Chapter 1

From Their Money to Yours

Leverage and Cash Flow

The concept of *property flipping* is not new and has been around for a very long time. As a form of *speculation*, flipping involves moving into an ownership position and then selling at a profit, sometimes in a very short period of time. In fact, the time element is most crucial in all real estate investments. The longer the holding period, the more critical the question of *cash flow* becomes. A flipper, by definition, is a very short-term investor.

The property flipper believes that an undervalued property's profit is maximized through the short-term period. Someone else may view an improved property as a viable long-term hold, either as a primary residence or as a rental; but the flipper is much more interested in the fast in-and-out of property flipping. Indeed, it is likely that the selection criteria for a flip property are entirely different than the criteria for a long-term growth prospect (owner-occupied or rental).

Flipping can certainly be applied to raw land as well as commercial and industrial property. However, in this book, the emphasis of discussion is limited to single-family residential property. This

property flipping
a form of speculation in real estate that involves a very short period of ownership. The flipper finds undervalued properties, improves value through cosmetic improvements in many instances, and then sells the property at a profit.

speculation
an investment strategy employed by short-term investors. These investors seek rapid turnover of investment funds as opposed to long-term investors, whose objectives are to buy and hold for many years.

cash flow
the movement of money in and out of an investment. In real estate, cash flow is of greater concern than ultimate profits. For example, speculators seek extremely short-term investments so that cash flow concerns are limited; therefore, they desire to sell properties as soon as possible after acquiring them.

is the type of property most investors emphasize; it is the most familiar; and market valuation, rental markets, and financing are more basic and straightforward for residential real estate than for most other types.

Property flipping may include speculation in raw land and has always been a popular notion for real estate investors. In fact, even in the colonial period, property flipping on the American frontier was widespread. In those days, land ownership often was defined by occupying the land and working it, and not by actual title. Many squatters assumed ownership by farming land, but as time went on, speculators moved in, as explained by one historian:

> Unlike the squatters, the speculators intended not to make homes on the frontier but merely to make money. Their strategy was to acquire title to large tracts of land, either directly from the Indians or, after that practice was outlawed (because of the abuses it invited), from the colonial governments or from the British Crown. They then sent out surveyors, who mapped their holdings, and wrote up legal descriptions. Finally they sold the lands, ideally at a handsome profit, to settlers. [1]

This description of frontier-level speculation literally involved surveying and describing the land involved. Today, virtually all land has been surveyed

Key Point

Most property flipping strategies involve residential real estate, which has the greatest number of properties and the higher level of market activity. Other types of real estate should be left to the experts.

[1] H. W. Brands, *Andrew Jackson, His Life and Times* (New York: Doubleday, 2005), p. 14.

and plotted, and legal descriptions exist; so at least today's property flippers do not have to carve descriptions out of the wilderness. But the description of speculation in the late 18th century applies as well in the early 21st century. The strategy is the same: Find undervalued land, acquire it, and sell it at a profit as quickly as possible.

The Lifeblood of Property Flipping

Other people's money—descriptive of how *leverage* and cash flow work—is a reference to how most real estate investors operate. This is out of necessity. When you buy your first home, you borrow most of the money through a mortgage; this is a form of leverage, the use of other people's money. The cost of borrowing, interest, is a long-term burden to every homeowner who needs a 30-year mortgage.

By the same argument, real estate investors almost always have to employ leverage to take up equity positions in real estate. Few people have enough cash available to avoid leverage. An important reality every investor needs to face is that leverage is accompanied by risk. The more leverage employed, the greater this *cash flow risk* will be, and this is unavoidable.

The fact that leverage (and its advantages) is tied unavoidably to risk (and its disadvantages) is the essential problem for all real estate investors. The homeowner can only qualify for a loan if the lender believes the borrower's income is high enough to afford payments. Real estate investors

leverage
an investment strategy in which a portion of equity is augmented through borrowings to purchase more expensive items than the investor could afford in cash. In real estate, mortgage loans are the best-known form of leverage.

cash flow risk
a form of risk involving the use of leverage. The greater the leverage used in investments, the greater the cash flow risk.

Key Point

Leverage is unavoidable in real estate. Most investors, like most homeowners, have to borrow the larger portion of the purchase price. *Affordability,* therefore, often refers more to managing monthly payments and expenses than to the stated purchase price of property.

Key Point

Those who consider property flipping too risky may prefer long-term holdings and working with tenants. That can be risky as well when potential cash flow problems are considered.

and their lenders assess borrowing in the same manner. The long-term investor, who probably will rent out the property, is concerned about whether market rents will be adequate to pay the mortgage as well as maintenance, property taxes, insurance, and other recurring costs associated with ownership. Because leverage determines the feasibility of such an investment, the landlord lives with the risk of high-ticket repairs, vacancies, nonpayment of rent, property tax increases, growing payments in adjustable rate mortgages, and any other factor affecting cash flow.

Every investor faces a multifaceted level of cash flow risk premised on the need to borrow money or to leverage the investment. At first glance, leverage is very attractive. A 20 percent down payment makes the investment look quite promising. By borrowing 80 percent, the capital invested goes much farther. Thus, even an investor with $200,000 to invest does not need to buy only one $200,000 house. It is "easy" on paper to buy five houses with 20 percent down and have $1 million in play. However, the problems of loan qualification and cash flow tend to curtail the extent of potential leverage; and reality itself (in the form of vacancies, unexpected costs, and other cash flow problems) increases risk, and can make the "sure thing" not so sure after all.

The concept of leveraging money is illustrated in Figure 1.1. Here, $200,000 is used to purchase five properties, each with 20 percent down. If all five properties were to double in value, leverage would produce greater profits than could be realized in buying only a single property—assuming, that is, that the profit can be realized before interest costs consume that profit.

Key Point

Leverage is an exciting idea when you realize how a small amount of money can work for you—at least on paper. A more in-depth study is essential.

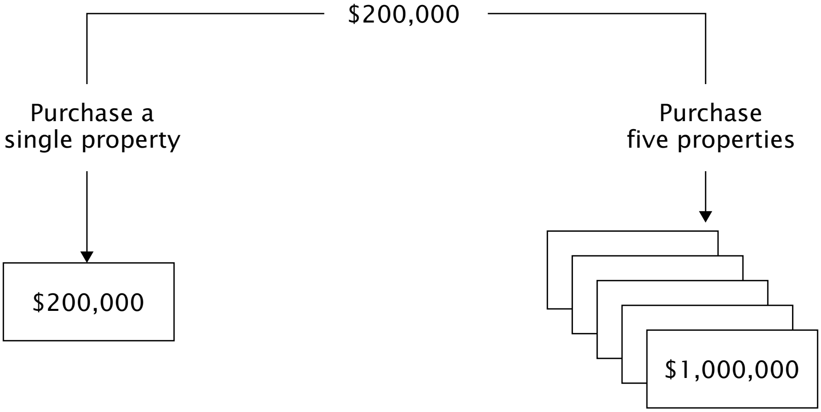

FIGURE 1.1 Leveraging Money

For example, look at what occurs if property values increase by 20 percent over one year (assuming average interest of 8 percent on all properties):

	Buying a single property for cash	***Buying five properties financed at 8%***
Purchase price	$200,000	$1,000,000
Profit, 20%	40,000	200,000
Appreciated value	$240,000	$1,200,000
Less: interest	0	–64,000
Net	$240,000	$1,136,000

Interest was calculated at 8 percent of $800,000 (overall property value of $1,000,000 minus $200,000 down payments). This illustration shows the power of leverage, but also assumes that all properties would be sold at the end of the one-year period. There is always the risk that property values will not grow at the rate or, for that matter, at all.

The *risk* involved with leverage involves management of cash flow. You need to assume that, in the ownership of five leveraged properties, there will be enough cash coming in from rents or appreciated market value to pay the mortgage payments. If that plan is not realized, the cash flow risk can make the venture expensive.

When the cash flow risks are considered in the overall scheme of things, many investors are discouraged from pursuing the most common real estate investment paths. Owning single-family homes and renting them out involves many types of risk, not the least of which is cash flow risk. So some people have preferred to invest in real estate partnerships or real estate investment trusts (REITs), where risks are spread and properties are managed by professional developers, builders, and investors. REIT shares are traded on public exchanges, so this course is far more liquid than direct ownership of property. Some investors have also chosen to take a debt position rather than an equity position, and invested in mortgage pools. These are similar in structure to mortgage funds, but portfolios consist of residential mortgages rather than stocks or bonds.

Finally, the property flipping alternative deserves a serious look as well. Because flipping is designed to work as a short-term strategy in real estate, the longer-term cash flow risk can be avoided and remains out of the equation. Exceptions may occur. You might enter a transaction intending to flip and later decide to hold the property for the longer term and rent it out. As a rule, however, the transaction is going to be designed to create a profit as quickly as possible, thus avoiding having to include cash flow risk in the equation. So for property flippers, the feasibility of a particular transaction is different than it is for buy-and-hold strategies. This is an essential point to keep in mind: Because the risk factors and assumptions are different between flipping and holding, you need to analyze a specific property using an appropriate set of criteria that matches the strategy properly.

market risk
the best-known type of investment risk—that prices will fall after money has been invested. Market (or price) risk applies in all markets. In real estate, the combination of market risk with timing often defines whether investments succeed or fail.

Opportunity and Risk in Leverage

Leverage itself can be viewed as a two-sided coin: opportunity on one side and risk on the other. This relationship cannot be avoided or mitigated. The greater the opportunity for profits, the greater the corresponding risk. The risk will be present in one form or another. Of the various types of risk, *market risk* is the best known; but cash flow risk growing out of leverage is equally serious. If the property does not increase in value in the short term, you have to wait out that market. If interest rates rise and you have financed property with an adjustable rate mortgage, your costs continue to climb. If the

Key Point

Most investors concentrate on market price and associated risks. In real estate, though, cash flow risk is at least as critical and should be studied carefully as part of your analysis.

demand for rentals becomes soft, a higher rate of vacancies will erode your cash flow.

The relationship between opportunity and risk is summarized in Figure 1.2. Note that if these two elements are charted in degrees, opportunity and risk tend to move in the same direction and usually at the same rate of change.

A mistake made by investors in all markets is to overlook this relationship between opportunity and risk. The tendency is to focus on the profit potential of an investment but to forget about the corresponding risk. This does not mean it is impossible to make a profit in real estate; but real estate investors accept specific types of risks as a trade-off for the opportunity.

The same is true in the stock market. Highly volatile stocks are likely to increase in value over the short term far more so than lower-volatility stocks. But that price can also move downward with equal speed and degree. So a very conservative investor will prefer stocks with little volatility and accept a lower overall return on their investment—a trade-off for safety and certainty with lower profits so as to avoid risk and uncertainty and the possibility of higher profit potential.

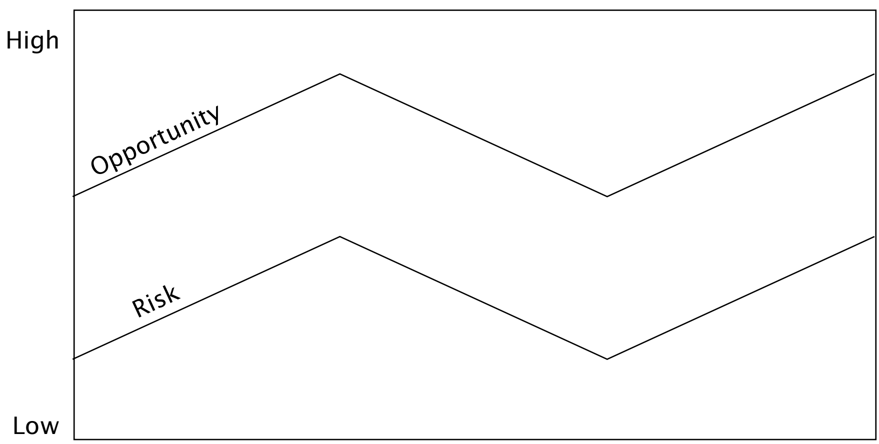

FIGURE 1.2 Opportunity and Risk

suitability
the appropriate matching of a particular investment strategy to an individual, based on experience, knowledge, income, assets, investment goals, age, and family status.

Managing risk in any investment portfolio is a matter of matching that risk to individual tolerance. For this reason, it makes sense to begin the process of studying property flipping by asking yourself: *Is this an appropriate avenue for me to pursue?*

Not everyone is suited for property flipping. Just as some stock market investors prefer strongly capitalized blue chip stocks, others are attracted to new issues, options or futures, and other more exotic (and higher-risk) market alternatives. *Suitability* is determined by several factors, including:

1. *Experience and knowledge.* If you are experienced in real estate investing and know the range of market risks, that is an important first step. You also need to be very familiar with real estate trends in your area, because those trends determine the strength or weakness of the market, today and tomorrow. Every market is different. There are few similarities between Manhattan and the Florida panhandle, for example; or between San Francisco and Colorado Springs. So the coupling of experience and knowledge define suitability for higher-risk investing.
2. *Income and assets.* You cannot afford to place capital at risk if you cannot afford a loss. So the overall value of your investment assets, plus annual income, are going to limit and define what you will be able to include in your portfolio. If you are barely making your family budget on today's income, you cannot afford to speculate in real estate. If your credit is poor, you will be at a disadvantage as well, because your ability to obtain favorable financing terms will be crucial. In addition to income and personal cash flow, your assets will also determine the suitability of property flipping.

Key Point

Every real estate market is regional. National trends may be interesting, but they do not apply to *your* city or town.

3. *Investment goals.* People invest for different reasons. Some want to accumulate wealth so that they can retire early. Others want to pay off their house, fund a child's college education, or start a business. Other people simply want to create financial security for themselves. Your goals and personal priorities should determine what kinds of investments are most appropriate for you. The range is wide. Insurance or annuities, conservative stocks and bonds, mutual funds, speculative stocks, derivatives, and many forms of real estate are all among the possible choices. Ultimately, your investment goals need to be foremost in how and why you pick one investment over another.
4. *Your personal opinion and point of view.* You may have a particular bias toward one type of investment, or against it. The reasons vary, but the fact remains that everyone makes their own judgment calls. It does not make sense to try and convince someone to change their bias. For example, if you are suspicious about the stock market, it is not likely that anyone will be able to convince you that your money should be invested in stocks. And if you believe that real estate is the only truly safe investment, it will be equally difficult to dissuade you. So the investments you choose will reflect your own beliefs.
5. *Age and family status.* Finally, you are likely to decide upon investing in one or more products based on your age and family status. Younger investors are more likely to take chances with their money, so they may be attracted to more speculative investments. As people grow older, they tend to become more conservative in their choices. Single people can afford to take greater risks as well. When people get married their priorities change; married people may want to buy a home and start a family, which means that investments have to be made more cautiously as well.

Ultimately, your decision to invest money anywhere should be based on research and full understanding of the risks involved, and not just the profit potential. The suitability of an investment or range of investments or strategies should be determined by analysis and comparison. Knowing the risk attributes of investments—especially real estate—requires becoming aware of the economic, demographic, and market factors of real estate in your city or town. Real estate is always

Key Point

You read a lot of general advice: You *should* invest today to beat the market, you *should* buy real estate now, or you *should* leverage your money. But in practice, everyone is different, and a course of action is best determined by your circumstances, and not by general advice.

local in nature, so no national averages are of any use in this research. Just as the Dow Jones Industrial Averages (DJIA) cannot identify the value of any one stock, national real estate averages provide useful information about broad trends, but they are meaningless in terms of the market where you live.

Leverage and Risk Analysis

Many leverage illustrations discuss how a limited amount of money can be applied to control multiple properties. This is the essence of leverage, of course. However, the emphasis on maximizing the use of money ignores the equally important element of risk. The greater the leverage, the greater the cash flow risk. When you leverage money, you cannot escape this risk, and a thorough analysis should include equating the advantages with that *liquidity risk*.

liquidity risk
a form of risk involving cash flow and the availability of money. The risk is based on the need for regular income from investment real estate to make mortgage payments, ongoing expenses, and unexpected repairs. The greater the leverage employed in a real estate portfolio, the higher the liquidity risk.

When you analyze an idea for investing in real estate (whether a single property or a number of properties), your analysis may include a number of review "points"—supply and demand, local vacancy rates, growth rates, and so on. These market analyses may be thought of as the fundamentals of real estate analysis. Just as stock investors study financial statements and track ratios to make judgments about corporations and their stocks, real estate investors can also study valuation and market potential.

Some stock investors also look at the technical side, the price movement and volatility of a stock. Real estate investors may do the same by studying attributes of price and market value; but in real estate, you also need to include cash flow in this technical analysis. In real estate, the equivalent of stock-based technical analysis has to include all price-related elements because, ultimately, these will also define the level of cash flow risk.

The asked price of a property (or average prices in your city) is not necessarily revealing about the strength or weakness of the market from a technical point of view; you need to find out more. Six elements of this analysis include:

1. *Cash flow "worst case" analysis*. A study of cash flow is intended to estimate the cash you receive from renting out property versus the cash you have to pay for mortgage obligations, property taxes, insurance, utilities, maintenance, and any major repairs. In its "worst case" form, the unknown risks can threaten the feasibility of your investment. You need to ensure that you can afford these unexpected surprises, including vacancies, nonpayment or late payment of rent, and major repairs.

   These potential problems certainly affect cash flow. Many investors perform an overly optimistic cash flow analysis. They assume rents will be received every month, and no unknown surprises will occur. So as a critical segment of your real estate technical analysis, you also need to be aware of the exposure to cash flow risk as part of the equation. It is not enough to be aware of potential growth in market value and profits, if you also risk not being able to afford to keep properties as long as you need to.
2. *The spread.* The difference between the listed "for sale" price and the ultimate "sold" price is called the *spread*. Checking the spread and the trend in spread over the past year gives you a very good indication of the strength or weakness in the market. The information is available through a Multiple Listing Service (MLS) most real estate brokerages use, and which many local bankers also subscribe to. The computation of spread is performed for properties of each kind. So the average spread for all residential

Key Point

The use of technical analysis is well known in the stock market; it also has a specific application for real estate investors and can greatly improve your ability to judge today's market.

Key Point

The *spread*—equivalent to "bid and asked" prices—defines the market for real estate in terms of supply and demand. For that reason, spread is one of the more important market indicators to study.

properties is summarized by month for at least a full year. The computation involves dividing the difference between asked and sales price, by the asked price, and is expressed as a percentage:

$$\frac{\text{Asked price} - \text{Sales price}}{\text{Asked price}} = \text{Spread}$$

spread
the percentage of difference between asked and sold price of real estate. To compute, divide the difference in the two values by the asked price and express the result as a percentage.

The greater the spread, the softer the market. For example, if the trend has been for an increase in the spread (meaning final sales prices have been increasingly lower than asked prices) means the market is losing strength. As a spread decreases, it indicates growing strength in the market (also meaning that the demand is growing stronger). In exceptionally strong markets, the spread will be very small. This reflects many properties selling for prices above asked price, so that the average is reduced greatly.

3. *The "time on the market" trend.* Another technical indicator of market strength or weakness is the number of months or weeks that properties remain on the market. This *time on the market* trend is very revealing. In very strong markets, properties move quickly, selling in one month or less from the date of the original listing. Typically, in balanced markets, properties tend to sell between 30 and 90 days. In very weak markets (where more sellers exist than buyers) properties may remain on the market longer than 90 days, and many may be withdrawn from the market without a sale. Time on the market is tracked through MLS services, and information can be found through a local real estate brokerage firm.

time on the market
the number of months (or weeks) that properties remain for sale on average. This indicates the relative strength or weakness—and the recent changes in time on the market indicate a trend in supply and demand.

4. *Inventory of properties for sale, expressed in time.* The current *inventory of properties* available for sale reveals how much turnover is occurring in today's local real estate market. The inventory represents the number of months of properties available. So if history shows that 25 properties sell per month, when 100 homes are currently listed, that is a four-month inventory of properties; if 300 properties are currently listed, that is a full 12-month-supply. The lower the inventory, the stronger the market.

> **inventory of properties**
> the number of properties currently listed and for sale divided by the average number of sales per month in a specific region or city; the lower the inventory, the stronger the market.

5. *Real estate price trends in the local market.* The most basic type of analysis of real estate is based on price. While that is only a part of the picture, it is an essential part. If you cannot afford the investment, the entire exercise is useless. In addition, you also must ensure that other price-related elements make sense. For property flipping, you must ensure that the trend in the market is likely to ensure a profit in the short term. For longer-term investing, it is equally important to ensure that the levels of market rents are adequate to cover mortgage payments and other recurring expenses. This is not always possible. In some markets, real estate prices are relatively high but rental rates may not be adequate to cover cash flow demands.

   Price alone is only one piece of the price puzzle. Of more importance is the *price trend* in local real estate. This is the typical, or average, range of prices for properties like ones you are considering buying. If you are interested in three-bedroom, two-bath homes with 2,000 square feet, then you narrow your analysis to homes generally fitting that description. Based on specific neighborhood characteristics, you can identify the price trend for

> **Key Point**
>
> Even property flippers need to be aware of trends in rental supply and demand—because that also affects real estate values and can signal the near-term price direction.

price trend
the historical prices of properties in a particular area, involving a period of 12 months or more. The trend is useful in judging how real estate prices are moving currently, and to anticipate future price ranges.

the kind of property involved. Even within one city, prices can and do vary considerably by neighborhood, even when close together. The actual or perceived value is going to be affected by numerous factors, some of which are simply known to those familiar with the market. Thus, it may take time to acquire the knowledge about local real estate that cannot be learned from MLS listings, analysis, or a study of the numbers. In some cases, you learn more by talking to other people in your city, those you meet over coffee or at the post office. Understanding the subtleties of local price trends is not always limited to pure analysis.

6. *Rental demand trends.* An entirely separate real estate "market" exists in the form of *rental demand*. This has to be reviewed separately from price trends, because it does not necessarily match. A broad assumption (which might be wrong) is that a strong overall residential demand will be matched by an equally strong rental demand. The two markets coexist but react to entirely separate market forces. Homeowners and renters are *not* the same demographic. The relative strength of one form of demand over the other depends on the local job market, demographic mix (college-aged renters versus homeowners and retirees), and prices. It is possible that real estate prices have grown substantially, but rental demand is weak (due, perhaps, to overbuilding apartments in the area), or that rental demand is very strong but real estate prices are weak (due, for example, to a large college population and overbuilding single-family housing).

rental demand
the specific demand market for rentals affected by the supply of rental houses and apartments. This market coexists with the larger housing market with its pricing trends; but renters react to different factors than homeowners, so the two markets may not necessarily move in the same direction.

Leverage and Other Types of Risk

If you view leverage as a specific type of risk, you can analyze its attributes wisely. As with all forms of risk, leverage contains both

Key Point

Leverage risk is specific, but the use of leverage also defines other forms of risk. Real estate analysis is more reliably performed with this in mind.

potential and risk, and these aspects need to be offset against one another in order to appreciate how real estate is bought and sold; how to manage your personal investment risks; and how to set a time frame for property flipping itself. For example, the *ideal* time frame might be to turn property over as quickly as possible, but in some circumstances you might be willing to keep a short-term equity position to maximize profit potential (while accepting a limited leverage risk during the same period).

So leverage risk needs to be analyzed as a specific type of risk involved in any type of financed real estate purchase. At the same time, leverage also has to be considered with five other types of risk:

1. *Debt and equity risk.* Every investor chooses to adopt either an equity or a debt risk. Equity investors in real estate almost always use leverage because real estate is a big-ticket item. Exceptions are some forms of extremely short-term flipping; purchase of REIT shares; purchase of limited partnership units; or purchase of real estate *exchange-traded funds* (ETFs).

   The debt investor lends money to others, directly or through a *pooled investment* of some kind. Among these are bond funds and mortgage pools—called “Ginnie Maes” and “Fannie Maes”—offered by such quasi-government agencies as the Government National Mortgage Association (GNMA) or Federal National Mortgage Association (FNMA).

exchange-traded funds (ETFs)
mutual funds with preidentified portfolios specializing in an industry or investing in stocks of a particular region or country. An ETF specializing in real estate companies offers one way of diversified equity investing without the use of leverage. ETF shares are traded over public exchanges, rather than bought or sold through the mutual fund itself.

pooled investment
an investment with the funds of many individuals combined to make purchases collectively, much like a mutual fund. Mortgage pools invest in bundles of secured real estate mortgages and are offered to the public by quasi-governmental agencies such as GNMA and FNMA.

interest risk
the risk that interest rates will rise, which has an immediate effect on real estate values. Higher interest rates also affect property flipping because higher rates slow down the market.

2. *Basic market risk.* The market risk every investor faces is complex in real estate, because a single market is not involved. When you buy shares of stock, the share value either rises or falls; in real estate, you have to consider the overall market risk relating to the value of property, *and* the risks associated with the rental market. Your market risk concerning rental supply and demand is entirely separate from the better understood market risk and, in some markets, may define success or failure. The risk itself comes down to one potential problem: that low rental demand may negatively impact cash flow even when market values are rising.
3. *Interest risk.* Investors in all markets are affected by changing interest rates and none more so than real estate investors. Because most investors depend so heavily on mortgage financing, *interest risk* is always present. This affects profit potential in more ways than one. The traditional purchase-and-hold strategy involves fixed or variable rates, so that any increase in interest curtails the market broadly. Higher rates create a more limited pool of potential buyers. Because payments grow higher with increased rates, more people cannot qualify for loans. Ultimately, the restricted market may also affect growth in market value. So the higher interest rates move, the *lower* the demand, and the lower the profit potential in investment real estate. This will have a direct impact on property flipping, which thrives best in a rapidly growing value environment.

Key Point

Interest risk is not limited to changing rates; higher rates create less demand because fewer potential buyers can qualify for financing.

4. *Diversification and asset allocation risk.* An ever-present problem for investors is management of investment capital to achieve *diversification* among several different products. Diversification comes in many forms; stock investors diversify by investing in mutual funds, and direct purchase of stocks usually involves several dissimilar stocks. Real estate investors diversify by buying different properties or mixing property types. An expanded aspect of diversification is *asset allocation*, which means placing capital in different markets (stocks, bonds, and real estate, for example) so that no one poor performing market affects the entire portfolio. The risk in both diversification and allocation is that it may not be done effectively. For example, if a stock investor buys four or five different stocks, that is one form of diversification; but if all of those stocks would react in the same way to bad economic news, then diversification is not achieved. The same risk applies to asset allocation. If you allocate your portfolio between directly owned stocks and mutual funds, a marketwide bear market will affect your whole portfolio. If you allocate between residential property and raw land, a regional softness in *all* real estate would apply to the entire portfolio and, again, the allocation would not be effective. So investors in all markets face the risk that their diversification and allocation strategies might not be effective. This demands constant reevaluation of the strategy itself based on current economic and market conditions.

diversification
a strategy for spreading risk, in which investment capital is placed in dissimilar products. The purpose of diversification is to ensure that bad news will not affect the entire portfolio in the same way.

asset allocation
an expanded version of diversification, in which capital is invested in different markets, such as stocks, bonds, and real estate. The purpose in allocation is to avoid a negative impact on the entire portfolio if and when a particular market suffers a downturn.

5. *Investment time risk.* Most people acknowledge the fact that, were it possible to hold on to real estate long enough, it would eventually become profitable. The *time risk* in real estate involves cash flow because you need to generate income adequate to cover all of the expenses and payments required by owning real estate—and

Key Point

Time often determines success or failure in real estate investing. Profits are secondary. If you need to hold on to real estate longer than you want, that destroys your annualized return and ties up capital.

time risk
the risk in real estate that profits will not materialize in the desired time frame. In that case, investors either accept losses or convert properties to longer-term rentals.

over a lengthy period of time in some cases. Property flipping is designed to generate a profit in a very short period; but the risk is that profit will not be possible in that time. This means you either have to get rid of the property and accept a loss or convert it to a long-term hold. With this in mind, the risk can be mitigated in the selection of property. The potential for fast profit is a key to the property flipping strategy. In addition, however, it may be necessary to also investigate the rental market and to compare market rents to the level of payments a property would require as a long-term hold. Because this additional criterion would limit the potential market for property flipping, it is often ignored or left out of the analytical equation.

Comparisons Between Flipping and Holding

An important step in the analysis of property and the feasibility of a specific strategy requires comparisons. Will it be more profitable to flip properties or to hold for the longer term? To expand this question a little more: Will it be more profitable one way or the other, *and* what are the relative risks?

It is likely that the differences in cash flow between the two strategies will ultimately define those risk levels and compel you to move toward one strategy or the other. More conservative, risk-averse investors tend to want well-priced rental properties, especially if and when the cash flow picture is favorable. Criteria include strong rental demand, affordability of the property itself, current condition (of property and neighborhood), and required down payment. Less conservative investors tend to seek extremely short-term profits through property flipping. The bargain-hunting aspect to property flipping is only one element of this approach. In addition, property flipping involves the ability to identify not only the price advantage, but also to grasp precisely the current market conditions. Property flipping works best at times when demand is very strong and values are growing strongly.

A worthwhile exercise to go through before deciding how to invest in real estate involves comparing flipping and holding. The following are valid means for comparison between these two markets:

1. *Market conditions in your area today.* The starting point in any investment is a critical analysis of the market itself. Stock investors seldom are enthusiastic when markets are volatile and weak; they prefer investing when the market is strong and the mood optimistic. The same rule applies in real estate. What are today's conditions and mood? Remember, real estate markets—unlike stocks—are always local, so national averages or news from other areas is not valid in your regional analysis.
2. *Growth history and potential.* Specific study of local growth in market value of property, as well as potential for continued growth, is the second step in your analysis. Part of this has to involve the time element. If property values have increased 20 percent in the past year, that is far more significant than another area where values have doubled, but that took five years. The rate of growth, coupled with the time involved, define potential for continued growth in the future.
3. *Rental market conditions.* The strength or weakness in rental demand defines the market in some respects. The overall trend in market value is usually associated with owner-occupied, single-family housing. Rental markets, however, may anticipate future trends in the overall market. While owner-occupied housing is an entirely separate market than the market for rental apartment units and houses, the two are related, and demand in one market affects future growth potential in the other. If a previously strong rental demand is beginning to weaken due to overbuilding of apartments, that means that rental houses may be going up for sale in the near future. And with more inventory on the market, that may also mean a slowdown in the rate of growth in housing market values.

   This example is simplistic, of course, because many factors come into play in setting real estate values. However, it does illustrate one way that rental demand—increasing or decreasing—will affect property values in the future.

4. *Interest rate trends.* More than any other single economic feature, interest rates have an immediate effect on property values. With historically low rates from 2000 to 2005, real estate values in many regions continued to grow at double-digit rates. In part, this was caused by higher demand as more people were able to qualify for homes—because their payments were lower with reduced interest rates, meaning a broader qualification for conventional financing. Strong demand is always going to be a feature directly tied to low interest rates; and by the same argument, as interest and mortgage rates begin rising, demand for real estate slows down as well. Although other regional factors definitely affect real estate, interest rates cannot be ignored. With high rates, housing demand may not change due to local factors such as a growing population (related to employment opportunities, for example), so two or more economic realities may offset one another.
5. *Your personal financial condition and risk tolerance.* Finally, any investment comparison has to rest with personal factors. You need to be comfortable with a strategy and the market involved before you proceed, or the decision will not be a good one. In the case of real estate, some people are naturally conservative and will seek the safest possible long-term situation; others are willing to take greater risks in exchange for higher short-term profits, and will pursue property flipping strategies (assuming that market conditions are appropriate). To a great extent, your risk tolerance is determined by your personal financial condition: income, investment capital, and net worth. You need to be able to afford the strategy, and by definition you are only able to tolerate what you can afford, what you understand, and what represents a good fit with your circumstances, conditions, experience, and investing goals.

risk tolerance
the level of risk you are able to accept in a particular product or market, determined by personal income and net worth; experience; and investing goals, attitudes, and preferences.

Key Point

It is a mistake to enter a market based solely on generalized advice. Your personal circumstances should dictate what risks you can afford to take and, as a result, how and where to invest.

Defining your level of investment risk and potential—in terms of what you want and what you can afford—is always an essential part of the investment process. This also includes defining your entrance and exist strategy, whether in the stock market or in real estate. You need to set goals and contingency plans so that you know in advance what you need to do as market conditions change. The next chapter examines this topic.