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PROS AND CONS OF REAL ESTATE INVESTING

Many investors think that real estate represents a good form of diversification away from traditional stock and bond markets. They are right, but as with all forms of investment, while it is important to know about different ways of putting your money to work, it is equally important to know the relative advantages and drawbacks of each avenue.

When people tell me with certainty that real estate values must go up, I become skeptical. Just because there are more and more people coming into an area doesn't necessarily mean that the price of any particular parcel of land or building will rise, especially in a short time period.

One central lesson for real estate entrepreneurs is that one must have patience and the ability to hold the investment for an indefinite time period. A year or two or three will not make a difference to an astute buyer or seller. People who have purchased property using debt are often under extreme pressure to get results quickly, as the cost of debt over time can depress the returns on investment property.

It is true that, in general, demographics point to rising populations and increasing demand for housing. But, housing is often cheaper to build new than buying older properties so the rate of new construction can keep prices down for sustained periods of time. While desirable locations tend to become more expensive over time and recreation properties, in particular, fetch higher than normal prices for their surrounding areas, without proper zoning and environmental protections the character of property can change rapidly outside investor control, putting the investment at risk.

An advantage of raw land is that it requires little maintenance, other than possibly fencing and the annual cost of liability insurance. Dealing with governmental agencies is usually a prerequisite to increasing the value of vacant land as changing land use is one common way to increase property values. The truism "Land, they ain't making any more of it" can easily lead to the conclusion that it is without risk. Nothing could be further from the truth.

Investors in land can be subject to sharply increasing taxes, condemnation (where the government decides it wants to use property for the public good), or just plain bad luck, such as residents near Love Canal, Three Mile Island and farmers near the Hanford Nuclear site discovered.

People who need income from their investments are generally not well suited to raw land purchases as there is usually no cash flow coming out of the property. For these type of investors, rental properties, be they residential or commercial are attractive but tricky places to look. Each type of tenant in a rental unit has their positive and negative aspects and the choice of whether to invest directly, on one's own, or with other people is an important decision.

The need for ongoing management of rental real estate cannot be over emphasized. There are defined costs to contracting this service to outside parties, such as professional property management firms while the "hassle" factor of doing it oneself is ambiguous and varied. From a profitability point of view, however, buying a rental unit and managing it oneself is usually the best way to go.

In my experience, there are not many people who can afford to buy rental units who want to or who are willing to personally interrupt their lives, at any time during the week or weekend, day or evening, to deal with finding and qualifying renters, to deal with complaints both real and imaginary, to physically do or arrange for maintenance and repairs, to do the book-keeping, and to monitor tax and insurance issues. Most people get tired just thinking about it!

There are several possible alternatives for investors who want and need a steady stream of income and who desire the underlying source of revenue to be real estate, as opposed to bonds or bank deposits. It is easy to buy stocks known as REITs or Real Estate Investment Trusts in a brokerage account. These are investment firms who concentrate in a particular type of property: from apartments to storage units to health care facilities to office parks to shopping malls to prisons to rehabilitating historic or low income housing.

REITs package several properties together and then are responsible for the management of the properties as described above. All investors do is sit back and collect their income on properties they usually know or care little about. The downsides are high management fees, wide fluctuations in the price of the REIT stock due to investor perceptions about the markets and interest rates, and the possibility of high levels of debt or unsustainable payouts to investors at the expense of the long term value of the real estate. On the other hand, these are one of the few forms of real estate where investors can get their money out relatively quickly. This is both a blessing and a curse as the investors who opt to stay in can be penalized if enough other investors bail!

Private limited partnerships (LPs) or Limited Liability Corporations (LLCs) are available to investors who qualify through a government mandated process called accreditation. These deals require higher minimum investments, usually at least $25,000 and generally over $100,000. They are fairly illiquid and non-transparent, meaning investors do not control when the properties are sold or at what price. The managing partner or member collects a management fee and shares in the profits. These opportunities are more targeted than the REITs, meaning they can choose one or two locations and the managers are hands on in selecting tenants, arranging for repairs, etc.

Which avenue is right for you? Let your tolerance for pain be your guide! Some individuals like to "kick the tires" on real estate they own so they restrict their investments to ones that they can easily drive by on a regular basis as there are so many details when dealing directly with property. If you choose to go with a small group like a LP or LLC, find one with a proven track record of producing consistent, positive after tax net returns including the eventual disposition of rental properties.

Look for someone you know who has a personal involvement with the real estate investment group, either as a professional investor on behalf of others or with money of their own in the project. There is no substitute for "due diligence", the discovery process whereby the books, records and the property itself are inspected not just the marketing materials. You can tell from my description above that I believe in all silver boxes there is a cloudy lining.

Real estate is a great way to diversify your portfolio, either through appreciation or income opportunities. It doesn't necessarily have to be a huge headache but don't go into it with unrealistic expectations. Expect to pay for management services and understand properties limitations in terms of liquidity, possible cost overruns, and the uncertainties of particular geographic markets. Your final results will depend, as they always do, on buying at the right price and selling at the right time. Nothing feels as good as buying a piece of real estate except selling it!

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