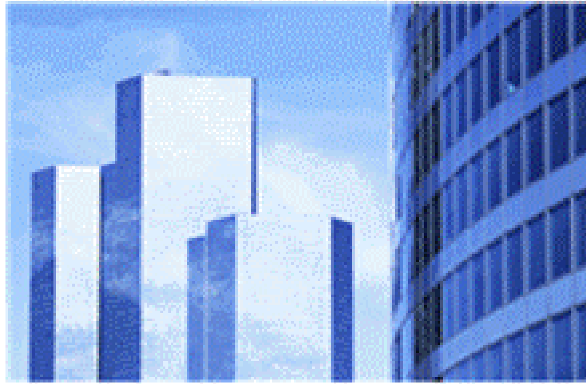

It has been estimated that ninety percent of all millionaires in the United States made their fortunes thorough real estate. Many financial planners look somewhat more unfavorably at real estate as an investment than I do. Financial Planning is a comparatively new profession; actually an offshoot of the insurance industry. Many financial planners have connections either to insurance or stock brokerage houses and are naturally more familiar with those investments. Let me confess my own bias. I have been involved with some aspect of real estate all my life. Real estate, more than stocks and bonds where you are at the mercy of the market or another's management, allows you to retain more control over your investment. Success may be hastened by your own creativity and hard work with the potential for profits being almost unlimited.

THE NEGATIVES OF REAL ESTATE INVESTMENT

ILLIQUIDITY

Real estate is an illiquid asset. It takes time to convert real property into cash. However, the recent advent of institutional investors into the real estate market has meant an increased liquidity because they have been able to establish certain guidelines which leads to faster analysis within the real estate community. Here I am speaking of investments in commercial real estate; shopping centers, office buildings, industrial property and the like. Income and single family residential property cannot usually be sold quickly because the investor depends heavily on subjective things that cannot be analyzed by a computer.

CYCLICAL

The health of the real estate market is tied more closely to the general health of the economy as a whole than some other investments. This is especially true in commercial and developmental real estate. The areas of real estate with the most potential for profit, as you would expect, have the greatest risk. On the other hand, residential real estate is always in demand. High interest rates were responsible for the depressed housing market in the early 1980s and low interest rates were responsible for the twenty-five year boom that followed. Interest rates are a cyclical problem.

VACANCY

An unexpected migration by a segment of the population from one part of the country to another can have drastic effects on the real estate market. This is beyond an investor's control but no more so than when he invests in aerospace stocks and bonds and government policies change. Besides a vacancy factor is taken into consideration when analyzing a real estate investment. It is only when the normal vacancy rate is exceeded due to other factors in the economy that vacancy becomes an unanticipated problem.

GOVERNMENTAL AND POLITICAL MEDDLING

Zoning changes, rent control, energy and new code requirement, moving a highway or construction of a new road, school or park all affect real property for better or worse.

OBSOLESCENCE

Buildings become outdated, require maintenance and repair and decline in value as new buildings come onto the market. All this is taken into consideration when analyzing a real estate investment opportunity. The government allows real estate investors to reduce their taxes according to a formula. This is called a depreciation allowance and is a factor in figuring the yield on a proposed real estate investment..

POSITIVE ASPECTS OF REAL ESTATE INVESTMENTS

APPRECIATION

Real estate values have gone up more than they have gone down since the end of the Great Depression. The influx of foreign money into the United States real estate market attests to the

general feeling that a well considered real estate investment is extremely safe because of the political stability of America. Besides providing a hedge against inflation, an investment in real property enables investors to pay debt with inflated dollars. The dollars borrowed to purchase property are generally worth more than are the ones with which repayment is made over time to the lender. Keep in mind that one should borrow during times of inflation; never lend, for when you're paid back you'll be short changed.

CASH FLOW

Often real property can provide a monthly income rather like the dividends paid by stocks or interest received from bonds. Usually in order to obtain a cash flow right away, a considerable down payment must be made when purchasing the property, otherwise, the mortgage payments together with other expenses connected with the property, use up rents received or other proceeds. However, depending on the ease and cost of borrowing, it is sometimes possible to reduce the down payment and postpone cash flow until a second or even a third mortgage has been paid off. If you choose to invest in rental property location is very important. There is always high demand near large universities for example so the vacancy factor is low and income is constant. Real estate investors look for high growth areas where demand exceeds supply. This affords an opportunity to increase income and a supply of tenants.

TAX BENEFITS

Although an investment should never be made solely for its attractive tax features, those features should not be overlooked when it comes to investing in real estate. There are possible capital gains treatment, depreciation, interest and maintenance deductions, investment credits plus the fact that the *at risk rule* (the rule that no more may be deducted from taxes than what the investor actually has "at risk") does not apply to real estate.

LEVERAGE

Leverage is quite simply the use of borrowed funds. In real estate it is common to use seventy-five to eighty percent of another person's money to purchase a property. This is usually in the form of a mortgage. It has been possible, and we did it often in our youth, to fully finance a property and that was before Robert Allen came out with his book titled *Nothing Down*. That is

the ultimate leverage and can be done only at certain times and in an economy that we are not likely to see anytime soon since the bubble burst in 2008..

KINDS OF REAL ESTATE INVESTMENTS

SINGLE FAMILY RESIDENCE

During the 1970s single family homes appreciated at a rate of fifteen percent annually across the nation. That rate was even higher in sections of California and other sun-belt states. Such rapid inflation could not be expected to continue indefinitely. Because the cost of financing got out of hand, putting home ownership beyond the reach of many people, in the 1980s we saw fewer turnovers of the higher priced residences and a pick-up in the sales of more affordable vacation homes. Young people preferred to rent near their workplace and reap some of the benefits of home ownership in a resort area. This would not have made sense 15 or 20 years earlier but life styles began to center around sports and recreation and more and more people were delaying marriage and/or children or eliminating that option altogether.

Parents have often helped their children buy their first home but it was more prevalent in the 1980s and new methods were created. "Necessity is the mother of invention."

Children borrowed part of their down payment from parents in exchange for a personal note with principal and interest all due in seven to ten years. That way the parents didn’t have to pay taxes on the interest until they received the money that allowed them to do so. Children were allowed to deduct the interest paid to the parents when they were in a higher bracket. If the parents didn't charge interest or the interest charged was lower than the market dictated the IRS was likely to consider the difference between zero or low and market interest as a taxable gift.

For families that could afford it, the large allowance for gifts, then $10,000 non-taxable per person, if a mother and father combined their allowances and made gifts to a child and his spouse, $40,000 could change hands tax-free. Today, 2008, the allowance is $13,000 each to each child meaning a down payment of $52,000 could be given to the young couple tax-free. Of course, not many parents can afford to be that generous what with the recent loss in retirement funds and most investment vehicles.

Another way to lend a helping hand was for the parents to buy the house and rent it to the

children giving them an option to buy it at a later date. The rent would cover the mortgage payments, insurance, and taxes and the parents would take the depreciation and interest deductions as long as the house was in their names. The rent would be taxable income but out-of-pocket expense for upkeep and maintenance could be off-set against it. Similar to this plan was the idea whereby a parent would deposit enough money with a lender to make up the difference between the ten percent his child might be able to afford and the fourteen percent market rate charged by the institution. This plan allowed the child to qualify for a mortgage that would otherwise be unattainable. The real estate industry referred to this solution to the high priced housing dilemma as a *buy-down* mortgage.

Equity sharing was another popular idea. Parents received an interest in a house for their part of the down payment. Parents and children became co-owners with expenses, including mortgage payments pro-rated. The children paid rent to the parents for the use of the parents' share of the house. Of course, the children saved more on the reduced mortgage payments and expenses than they paid in rent plus the parents got tax-shelter and a share of any appreciation, which was taxed at the lower capital gains rate when/if the house sold.

THE SINGLE FAMILY FIXER-UPPERS

Recycling, renovating or fixing up; whatever you want to call it, the system works. This is probably the surest, safest way to invest in real estate. Perhaps because it demands more brawn than brain; more elbow grease than conjecture. You have to be able to swallow your pride and become familiar with dumps, dirty garbage cans, cracked paint and old plumbing. The less capital you have to start the more willing you have to be to do what needs doing yourself. There are hundreds of excellent *How To* books available and contrary to popular belief, city inspectors can be very instructive and even helpful when it comes to saving money.

Then there is the time-worn admonition, "buy cheap; sell dear." But buying "cheap" isn't the whole story; you must buy right. Ideally, you should purchase property in the worst condition in the best neighborhood. Location is everything in real estate. You want the worst house on the block so the surrounding property will compliment and benefit any work you do to improve your

own property not vice versa.
Probably the most common mistake made by beginners is over improvement. You must know what houses are selling for in the area. You can find this out by contacting your local Realty Board, Title Companies or City Hall. Stop improving when the house has been brought to neighborhood standards. It is ridiculous to add a swimming pool and a tennis court to a house in an area of modest homes. You will not even get back your cost.
The other trick in renovating rundown properties is to put as little of your own money into the project as possible. Use lenders' money; usually a bank or savings institution, but it could be a private party. There is no doubt that looking back from 2009 that there has been too much creative financing but that was the industry’s response to the soaring price of homes. But there are all kinds of creative financing and now we’re not talking about creative financing for the rich. Creative financing has always been the mainstay of the shoestring investor. There's nothing new about getting a seller to carry back a mortgage on his rundown property. The worst that could happen, from his point of view, is that you (the buyer) will put some time and effort into his neglected property and then default on the loan. If you can't pay as promised then the poor seller just gets the renovated, or partially renovated property, back, You bet he's willing! If you approach him in the right spirit he may be willing to sell you the property with nothing down. There's no mystery to it, it's just common sense.

RESIDENTIAL INCOME PROPERTY

What I said about using the other guy's money and doing work yourself holds true for residential income property too if you are short of cash. A little more *brain* must be added to the *brawn* in this area, however. You must figure the gross income of the property you propose to buy and apply the proper *multiplier* for your area to determine the price you are willing to pay. Gross income is all the money the property brings in on an annual basis. For instance, if the property is small, three to four units, it might gross $20,000 a year. If the *multiplier* for your area in the current market is 9 you might want to pay $180,000 for the property. You would then figure how much it would cost to improve the property so your gross income could be raised. Everyone seems to have their own rule of thumb in this area. To pick one; let's say for every $10 of improvement you should get $30 more rent or $100 more selling price. You can begin to see that

if you do such and such you will realize such and such return. We're talking about the same concept we've been using with stocks, bonds and mutual funds; the actual return on dollars invested. In real estate the rate of return is the net income on dollars invested. Another rate of return is the net income from the property before interest and depreciation, divided by the purchase price. For example; $20,000 divided by $180,000 = eleven percent rate of return.
If the property needs work but the income is already too high or even at market, pass that property by. You need to be able to add to or improve in such a way that the income will increase as a result of your work.
The next thing to consider is the net income (gross income minus expenses). Will the property carry itself or will you have to dig into your own pocket every month to meet the mortgage(s), taxes, utilities, insurance, maintenance and repair cost? But even so, remember all such losses are tax deductible as are interest payments and a certain amount of the property's' supposed loss in value over time (depreciation allowance). Real estate is valued for its tax shelter possibilities and you just may find the benefits outweigh the negative aspects. Where else can you get such a combination of capital growth and tax shelter in one package? Not only have real estate prices gone up in past years, keeping pace with inflation, but an investor's equity in the property increases with each mortgage payment indirectly paid by tenants. All this is in addition to the regular pull of supply and demand at work in a free marketplace. But you should beware. Income property requires you to have the hours of an obstetrician (plumbing and heating emergencies always seem to occur in the middle of the night) and the stamina of the head of the complaint department at you local shopping center.

DEVELOPMENT

We have seen that residential real estate can be a good investment even for amateurs who are willing to ask questions and work hard. Success or failure can be in your hands if you choose to keep control. Not so in development. You are at the mercy of contractors, architects, raw material suppliers, attorneys, lenders and even the overall political and economic situation. Development is not for the uninitiated.

COMMERCIAL REAL ESTATE

When we speak of commercial real estate and industrial real estate we refer to shopping centers, office buildings and warehouses. Just as the value of residential income property is determined by multiplying gross annual rental income by a fluctuating (fluctuating according to locality and market conditions) *multiplier*, commercial real estate is valued by applying a similar market derived figure known as the *cap rate* (capitalization rate) to revenue using one of two possible methods, the pre-debt or cash-on-cash approach. Figuring what it would cost to build a new structure similar to the one you are contemplating as an investment is an alternate means of determining value for all types of real estate. The ideal balance is where the capitalized value of the investment approximates the reproduction cost of the property.

The key to success in commercial real estate lies in finding a property in a good location, a tenant with strong credit and negotiating a good lease. Investors not interested in managing their properties often look for triple-net leases. Under a triple-net lease the tenant, in addition to making the rental payments, is responsible for all operating expenses, debt service on the landlord's mortgage and the property taxes.

Because commercial real estate is based heavily on judgments and negotiating skill which can not be acquired overnight, this is not a suitable investment for the novice unless he is fortunate to have at his side an extremely competent broker in whom he has complete trust.

REITS—REAL ESTATE INVESTMENT TRUSTS

A real estate investment trust may be either a trust or a corporation. The trustee or directors invest the assets only in real estate holdings. Each individual investor owns shares of the portfolio. There are basically three types of RREITs: those that own real property, those who lend money for real estate development and a combination of the two. Since shares are traded on the stock market, REITs are a liquid asset. This is the only form of real estate ownership that can be priced daily without an appraiser. The supply and demand of the stock market fills that role. Potential investors should investigate this form of real estate ownership as they would any cyclical stock with the additional warning that in general REITs are not widely held so the small investor may find himself at the mercy of larger stockholders whose movement could drastically affect the price of the stock.

LIMITED PARTNERSHIPS

SOMETIMES REFERRED TO AS SYNDICATIONS

A limited partnership is made up of one or more general partners who actually manage the affairs of the partnership and assume personal liability, and one or more limited partners who are passive investors with their liability limited to the size of their investment. The passive investor finds himself dependent upon the management and expertise of the general partner. Therefore, it is imperative to find out everything you can about the general partner before committing your investment dollars. Because partnership equities are not sold on a liquid market (like the REITs) it is wise to see that a buy-out arrangement is included in the purchase agreement, tied somehow to the fluctuating market price of something agreed upon by all at the inception. If there is no such provision, you may find you are forced to suffer a sizable loss should you need to sell your investment in an emergency situation.

Limited partnerships provide a way for the investor who has little knowledge of real estate and no desire to learn, an opportunity to participate in the benefits of appreciation and depreciation (tax deduction) with a relatively small capital outlay and limited risk. Limited partnerships are very attractive vehicles for real estate investments if you don't mind putting your investment beyond your control. So much depends on the qualifications and integrity of the general partner. I, therefore, cannot emphasis strongly enough that you should proceed with extreme caution before going ahead with this type of investment, both because of the liquidity problem and the required dependence upon the general partner.

SUMMARY

On the plus side real estate provides an opportunity to leverage, attain capital growth, is a hedge against inflation and has various tax advantages. On top of this it offers shelter (single or income residential) as well as pride of ownership.

On the negative side, it is relatively illiquid, cyclical and more vulnerable to changes in the economy than most other investments.

It is hard to go wrong with residential real estate if you buy the worst house or 4-plex on the block at a low price in a good location. REITs and limited partnerships can be very lucrative investments for the passive investor who has a degree of sophistication in this area and has done his homework. Real estate development and commercial industrial investments, however, should be left to real estate professionals.

WHAT KIND OF REAL ESTATE INVESTMENT IS RIGHT FOR ME?

Circle a number. 1 means you agree strongly, down to 5, signifying strong disagreement.

1. I would like to work with tenants. 1 2 3 4 5
2. I can do "fix up" myself. 1 2 3 4 5
3. I can and want to make time to manage property. 1 2 3 4 5
4. I like responsibility. 1 2 3 4 5
5. I have other liquid assets. 1 2 3 4 5
6. I want profits or capital gain more than safety. 1 2 3 4 5
7. I don't like passive investments. 1 2 3 4 5
8. I don't mind borrowing money. 1 2 3 4 5
9. I like to set goals and follow plans. 1 2 3 4 5
10. I like to be in control of a situation. 1 2 3 4 5
11. I have adequate emergency funds set aside. 1 2 3 4 5
12. I have trouble putting my trust in another's judgment. 1 2 3 4 5

SCORING

If you scored 12-25 give residential income property a try!

If you scored 40 or above REITs or Partnerships may be for you.

In the 26-39 range analyze your answers carefully:

If you circled #1 or #2 for questions 4,7, 10 and 12, stay away from REITs and Limited Partnerships.

If you marked #4 or #5 on questions 4, 7,10,12 stay away from income property involving management responsibilities.

RECOMMENDED READING

Complete Guide to Real Estate Financing, by Jack Cummings

You Can Profit form Real Estate Appreciation, by Maury Seldin
How to Borrow you Way to Real Estate Riches, by Tyler Hicks
Inspecting a House, by Alan Carson & Robert Dunlop
Real Estate Investment, by John E. Wiedemer
Tax Planning for Real Estate Investors, by Kau & Sirmans
The Real Estate Investing Profit Guide, by Michael Glasscock
How to Use Leverage to Make Money in Local Real Estate, by George Block
The Complete Real Estate Investment Handbook, by Sirmans & Jaffee
The Real Estate Book, by Robert Nessen
Prentice Hall Master Guide to Real Estate Investing, edited by Oliver Ray Price
How We Made A Million Dollars Recycling Great Old Homes, by Sam & Mary Weir
House Recycling, by Mary Weir
Professional Real Estate Investing: How to Evaluate Complex Investment Alternatives, by Fred E. Case
Rental Homes: The Tax Shelter That Works and Grows for You, by Vincent Zucchero