Real Estate: The Search For Income

Sept 02

Many investors are looking for alternatives to stocks and bonds. Interest rates on US treasury bonds are currently at 1.7% for 6 month T-bills, 3.13% for 5 year T-notes, and the long-term 20 year US treasury bond is only paying 4.94%. These are the lowest rates since the 1960's.

The stock market has not yet climbed out of a morass of fear and anxiety, the culmination of international turmoil, domestic threats, dismay with a year of corporate malfeasance. There is mixed news regarding the strength of the economy. The market may well remain in a sideways moving pattern, going nowhere for several years.

Real estate, as an alternative investment vehicle, has some appealing aspects. Like all investments, it has both positive and negative aspects. In Santa Fe, and many other rural areas that have scenic or recreational appeal, realty prices have risen more than stocks or bonds over the last several years. In such an environment, it is crucial to remember that real estate is just another type of investment. It has its own cycles. Our estimate is that prices of the homes in most metropolitan areas are fairly near their peak.

There exists today a dangerous assumption, on many investors part, that real estate is "a sure thing".

As in all investment areas, the key to a good investment is buying at the right price. Here is a way to estimate if a piece of real estate is of "value".

One way to figure out the underlying value of a piece of real estate is to use the capitalization rate, often referred to as the "cap rate". Here's how it works. If you are looking at a piece of property which is a rental, or income producing, try to figure out what the <u>net</u> income will be, that is, the income that you can put into your pocket after paying real estate taxes, building insurance, repairs and maintenance, and any management fees. If you can reasonably expect a thousand dollars a month, multiply by 12 to get $12,000 per year, then divide the $12,000 by 8%, the expected before tax rate of return. 8% is also .08, so take $12,000, divide it by .08, to arrive at a value for the property of $150,000. If the expected net after net income is $2,000 per month, it would indicate that the property is worth around $300,000. You can play with the "cap rate," lowering it to 5%, which is close to the risk less rate of return on US treasury bonds, or increase the "cap rate" to 10%, the rate of return most investors want on their growth investments. You will then have a range of what is reasonable to pay for the particular piece of real estate.

Many people assume that the appreciation of real estate is a "sure" thing. Assumptions are dangerous, as they figure the unknown can be known. Here are a few aspects of real estate that are possible to know. First it takes time to manage property, often-considerable amounts of time. Dealing with city and county ordinances is usually a hassle and having rental properties involves being a landlord. While there are useful aids to establishing straightforward relationships with renters, there are always challenges dealing with the various kinds of people one encounters as potential tenants. Real estate investors can contract out these services to management companies, who are skilled in checking references, collecting rent, inspecting properties for damage and dealing with other ongoing issues. Management companies can be fairly expensive, but they work hard for their fees and serve to relieve investors of much of the hassle factor involved in direct ownership of real estate.

Real estate investing also involves an ongoing cost of repairs and maintenance. It is possible to write a lease that passes along these costs to renters. This is called a "net lease" and there are even "triple net" leases where the tenant pays for taxes and insurance as well as repairs and maintenance.

In my experience, any thing that can go wrong with buildings eventually will. Any job that needs to be done will likely need to be redone at least once. So you should figure in the time and money supervising and all the other activities that are involved in keeping a property in good order.

One decision to be made regarding real estate is whether or not to have a mortgage. In times of rising real estate prices, borrowing money to buy property is generally a good investment move. This is true when the rate of appreciation one receives is higher than the rate of interest one pays. Often, investors end up paying high rates of interest on their mortgage while struggling with low or negative cash flow investments. You won't know if borrowing makes sense until you sell the property, but another good guideline is not to invest in property that can't pay its own mortgage.

Many people cling to the myth that having a mortgage is good because the government is paying for part of the interest costs through the tax deduction for the mortgage interest. However, if the rate of total earnings after tax on the real estate is lower than the money paid out on the mortgage, it doesn't make sense to borrow money. Taking a deduction on our income tax return makes us feel good; paying interest in general feels pretty bad.

One final point to be aware of is the lack of liquidity in the realm of real estate. This means it is difficult to change your mind and investment strategy if things don't work out. As a rule of thumb, I advise people to buy real estate only if they plan to keep it for five years. The cost of buying and selling real estate, as well as fixing it up, are expenses that usually involves a considerable outlay of cash. Real estate can sometimes be liquidated quickly, or it often takes years. Patience is not just a virtue when it comes to investing in real estate, it is a necessity when looking for tenants, searching for appropriate brokers, or fixing things up in order to get maximum value.

With all that in mind, real estate can be an excellent addition to an overall portfolio, as long as it does not comprise too big a portion of one's overall assets. One third real estate, one third stocks, and one third bonds is a diversification guideline. This is one way to deal with the uncertainty we all feel about the future. No matter what