Part 1

Approaching the Market

Chapter 1

The Traditional Approach

Buy, Hold, Hold a While Longer, Sell

The creation of rental income is not automatic. It does not come into existence simply by virtue of an investor buying rental property and finding a tenant. Successfully generating a long-term income stream from your rental income depends on advance research; an understanding of your local market—and a keen awareness of the many alternatives you face in terms of opportunity as well as risk.

cash flow
the amount of cash moving in and out within an investment program. Cash flow has to be manageable in order to justify the investment, based on income, expenses, nondeductible payments, and tax benefits.

In the stock market, the well-known buy–hold–sell implies the possibility of quick turnaround. The stock market itself can be a fast-paced experience. Day traders go in and out of positions, minute by minute, often making huge profits or suffering huge losses before lunch. Real estate investors cannot have the same experience. In real estate, the prices of properties do not change in the liquid environment of an auction marketplace like the stock market. The cost and time involved in completing real estate transactions requires a different mindset from that of the stock market. If you want to generate rental income, you need to appreciate the differences between stocks and real estate.

In this chapter, we learn about the differences between real estate and other investments, setting the stage for how the traditional approaches to markets work; how your investing, financial and personal life are affected by owning rental income; and how to make sure that buying real estate is not only profitable, but enjoyable as well. It is unlikely that you will find many investments that give you high returns, safety, tax benefits, and *cash flow* to match real estate. At the same time, you also need to be prepared for the interaction with tenants, complexities in recordkeeping and taxes, and the need to tie up capital for a longer period of time than with stock.

Studying the Rental Income Market

There is an old expression that "the market rewards patience." While this was aimed originally at stocks, it is equally true of real estate. In the Internet world, the stock market may punish patience and reward high-volume trades in some instances. But even with the Internet, real estate transactions usually still take a lot of time.

You may be able to narrow down your search using the Internet. Many sites offer not only references to local brokers and agents, but also current listings of property for sale. This means that you can study a range of potential properties without having to spend time with a real estate agent and be shown properties beyond your price range, out of your desired investment region, or otherwise inappropriate for your needs.

The method you employ at the very beginning of the process largely determines the quality of the properties you review. A common method for finding property, whether as a primary residence or for investment purposes, is to visit a local real estate office and speak to the agent on the floor. This is often done with no references, prequalification, or other tests. Even the process of looking at properties may be flawed. The agent is likely to show you only listings held by that brokerage firm, which can severely limit what you are shown, in terms of location, price, and features.

Valuable Resource

Online sites can link you to state-by-state professionals as well as actual current real estate listings. Check these sites as examples:

- http://www.imrmls.com:8080/servlet/lDisplayListings
- http://dmoz.org/Regional/North_America/United_States/
- http://www.realestateregional.com/

A wiser method (but one that requires more patience) is to begin by drawing up a list of features you need to know about before investing in property. These include:

1. *Price*. The first question on most people's minds is what properties cost. For some, this is limited to the question, How much do I need to make a down payment? It should extend far beyond this question, however. The evaluation of price should be made in context of typical prices in the area. Is this price a bargain? What are prices of similar homes in the same or nearby neighborhoods? Don't expect real estate agents to show you only the bargains; perform your own investigation.
2. *Location.* The location of the property is crucial to identifying properties that are likely to appreciate in value. Location extends not only to a specific neighborhood and its attributes, but also to the area of a town or city, economic status affecting real estate values, noise and other nuisances nearby, and availability of conveniences.

   A *neighborhood in transition* can be either a plus or a minus. If you observe areas over time, you notice that the makeup of a specific neighborhood changes. As a generation passes, properties are sold to new residents, older homes may be renovated, and new features added. This positive transition is a good sign that property values are going to rise as well. A negative transition occurs when residents stop maintaining properties, when low demand leads to empty or boarded-up houses, where empty lots are left for long periods because no one wants to build in that area, and where deleterious social trends like crime levels or gang activity are on the rise. In these areas, property values tend to decline, and while many bargains may be found, the long-term investment value is going to be questionable. Some investors specialize in buying and holding "distressed" properties; this is not a specialization most beginners will want to enter.
3. *Features.* The specific features you seek in a rental property should be defined by the demand for rentals itself. For example, the greatest

neighborhood in transition
an area in which the quality of housing, maintenance levels, appearance, and social trends such as crime levels are changing. In a positive transition, older homes are improved, renovated and updated in preparation for turnover to a new generation of owners. In a negative transition, lowered demand is characterized by empty and boarded-up homes, empty lots, and increased crime levels.

supply and demand
the driving forces of the real estate cycle, which includes three categories: financing, market, and rental. The supply of money determines interest rates, lender policies, and closing cost levels as well as the willingness of lenders to work with real estate investors. The supply of housing and demand for new housing determines pricing of residential property as well as how long it takes for properties to sell, whether they sell at full price or at a discount (or premium), and whether or not bargains can be found under present conditions. The level of supply and demand for rentals determines market rates as well as vacancy levels and trends.

return on investment may be found in one- and two-bedroom homes or duplex and triplex units; you may discover that four-bedroom homes do not yield adequate rents to cover your cash flow and expenses. This analysis is going to vary from one area to another; but it is important to analyze local features as a starting point. Compare market rates for rentals with different features to get an idea of how you can produce the best return on your investment.

4. *Age and condition.* What market are you interested in? Do you want a no-maintenance property that you can just rent out the day after the purchase is complete? Or do you seek a lower-priced bargain property that will require cosmetic improvements? The cost of properties will reflect the level of work you will need to do, so you should first define whether you are interested strictly in buying and holding rental property, or whether you want to buy, improve, and sell at a profit. There are many ways to approach the market, and defining your preferences is an important step to go through before you start putting offers on houses.

5. *Demand attributes.* One of the most overlooked steps in deciding whether to develop a rental income investment portfolio is a study of local *supply and demand* features. Demand comes in at least three forms: financing, market, and rental.

   Financing demand refers to the availability of money to lend. When a lot of money is available, when rates are low, and when lenders want to find borrowers, they offer attractive closing cost terms, low rates, and fast review. When money is tight, borrowing will be more expensive. Interest rates will be higher, lenders will charge more *points*, and closing costs will have to be paid just to process the paperwork.

Market demand is reflected in the prices of real estate. The *real estate cycle* is similar to all cycles; it has up and down times. When demand is high—meaning there are more buyers than sellers—prices are driven up and builders cannot complete houses quickly enough. When demand is low—meaning there are more sellers than buyers—it takes longer for housing sales to be completed, sales take place at discount from the list price, and builders do not begin new projects. This cyclical tendency is illustrated in Figure 1.1.

The history of real estate prices reflects changes in demand over time. This is shown in the summary in Figure 1.2 However, demand itself is local. So the conditions reflected nationally will not necessarily apply to condition in your city or town.

This summary of housing prices demonstrates the strong and consistent nationwide market demand. Over many years, average sales price for residential property have climbing upward steadily, outpacing the rate of inflation during most years. The dollar values and percent of annual change are summarized in Table 1.1.

financing demand
the demand for money that can be used to lend in real estate transactions. As lenders' interest rates rise and fall, their policies and offers vary based on the money supply. When money is plentiful, rates are low and closing terms will be offered at attractive rates; when money is scarce, interest rates are higher and it will cost more to move through the borrowing process.

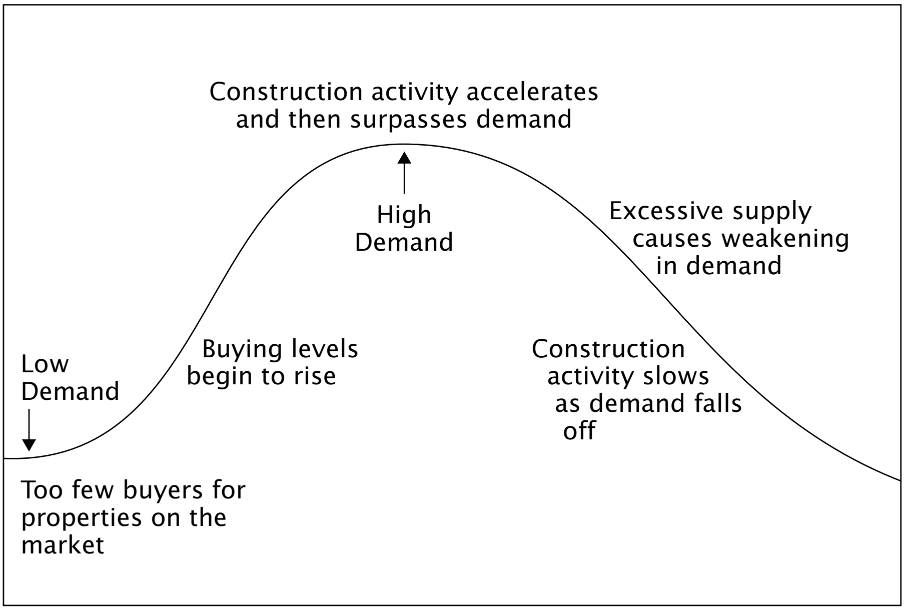

FIGURE 1.1 The real estate cycle.

points
a cost of borrowing charged by lenders, equal to one percent of the amount to be borrowed. Also called "loan origination fees," points reflect the current availability of money to loan. When the money supply is plentiful, lenders tend to reduce fees, and when money is scarce, points and other fees tend to rise.

Note that average prices declined in only two out of the 25 years in the Table 1.1. This demonstrates the historical strength of real estate values.

Rental demand is the least understood of the three types. It is unrelated to the better-known market demand in an area. Because market demand is usually driven by purchasers who will live in the houses they buy, the trend in supply and demand is reflected by local employment statistics, lifestyle, and other social attributes. Rental demand is driven by the number of people who cannot afford to buy or who do not want to buy—they want to rent. In some areas, market demand can be strong but rental demand weak. In other areas, the opposite is true. The important thing to remember is: Market and rental demand are driven by different forces. For example, in a city with a large college population, rental demand is likely to be high, at least while school terms are active. However, if the permanent population of the same area is primarily retired, market demand could be relatively low.

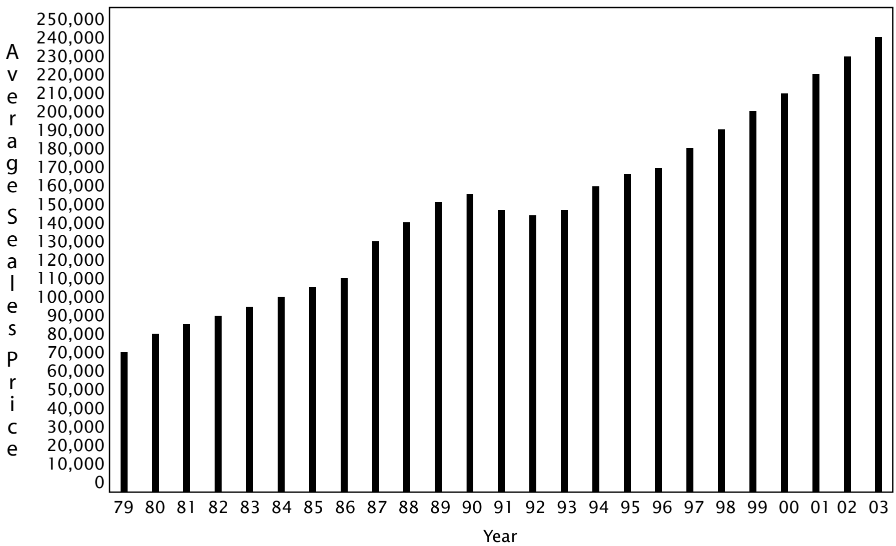

FIGURE 1.2 Average housing sales prices.
Source: U.S. Census Bureau

Table 1.1 Average Housing Sales Price

Year	*Price*	*Change*	*Year*	*Price*	*Change*
1979	$71,800	—	1992	$144,100	–2.1%
1980	76,400	6.4%	1993	147,000	2.5
1981	83,000	8.6	1994	154,500	4.6
1982	83,900	1.1	1995	158,700	2.7
1983	89,800	7.0	1996	166,400	4.9
1984	97,600	8.7	1997	176,200	5.9
1985	100,800	3.3	1998	181,900	3.2
1986	111,900	11.0	1999	195,600	7.5
1987	127,200	13.7	2000	207,000	5.8
1988	138,300	8.7	2001	213,200	3.0
1989	148,800	7.6	2002	228,700	7.3
1990	149,800	0.7	2003	244,800	7.0
1991	147,200	–1.7			

Source: U.S. Census Bureau

Valuable Resource

To check housing statistics and trends, check the U.S. Census Bureau Web site, at http://www.census.gov/.

6. *Financing.* In the stock market, it is relatively easy to get an investment program started. With a few thousand dollars, you can buy stocks directly—for as little as $100, you can open a mutual fund account. In real estate, cash investments are beyond most people's means, so the majority of equity value will be financed. This means that you have to address several questions in your initial analysis. Is your credit excellent? Good credit paves the way for more financing options, whereas a record of poor credit prevents many people from being able to get loans for a rental income program. Another question worth investigating is that of financing alternatives. Do local lenders offer a

market demand
the demand for property, reflected in price trends of housing; when demand rises, property prices rise as well, especially if housing is scarce. When an excess of housing is available, the demand levels off and prices flatten or decline.

real estate cycle
the supply and demand cycle for real estate. When the cycle is an a low point, prices are depressed or flat, and houses take longer to sell; as the market demand begins to rise, more building activity occurs and prices rise.

rental demand
the current level of demand or the number of tenants seeking rentals versus the number of rental units available. Rental demand levels determine market rates as well as vacancy levels and duration.

variety of programs? Are rates attractive? (Rates for investment properties tend to be higher than for owner-occupied housing, and down payment requirements are likely to be higher as well.)

If commercial loans are not available, what other methods can you use? You could seek properties in which sellers will *carry* all or some of the debt. The problem here is that when sellers offer to finance a sale, it often means there is a serious problem with the structure. If the seller knows it is impossible to get conventional financing, that could be a troubling sign. You may be buying someone else's problems when you deal with seller-financed properties. At the very least, you would want to get an independent home inspection before agreeing to accept a seller's offer to carry a loan.

7. *Cash flow.* When you have analyzed all aspects of your local market, demand, financing, and other aspects, you end up with the most important question of all: Do the numbers work? In Chapter 2, we explore the importance of cash flow and show how to make these important calculations. It is essential for you to determine whether cash flow is practical in your situation. For example, if you expect to make monthly mortgage payments of $1,100 per month but market rates for rents are only $500, it is obvious that cash flow doesn't work out. And it is not as simple as comparing rents to mortgage payments.

Valuable Resource

To whom do you go to find an independent home inspector? Stay away from contractors who will also offer to perform work or refer work to someone they know. Ethical home inspectors refuse to perform repair work or offer referrals. Use an inspector who is a member of the American Society of Home Inspectors (ASHI). To review performance standards and to find a qualified inspector in your area, check the ASHI home page at http://www.ashi.org/.

You also need to consider nonmortgage expenses and payments; tax benefits; and the possibility of vacancies. How much cushion do you have between your monthly family income and expenses? If unexpected expenses or a period of vacancies would cause a disaster in your finances, you need to evaluate that realistically, and consider whether it makes sense to invest in rental income. Some alternatives include higher down payments (translating to lower monthly mortgage levels), seeking less expensive properties or multiunit properties, where the ratio between income and mortgage expense may be more favorable, or simply waiting until your financial picture is stronger. It makes sense to identify risks now, before you invest money, so that you know what risks you may face after you have closed on a rental property.

carry
taking a loan on property; when a seller agrees to carry the loan, it means the seller transfers title to the buyer and then takes on the role of lender.

Advantages to Long-Term Investing

You may divide your investment into classification on several criteria: risk level, dollar amount allocation, or type of investment, are examples. You can also distinguish between investments by how long you plan to hold them. Traditionally, real estate has been thought of as a long-term investment, whereas stocks can be either short term or long term. This distinction has much to do with the *liquidity* levels of each market. You can buy and sell stocks or mutual fund shares with a telephone call and the transaction can be completed in seconds. Real estate purchases, in comparison, are expensive, complex, and take time. By this distinction alone, the cost of completing a real estate transaction makes the entire market far different than stocks. One advantage to real estate investing is that its long-term characteristics provide stability and safety, attributes that appeal to most investors. In spite of the illiquidity of the market, your inability to buy and sell real estate quickly or easily provides discipline to your long-term investment program and may be well suited to your personal financial goals.

Price appreciation is a second way to distinguish between investments, and also a second form of advantage to real estate investing. Both the stock market and real estate have performed well over the long term. However, stocks tend to go through highly volatile price cycles. Investors have often experienced months and, in some instances, several years in which prices were depressed or

liquidity
a market condition referring to the ease of buying and selling, or the availability of cash. A highly liquid market (like the stock market) allows investors to move cash in and out of positions cheaply and quickly. Illiquid markets (like directly owned real estate) require complex and expensive closings to buy and sell investments; or refinancing or additional mortgages to remove cash.

volatility
a measurement of market risk; the tendency for market value to changes gradually over time (low volatility) or to change erratically and unpredictably (high volatility).

erratic. The same economic forces leading to stock market instability have also affected real estate values, but by no means as drastically. Figure 1.2 made this point; Census Bureau statistics make the case that on average, residential property values move upward with reassuring consistency. So while both stocks and real estate offer long-term price appreciation to investors, *volatility*—the tendency for market values to remain consistent over time (low volatility) or to change unexpectedly in either direction (high volatility)—can be viewed as one way to measure *market risk*. The low volatility of real estate, in comparison to stocks, makes it a safer long-term investment.

Another advantage to generating rental income is that, over a long period of time, rent-paying tenants provide funds to pay down your mortgage. The often-observed point that "your tenant pays your mortgage" is simplistic because, in fact, you also take on many risks when you create a large debt and come to depend on tenants to provide the cash flow you need. There is much more to it. However, assuming that you are aware of those risks and that you pick tenants and screen them diligently, the regular cash flow produced by tenants makes financed real estate viable.

Financing real estate is seen by many as a large risk. You may carry debt as high as 70 or 80 percent of property value in the form of a mortgage, and you require rental income to keep up with those payments. As with all forms of risk, there is an associated advantage. Using a relatively small down payment and financing the majority of your investment basis is a popular form of *leverage*, which is the use of a small amount of money to control a much more valuable asset. Just as some stock market investors use margin accounts to increase their stock positions, real estate investors borrow money to leverage and, thus, to afford to purchase property to produce rental income. The concept of leverage depends on building equity value over the long term to build wealth. Rental income generated by tenants is applied to *debt service*, the monthly payments you are required to make to the lender, including principal and interest and, when applicable, *impounds* as well. When impounds are included, the total of monthly payments is referred to as *PITI* (principal, interest, taxes, insurance).

Among the advantage to investing in rental income property, one of the most significant is the income tax benefit it provides. Most investors are not allowed to deduct losses in many forms of investments, except to offset them against gains in other investments (see Chapter 7 for the details). Real estate investors are given a special provision in federal tax law allowing them to deduct up to $25,000 of losses each year, subject to some limitations. They can depreciate the buildings they purchase and also deduct mortgage interest, property taxes, utilities, insurance, and other expenses necessary for operating a rental income program. The tax benefits are significant; it is often possible to report a yearly loss for tax purposes while also generating more cash coming in than you are paying out. So the tax benefits also affect after-tax cash flow, often making the difference between practical and impractical in your investment program.

Yet another benefit in buying real estate is the fact that its value can be insured. In fact, your lender is going to require that you carry insurance to protect against fire and other possible damages to your rental income property. You cannot insure stock market investments in the same way. Stock market investors face the possibility of sudden and unexpected loss on a daily basis; real estate investors face the remote possibility of loss but their equity is protected through insurance coverage.

When you own rental income property, you also achieve an important form of *diversification* in your portfolio. The basic idea of diversifying is to spread capital among several dissimilar investments so that, in the event you lose in one, you will not lose in all. Stocks and real estate are perfect examples. There is a tendency for investment capital to move back and forth between stocks and real estate depending on a number of economic conditions and trends, most notably prevailing interest rates. Diversification itself can be achieved within one market by placing money in many different

market risk
the primary risk to investing money, that value will fall either temporarily or permanently. Market risk exists in all forms of investing but it varies by degree. The most effective way to offset market risk is through research and analysis before purchase.

leverage
the use of capital to control or to purchase assets worth far more; rental income is applied to paying the cost of leveraged capital, specifically its debt service.

debt service
payments to a lender required each month, consisting of principal and interest and, if applicable, impounds for property taxes and insurance.

impounds
amounts included in a monthly mortgage payment beyond principal and interest, required under the terms of some mortgage contracts. Typical impounds are collected monthly for property taxes and insurance. The lender then makes periodic payments for those obligations.

PITI
a term describing a monthly mortgage payment that includes all four elements: principal, interest, taxes, and insurance.

diversification
a method for reducing risk by placing capital in several different products; the purpose is to avoid a large loss if and when economic conditions cause price declines in a particular market sector.

areas. For example, a stock market investor is advised to own shares of many different types of stocks that operate in dissimilar economic cycles, to avoid a portfolio-wide threat of loss. A more advanced form of diversification is *asset allocation*, a method of selecting investments in several different areas to reduce the economic risks even further. Asset allocation is really a broader form of diversification. The distinction is that a diversified portfolio may exist solely in the stock market or in real estate; asset allocation, on the other hand, usually involves placing percentages of investment capital in several different areas: stocks, real estate, cash reserves, personal retirement funds, insurance with cash value or annuities, or precious metals, for example.

In a diversified investment portfolio, you not only spread risks; you also create dissimilar investment features. In stocks, relatively small dividend payments do not usually represent a lot of current income unless you own a large portfolio of stocks. In comparison, rental income generates substantial monthly cash flow, and this is both necessary and an important advantage. You need the cash flow to cover your mortgage obligation (debt service) and also to maintain the property. So cash flow is actually more critical than net income or loss for tax purposes, because it determines whether or not you can afford to buy and hold real estate. Chapter 2 examines the whole issue of cash flow in detail.

A final point worth mentioning in the list of advantages is that of personal control. To many real estate investors, this is the most attractive feature of all. When you buy shares of stock, you own a small piece of a larger equity in a corporation; but you have no voice in the day-to-day management decisions. The executives and board of directors decide whether to acquire or merge with other companies, which products or services to promote or to abandon, and when to buy or sell capital assets. These are important decisions that define profit and loss; but the individual stockholder is only going along for the ride, hoping that those shares of stock grow in value. Whether or not that happens depends on how well management makes those important decisions. In comparison, when you buy a rental income property, *you* are your own management and board of directors. You decide when to buy or sell properties, how much rent to charge, and who you will accept as tenants. You set policies regarding maintenance; if you do the minimum, property will deteriorate and value will follow, and if you keep property in excellent shape you will experience increased value and more responsible tenants. This personal control is the single feature that will determine, more than anything else, how well your investment appreciates in comparison to other property in the same neighborhood.

asset allocation
an expansion of investment diversification, in which percentages of total capital are invested in dissimilar types of investments, such as stocks, real estate, or cash deposits.

Disadvantages to Long-Term Investing

Just as every form of investment has advantages, it also has disadvantages. This is as true of real estate as of any other choice. In fact, some of the advantages listed in the preceding section have a corresponding disadvantage. You should be aware of these features of a particular investment before deciding to proceed with an investment program, whether you are considering stocks, real estate, a combination, or some other product.

In real estate, one of the most significant disadvantages is the long-term cost of buying property. Mortgage payments have to be made every month, even when property is vacant or when tenants are late with the rent. In the earlier years of a long-term mortgage, the majority of the monthly payment goes to interest. This cost is far higher than most people realize. For example, if you borrow $100,000 and finance your investment with a 30-year loan at 6.25 percent, your monthly payment will be $615.72. Over the full term of the loan, your payments will add up to $221,659.20, more than twice the amount you borrowed. So the "real cost" of buying that property has to take interest into account.

The true cost of your home comes into focus when you also consider how long it takes to pay down the principal balance of the mortgage. The 6.25 percent loan will be less than 7 percent paid off at the end of the fifth year; the rest of the payments are all interest. In fact, it takes 21 years to pay off one-half of the entire mortgage. Because of the way that interest is calculated each month (based on the outstanding loan balance) the amount you owe declines very slowly at first, and only gradually accelerates in the last 10 years of the 30-year period.

Even when tenants cover the cost of financing rental income property, the true cost is significant. It is quite possible and even likely that the impressive gains in market value over many years will go primarily to interest payments. This means the lender really makes money on real estate, and the investor does not. Look at some numbers. If you had purchased a home in 1979, the average price nationally would have been $71,800 (see Table 1.1, Census Bureau information). If you put down $11,800 and financed $60,000 at the typical 1979 market rate for investment property of 12 percent, your monthly payment on a 30-year loan would have been $617.17. Assuming you did not refinance that debt, by the end of 2004, 25 years later, you would have paid a total of $185,151 and your remaining balance on your loan would be $13,872. So the total of payments consists of $139,023 in interest and $46,128 in principal. At that point, you would have paid the original purchase price of the property 2.5 times over. Of course, the transaction would involve tax benefits as well as tenant payments of rent, so is this a fair analysis? Yes. It is not the complete analysis, but it makes the point that rental income property is more expensive than the simple purchase price. In fact, the *real* cost of the property has to involve a calculation of purchase price, plus interest, minus net rental income, minus tax benefits. And then you would have to calculate the annual average return. The point to be made is that financing the majority of your investment does not produce profits that can be judged easily. Returning to the example of a property purchased in 1979 for $71,800, based on national averages, what would that property be worth 25 years later? According to the Census Bureau, the average value at the end of 2003 was $244,800. If we perform a simple calculation comparing market appreciation to the cost of borrowing, we discover:

Current market value	$244,800
Minus: original purchase price	–71,800
Minus: Interest, 25 years	–139,023
Profit	$ 33,977

To take this calculation a step farther, examine the rate of return. You originally made a down payment of $11,800, which was the amount of capital you had to put into the investment. Your overall profit over 25 years was $22,177, or an average of $887 per year. That works out to approximately 4.3 percent compounded over those years:

$$[1.043\% \times \$11{,}800]^{25} = \$33{,}806$$

$$\$33{,}806 - \$11{,}800 = \$22{,}006$$

The stock market averages about 7 percent per year in comparison. So a stock market investment in 1979 would have produced *average* returns adding up to $64,044, or a profit of $52,244. The comparison between return on a real estate investment and the stock market is shown in Figure 1.3.

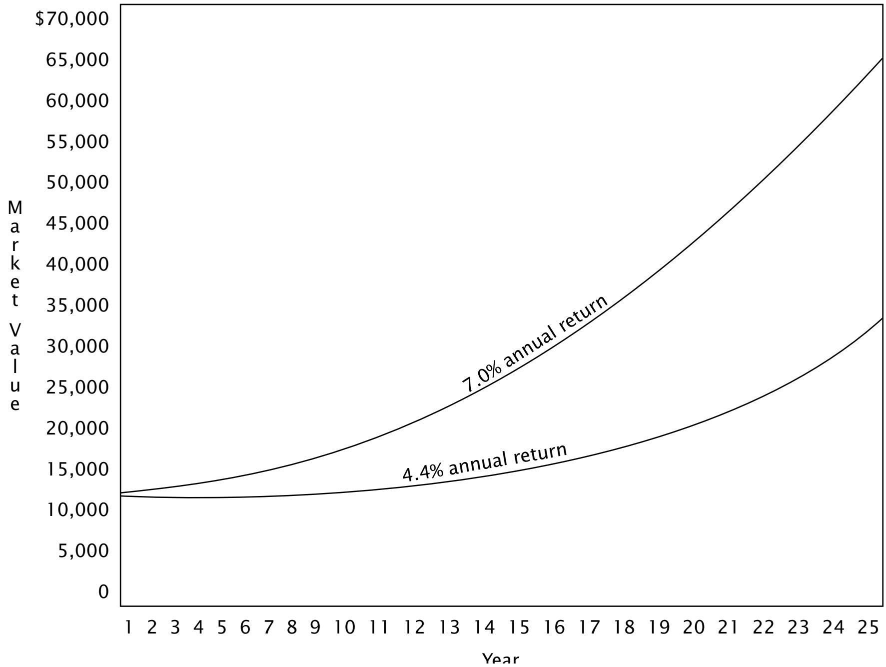

FIGURE 1.3 Comparison of a 25-year compound return.

This analysis is incomplete; it only shows the different values between the two markets. It does not consider the importance of cash flow (tenants paying rents to cover mortgages) or tax benefits, which can be significant in real estate. Even so, the point is worth making: Investments in real estate cannot be judged by comparing purchase price to sales price; there is much more involved in that calculation.

A valid comparison of the true rate of return in rental income property, versus the stock market, does not take all the variables into consideration. The purpose to this comparative exercise is to demonstrate that in fact, you cannot simply compare market rate increases without also keeping the *cost* of ownership in mind. The varying costs and benefits change the equation. As long as rental income is adequate to cover all of the costs, the real final outcome over many years is going to be based on how successfully the investment builds wealth. The value to having rents is that they offset interest costs, so that the effect is as close as possible to zero. This means that for no year-to-year growth in your tax liabilities (and often, a decline in liability) you gradually build equity from market appreciation as well as from slowly reducing your mortgage debt level. The overall real cost of purchase can be reduced in several ways, including:

- Replacing original mortgages with lower-rate mortgages as market rates fall
- Using high down payments to reduce long-term interest costs
- Contracting for faster pay-off terms of the mortgage
- Accelerating mortgage payments

These ideas are explained and examined in greater detail in Chapter 8. Looking beyond the long-term cost of real estate, it is equally important to compare markets in terms of liquidity. Real estate is an illiquid market, especially compared to the stock market. To get money out of your real estate investment, you have only three alternatives. These are:

1. Sell the property.
2. Refinance and take out cash.
3. Find a source for a second mortgage or equity line of credit.

The illiquidity of the real estate market is more severe for rental property than for your own home. Interest rates are usually higher for investment property, and most lenders also require a higher down payment. You may be able to finance your home for 10 percent down, sometimes even less. But for investment property, you could be required to put as much as 30 percent down. It may also be difficult if not impossible to take cash out upon refinancing investment property, if only because the lender's risks are much greater for investment property than for your primary residence. Finally, while people with good credit can easily find an equity line of credit, the majority of lenders will not grant these lines to anyone except owner-occupied housing. All of these rules add to the illiquidity of real estate, so realistically, you need to appreciate the long-term nature of real estate as well as the restrictions on accessing equity.

In the preceding section, we discussed cash flow as an advantage. The tenant-generated rents should be adequate to make mortgage payments and cover maintenance. However, the question of cash flow can also work as a disadvantage. Vacancies, nonpayment of rent, and unexpected maintenance expenses all add to the burden of owning real estate and you need to be able to afford a period of unexpected demands on your cash. If your family income is barely adequate to cover your expenses, an unexpected loss of rental income, even if only for a month or two, could be financially catastrophic to your personal budget. If that margin is too close, rental income property may be too high-risk right now. You might need to wait until you have more flexibility in your budget, or until you can create a savings cushion in the event the cash flow stops or maintenance expenses come up.

Every landlord knows that among the *potential* risks of owning rental income property, tenants can turn a positive one into a negative, and very suddenly. For many people, this factor alone has prevented them from embarking on an otherwise profitable real estate investment venture. There are ways to minimize risks, however. It is not necessary to avoid rental income altogether.

Stock investors know that the more advance research they perform, the less chance they will make a mistake in picking stocks. So they study financial statements, watch earnings trends, and even chart stock price movements. In real estate, you need to do the same advance analysis, not only to pick the right properties and to identify the strongest possible markets, but also to find the very best tenants. This means that you need to go through several steps when tenants apply for consideration. These include:

1. *Use a detailed rental application form.* Use a detailed rental application including bank account numbers, current tenant address, current and past landlord contact information, and permission to check credit (and collect a fee to cover the cost of the credit check). If the tenant does not complete and sign the form or cannot provide you with *all* of the required information, reject the application. There are good reasons why applicants will not give you landlord's phone numbers, for example.

2. *Check* all *references thoroughly.* Once you have the completed form in hand, get in touch with both current and previous landlord and ask them for details about their experiences with the applicant. The past landlord contact is important; current landlords might leave out important information because they want the tenant out. An ex-landlord will be more candid about what kind of tenant the person was.

   If the tenant lives locally, drive by the current address and see how the property looks. Has the tenant taken good care of the property? Or is landscaping in disarray and junk thrown out on the lawn? If you accept a tenant, the appearance of their current house or apartment is what your place will look like in a few months.

   Also call current employers and verify that the person is employed there. If a tenant does not have a job, why would you rent your property to them? How will they pay rent? If the tenant does not put down accurate information concerning employer, monthly income, or other details on the rental application, that is a red flag. Also verify the existence of a current bank account. When applicants are unable to provide you with a bank reference, it could mean they are avoiding liens or judgments or have other money problems.

3. *Also check credit history and local criminal history.* Get a current credit report using the tenant's payment, and read it carefully. Such reports may list judgments, evictions, bankruptcies and other problems you should know about, and the credit report is the place to start. You can also check with your county's Superior Court for any criminal convictions. This is public information. In most counties, all you need to do is go to the court clerk's office and ask whether any convictions have been recorded, and provide the applicant's name. For example, if an applicant has been convicted for operating a "meth lab," you would not want to rent out your house to that person.
4. *Use a printed rental contract form for complies with your state's laws.* Always use a printed rental contract that spells out all of the terms and conditions of the rental agreement. You are usually better off renting *month-to-month* rather than entering into a lease. The one-year lease usually protects tenants more than landlords and may bring up many problems if the tenant turns out to be less than perfect.
5. *Require a security deposit as well as first and last months' rent.* Protect yourself by collecting enough cash up front so that, in the event of damages to your property, or nonpayment of rent, you have some flexibility in dealing with the tenant. Some landlords are sympathetic to those who cannot afford first and last plus a security deposit; but when tenants are not asked to pay up front, problems can arise. For example, if tenants decide to give notice, they may simply fail to pay the next month's rent, reasoning that the security deposit can be converted to a rent payment. However, if they damage property or do not clean the place, then you are going to end up losing money as a consequence.
6. *Complete a statement of condition with the tenant present.* As part of the process of moving a tenant into your property, walk through with the tenant and complete a very detailed statement of condition, noting any and all defects, condition of walls, carpets, any furniture, appliances, and fixtures. Both you and the tenant should sign the form and each gets a copy. This solves problems that may arise when the tenancy ends. You may claim the tenant depreciated the place, and the tenant may argue that the damage existed when he or she moved in. The statement of condition, signed by landlord and tenant, resolves the disagreement.
7. *Enforce all of your rules regarding rent payments and more.* Having a written contract protects you; however, the conditions have to be enforced. So you need to make sure the tenant does not move extra people into the property beyond those names listed on the application. If you have a no-pets policy, don't allow the tenant to get a puppy or a cat later on. If the tenant is supposed to keep the lawn mowed and does not, give

the tenant a choice: Either do the work or you will raise their rent to cover the cost of hiring someone else to do it. In other words, you have a contract that both sides signed; make sure the tenant follows the rules.

8. *Check the property frequently.* One step a lot of rental income property investors overlook is the importance of monitoring tenants. This does not mean you have the right to enter the property without good reason or without notice; you do not. But you should drive by the property frequently. Danger signs include many cars parked at the house, high levels of traffic, garbage, or appliances in the yard, and other signs of the property being poorly maintained.

month-to-month

a type of rental agreement in which landlord and tenant continue the rental from one month to the next. In comparison, a lease binds both sides for the entire lease period.

Also give neighbors your name and address and tell them you are renting out the property. Invite them to contact you if they have any complaints concerning noise levels or unusual activity. Check out any complaints promptly. If you find that the tenants are disturbing their neighbors, tell them the problem has to stop immediately. If it does not stop, give them notice. If you have good reason to believe tenants are breaking the law (i.e., manufacturing or selling drugs from your property) contact the police and tell them your concerns.

There is a tendency for first-time investors to assume that tenants and houses cannot be distinguished by type. But in fact, a particular type of house is going to attract a particular type of tenant. For example, a very modern house located in a suburban neighborhood is likely to attract families, whereas smaller, more remote units are more likely to attract single people or young married couples. The rent level, condition and age of the property, and proximity to services and conveniences, will all determine the mix of tenants who are likely to be interested in renting the property. This is an important point in how well you are going to interact with your tenants. As a general rule, the better the condition of the property, the better the mix of tenants will be; this does not ensure that a well-maintained home will always attract responsible, fair-minded tenants. It just improves the odds.

A final point about tenants: You have to determine whether you are suited to dealing with other people. Investing in rental income properties requires that you be willing to deal with occasional problems and perhaps even confrontations. You have to expect telephone calls for petty complaints on evenings and weekends, and the unexpected catastrophe. For example, your water heater may burst on Sunday evening, so you will need to know where the shut-off valve is located. And the top priority the next morning will be to find a plumber who can install a new water heater that day. Tenants may call you late at night because the sliding door is stuck or because they think they hear a noise outside. You may need to place an answering machine on your telephone. In fact, many landlords pay for a second line specifically so that they can screen calls and have control over when they respond to tenants.

To some people, these minor annoyances go with the territory and they take it in stride. For others, the never-ending intrusion makes the entire venture a big hassle, and they conclude that they are not cut out for landlording. One solution is to sell and get out; another would be to place properties under professional management. Local companies provide services including fielding tenant complaints, filling vacancies and checking applicant references, and even paying bills and keeping books, usually for about 10 percent of monthly rents collected. For some people, the ability to not deal with tenants directly is well worth the management expense.

Deciding When to Sell

Every investor, whether holding real estate or other investments, constantly faces the problem of knowing how to time a sale correctly. The question depends on your personal investing goals as well as market price trends. For example, if you intend to hold onto property to build equity for your retirement, it would make sense to keep that property (or exchange it for another) until retirement age. If you want to dispose of property more quickly, when is the best time? When the price of your rental income property has risen, it is likely that the entire market has risen as well. If you intend to transfer investment capital from one property to another, you face three problems in this situation: properties are generally going to be high, you will be taxed on your gain when you sell, and there are costs involved in selling one property and buying another.

With these problems in mind, you need to know before you buy property how long you intend to keep it. That goal will be affected by several unknown elements, including:

- Your discovery that you do not enjoy working with tenants
- The realization that in a particular case, cash flow is not strong enough
- Changes in the market leading to weak demand for rentals
- Your decision to move capital from real estate into other investments
- The realization that the level of work required is too high

Market timing is only one aspect of when you will want to sell. For most people who go into rental income investments, the hands-on aspects of the venture are appealing and highly satisfying; but some people simply do not realize how much work is involved or what it is like to have to manage cash flow, until they actually buy and operate property. In situations where your dissatisfaction or risk level is simply too great, selling makes sense—even if that means cutting losses instead of making profits.

In timing a sale, you face the same problems you face in the stock market. In a market where prices have risen dramatically, you hesitate, thinking prices might continue to rise. No one wants to miss out on more profits. In fact, the temptation at those times is to put *more* capital into real estate so that your future profits will be even higher. When markets are moving up, there is a tendency to believe the trend is permanent. This belief is wrong, but it is widely believed.

In a market where prices have flattened out or fallen, investors also tend to believe that the profitability of real estate is over, and permanently; that profitable growth will never return; and that the decision to invest in real estate was ill-advised. Many people sell at such times, to later realize that the timing of their decision was a mistake. At the height of despair among investors, it is likely that the next run-up in values is about to begin. This has happened over and over and will happen again in the future.

To overcome these normal investor attitudes and take control of your investment policies, set specific goals. Your goals may be structured in one of several statements, such as:

1. I will sell this property when it has doubled in market value.
2. I will sell in 10 years, no matter what price changes have occurred.
3. I will hold onto this property as long as it is paying for itself (meaning that rents are adequate to cover all expenses and debt service).
4. I will continue investing in rental income property as long as rental demand remains at or above current levels (expressed as a percentage, for example).

One problem in selling a specific property and replacing it with another is the tendency for real estate trends to occur locally. In other words, the trends you experience in one property are likely to be typical of the entire market in your city or town. You probably want to restrict your activity to rentals within your immediate area, because absentee landlording raises many more problems. So property values tend to be universal within a specific region.

If you want to dispose of one property and invest capital elsewhere, a sensible approach is to change the type of property. For example, single-family housing tends to increase in value better than most other residential properties; but multiunit rentals usually produce far better cash flow. So you might sell a single-family house and replace it with a duplex or triplex, to improve cash flow. A more ambitious idea would be to buy an apartment building.

These alternatives to outright sale can make sense when you are discouraged about cash flow or attributes of a particular property. When you are thinking of selling ask yourself: Do I want to sell because selling suits my long-term goals? Or is it because I am having problems with this property, a particular tenant, or the area where the property is located? The answer should determine whether or need to replace the property, or just move capital into other investments.

The Positive Long-Term Experience: A Matter of Management

Multiple Listing Service (MLS)
a subscription service available to real estate agents reporting all homes currently on the market. The MLS also includes valuable statistics about the current state of supply and demand in the market.

spread
the difference between asked and sales price of homes, expressed as a percentage. Example: Average homes were priced at $107,500 in the past year, and average sales prices were $102,300, a difference of $5,200. The spread is 4.8% ($5,200 ÷ $107,500).

With some sound preliminary research, you can create a positive long-term experience in managing your own rental income property. Invariably, people run into problems because they skipped one of the important steps to good management. There are five of these key steps:

1. *Investigate markets and market values in advance of buying.* Never trust a real estate agent to tell you how strong the market is today. Agents are always going to claim that the market is good; that is their job. Agents want to encourage you to buy, and they will invariably believe that today is a "good time" to pick up a property. You need to investigate on your own. Gather *MLS* data from a real estate agent or local banker and study it yourself. Look for the key indicators. These include the *spread*, the difference between asked and sales price; how long a property was on the market before it sold; and the current *inventory* of residential property for sale. The lower the spread, the shorter the time on the market, and the smaller the current inventory, the better the indicators are. All of this information should be available from real estate and banking institutions in your area, and MLS data usually include these statistics.
2. *Look for good bargains in market value and potential rental value.* When you buy stocks, you are wise to check the fundamentals: revenue and earnings, capital strength, and more. The same is true for real estate. Before deciding to buy, you need to check the

real estate fundamental indicators in your area. These include market price trends, the demand for rental units (often expressed in *occupancy rate*), and a comparison between market rent levels and the mortgage payment you will have to pay.

3. *Screen tenants thoroughly and check all reference.* Never accept a tenant who cannot provide references or whose references are poor. The importance of carefully screening tenants cannot be emphasized too much. Use a form requiring current address, bank, employer, and current and past landlords. Check all of these references. If an applicant is not willing or is unable to provide the information, that should end the process. If any references are negative, reject the applicant.
4. *Enter month-to-month rental agreements rather than leases.* In typical situations where you, as an individual, are going to rent a single-family house or multifamily units (duplex or triplex, for example), you have an advantage in using a month-to-month agreement. This allows you to give notice without going through the complex steps of breaking a lease. While leases can be broken for good cause, it is complicated. Some people argue that a lease is preferable because to commits a tenant to a full year. But in a case of nonpayment of rent, you probably will not be able to get full restitution, whether using a lease or month-to-month agreement.
5. *Calculate cash flow including tax benefits.* Never purchase real estate without first going through a complete calculation of cash flow. This has to be done on a realistic basis, including tax benefits and all forms of payment you will have to make. The calculation involves several steps, but it is not as complicated as some people believe. (See Chapter 2 for a detailed step-by-step explanation of how to calculate cash flow.)

inventory
the homes currently on the market, expressed both in number of properties and months' of availability. For example, today there are 206 properties for sale. Typically, 38 homes are sold per month. There is a 5.4 month inventory available (206 ÷ 38).

real estate fundamental indicators
the market facts that define whether it is prudent to invest in real estate. These indicators include supply and demand and its effect on current prices; levels of demand for rental real estate units; the cost of borrowing money to finance a purchase; and a comparison between market rates you expect to receive and debt service and other payments you will be required to make.

occupancy rate

the level of occupancy, expressed as a percentage. For example, a rental property was occupied 10.5 months last year. Occupancy rate was 87.5% (10.5 ÷ 12). On a statistical level, all rentals indicate the local trend. For example, in your area, a total of 1,462 units exist and currently, 1,391 are occupied. The occupancy rate is 95.1% (1,391 ÷ 1,462). This statistic is often expressed as "vacancy rate," which is the opposite, or the percentage of available rental space not occupied.

The whole point of going through the preliminary steps is to avoid mistakes. Discovering an error after you have purchased real estate is the expensive way to go, but spending time and effort on the fundamental preliminary steps will save you thousands of dollars in the long run.

The next chapter provides a detailed explanation of how to calculate and control rental income property cash flow.