Chapter 1

Should You Be a Real Estate Investor?

Headline: "The big run-up in real estate values is now over."

This headline could easily have appeared in any U.S. newspaper in 2006, 2007, or 2008. But, looking back over time, the same pronouncements were made at various times in the 1970s, 1980s, and 1990s. Real estate values change every few years, and the cycles are continuous. The big difference in the cycle that began a downward spiral in 2006 was that additional economic conditions aggravated the situation. These included liberal credit, widespread speculation, and predatory lending practices. Making matters worse, big financial institutions jumped into the speculative trend, investing billions of dollars in mortgages through formalized programs.

You have probably seen and heard the bad news for yourself. Foreclosures are up, housing prices are falling, and the number of homes on the market is higher than ever before. Adding to the problem are "experts" on television financial programs, some announcing that the housing crisis will last another two to three years. In fact, however, no one can really illustrate the market cycles that way, and financial news programs thrive on bad news. Unfortunately, this only makes things worse because audiences become increasingly afraid when they hear the endless streams of negative forecasts.

Key Point

Endlessly hearing bad news affects investors and adds to their apprehension. Remember, however, that when things sound the gloomiest, it is the best time to buy.

The downtrends always end, and the market always turns upward. But, knowing how long it will take can be very difficult because so many factors influence the timing of every cycle. Wherever the market is at this moment, it will be at a different place next year; and, in the future, the pattern will be repeated.

The uptrend cycle is also interesting. Once real estate cycles turn around, the same doom-and-gloom experts will tell you that you have missed the boat and that you should have bought last year. These experts fail to realize that, with real estate, even when you have missed the latest boat, there will be as many "boats" coming in the future as you have missed in the past—if not more. Real estate is not a one-time opportunity, as it is made to sound on financial programs. Many factors—shifts in the job market, population growth and migration trends, regional desirability, and economic factors like interest rates—all mean that real estate opportunities occur not just once, but repeatedly and in very predictable cycles.

The many advantages of owning real estate are difficult to beat with other forms of investment. Real estate comes with the usual investment risks, but some very special risks related to real estate should also be kept in mind when you compare it to alternatives. With real estate, you gain tax advantages and direct control over the asset, and attain the ability to borrow money to purchase a property without being taxed on the money borrowed. (In fact, by refinancing, it is possible to keep your capital working while you still own the property.) In exchange for these advantages, you need to buy an expensive property, place yourself in debt, and in most cases, be unable to get your cash out through a quick sale. You also cannot sell part of your investment as you could stocks or shares of a mutual fund.

Real estate provides you with a combination of benefits and control. You can influence the value of a property with landscaping, roofing, a new coat of paint, and interior design, for example. When you buy stock in a corporation, it does not give you the right to go to corporate headquarters and sit in on management meetings, and you cannot own the specific assets represented by your shares. Stock ownership gives you a portion of ownership in an intangible unity called "equity," which collectively owns the company and appoints executives and managers. This is an important distinction.

real estate
land and all permanent improvements on it, including buildings.

One of the risks that many first-time real estate owners do not consider is that if you become a landlord, you will have to interact with tenants. This means that they may call you in the middle of dinner or while you are trying to watch the game on Sunday. These problems keep many would-be investors out of the business entirely. But, with careful screening of applicants and by the proper use of a telephone answering machine, you can achieve a relatively comfortable balance, while still acting as a responsible and fair landlord. All you really want as a landlord is a tenant who will pay the rent on time and do a reasonable job of caring for your property.

rights
intangible assets added onto real estate, which have value not because of the land itself but because of the advantages these rights provide.

Looking beyond the potential problems of dealing with tenants, the potential gains from investing in real estate make it worth a serious look. Let us begin by establishing a few important distinctions. *Real estate* is land plus permanent improvements, which most often means buildings. You may also become involved in the *rights* attached to the ownership of real estate, broadly called *real property*. Also be aware of the important difference between the full value or price of real estate, as opposed to *equity*, which is the portion you own after deducting debt. Equity is the purchase price (or current value of the property) minus all outstanding debt balances.

real property
real estate plus the rights attached to it, such as leases, easements, and estates.

Should You Buy Real Estate?

The pros and cons of owning real estate help you not only to understand the breadth of this market, but also to decide whether the market is appropriate for you. A checklist of points to consider:

Positive Attributes of Real Estate

1. *Direct control:* It is up to you, the owner, to maintain and improve your real estate investment. You do not have this kind of control in any other type of investment.

2. *Monthly income:* Rent income pays all or most of your mortgage. This means that tenants pay your debt and that, as market values increase, you benefit.

3. *Tax benefits:* Real estate is the only investment in which you are allowed to deduct annual losses. You are allowed to deduct property depreciation, as well as interest, taxes, utilities, insurance, and maintenance expenses.

4. *Historical returns:* Although real estate cycles can last a while and markets can be tough, historically, returns from real estate have been better than in any other market.

5. *Insurance:* Real estate is one of the few investments that yields monthly cash *and* is insured. Through your casualty insurance plan, you are protected against fire, liability, and other losses.

Key Point

Check positive and negative attributes of any investment to identify risks and rewards of the decision.

Negative Attributes of Real Estate

1. *Landlord issues:* When you work with tenants, you are likely to experience some problems. Tenants can be demanding and, in some cases, they may even do damage to your property. Some investors are well-suited to take on this risk, but others are not. It is wise to know in advance how you feel about working with tenants. It also is imperative to check references carefully to make sure you get the best possible tenants.

2. *Cash problems:* Whether or not you have tenants who pay their rent, you have to pay your mortgage every month, as well as insurance, taxes, and utilities. So, extended vacancies or, even worse, having tenants who do not pay rent on time will negatively affect your cash situation. If your personal budget is not strong enough to carry you through a vacancy period, you could face problems with your investment.

3. *Market conditions beyond your control:* Cycles vary not only by duration, but from one region to another. These factors are unpredictable. So, as a real estate investor, you have to be willing to go along for the ride, no matter how long it takes or how many twists and turns are going to be involved.

4. *Financing restrictions:* As a homeowner, getting financing is relatively easy compared to getting investment property financing. You may be required to make a larger down payment and pay higher interest, as well as other loan fees. You may also be limited in the number of investment properties you will be allowed to finance. Lenders are going to be concerned about your personal financial strength and ability to continue mortgage payments, even if you have vacancies in your investment properties. In addition, to succeed as a real estate investor, you are going to need exceptionally strong personal credit.

equity
the portion of real estate you own. In the case of property bought for $100,000 with a $58,000 mortgage owing, the equity is the difference, or $42,000.

Real Estate as a Growth Fund

Some investors buy real estate for the long-term appreciation and tax advantages it provides. In comparison, the *speculator* is an investor who attempts to make the greatest possible profit in the shortest possible time and is willing to take higher risks than long-term investors because short-term profits will be much higher. Speculators often are accused of being opportunists in the market, but that characterization is not always accurate. The speculator is simply taking a different approach to investing. The

speculator
an investor who buys property with the goal of earning the greatest possible profit in the shortest possible time.

same distinctions can be seen in the stock market. Some investors buy long-term growth stocks, whereas others try to guess where short-term price run-ups will occur. In all such instances, speculators chase after higher profits, but they also assume considerably higher risks. With that in mind, some long-term investors believe that speculators often do not achieve as much in the long run because real estate, by its nature, is a long-term investment. Both approaches have their good and bad features. Consider the following examples, which compare two investors who each have $50,000 to invest.

Key Point

Decide ahead of time if you want to get into the market as a long-term investor or a short-term speculator. This will affect how you invest.

Example

Karen invested $50,000 as a down payment on a $160,000 triplex. Her rents more than covered her mortgage payment, and she held onto the property for eight years. At the end of eight years, she sold the property for $235,000, realizing a capital gain of $75,000. During the holding period, she enjoyed positive cash flow and tax benefits and, upon sale, she earned a profit on the investment. Mortgage payments and other expenses were covered by rent receipts.

Example

Adam paid cash for a run-down house in need of many repairs, mostly cosmetic. He landscaped the yard, painted inside and out, repaired the broken windows, and upgraded the plumbing and electrical systems. The total of his purchase price and repairs came to about $50,000. He sold the house about eight months after he bought it and, after closing costs, netted $60,000. He made a net profit of $10,000 (before taxes) in less than one year.

A comparison between these two examples is more complicated than it seems at first glance because the two people may be paying different tax rates and because there is no way to know what future appreciation may occur on the fixed-up house, nor what rental receipts could be earned by turning it into a rental unit. However, the illustrations demonstrate two different approaches. The first is the long-term strategy, aimed at achieving positive cashflow, tax benefits, and capital appreciation. This example is not unusual, but it is ideal. The second example demonstrates how short-term strategies may work. The risk here is that the cosmetic repairs may not add enough value to the property to make it worthwhile in such a short period of time but, again, the example is not untypical. These outcomes do occur if the speculator understands the market and knows good value when it presents itself.

The speculator made $10,000 on a fast turnaround of the property, which is a better annual rate than the long-term appreciation approach. However, the speculator gained no tax benefits or positive cash flow during the holding period. As you can see, the decision to be a long-term investor or a speculator depends on your tax circumstances, your ability to manage market risks, and even your personal temperament.

Speculators share a good part of the blame for the national bubble that began to appear in 2006. By buying properties and quickly selling them to other speculators, a process known as property flipping (see Chapter 13), speculators rapidly drove up prices. In some markets, notably places like Miami-Dade, speculation in the so-called *pre-construction market* was so severe that the county ended up with a nine-year supply of condo units. Even so, construction and speculation continued. Eventually, the market ran out of new speculators, and it was impossible to sell all of those units. This is what invariably occurs when speculation runs wild.

pre-construction market

a market for property that has not yet been built, popular among speculators during bubbles, when prices are rising rapidly.

Key Point

Watch what is going on in your area. If much building is taking place but there appears to be little or no demand, you may be in the middle of a bubble.

Combined with *predatory lending* practices that infected the markets at the same time, the real estate bubble was exceptionally severe. The lenders who made borrowing too easy, often giving loans to people they

predatory lending

the practice of granting loans to borrowers despite knowing they cannot afford payments; or performing little or no credit verification to close such loans; or actively pursuing current borrowers to encourage them to refinance existing loans with excessive loan fees or high interest rates.

knew could not afford them, aggravated the situation as long as prices were rising. Speculation and predatory lending were a dangerous and destructive combination.

The *riskless transaction* that lenders and mortgage brokers go through when placing mortgage loans has been and is one of the most destructive forces in the real estate market—and will probably continue to be in the future. It is riskless for lenders because, as soon as loans are underwritten, these loans are sold to agencies that package them in pools and sell them. These pools operate like mutual funds in that they are made up of numerous mortgages. So, for the lender or mortgage broker, there is no real concern about whether a borrower is financially qualified, or even whether the borrower can afford mortgage payments. Money is made by placing loans in secondary market agencies, which create pools and then sell them to investors.

Key Point

A riskless transaction always damages the market because it creates artificial economics. Anyone who watched real estate from 2006 to 2008 knows how much damage riskless transactions create.

A responsible way to get into real estate investing is to be realistic about what you can afford. Every investment contains risks; in the past—especially during price run-up bubbles—many people naively believed that no actual risk was involved. Many speculators lost significant capital because they bought property at the worst possible time–when prices were at their highest and just before the bubble burst.

A realistic approach to real estate investing should include a test of how well real estate matches your *risk tolerance* and personal goals. Additionally, ask yourself how real estate investments are likely to compare to non–real estate investments such as the stock market.

In the stock market, certain stocks are referred to as *growth stocks*. Generally, this means that the stock's value is expected to increase over time. If you buy shares today and the estimate of future price growth is right, your investment will steadily grow in value over many years. You will not be concerned with the day-to-day fluctuations in stock value.

The same is true when you invest in growth-oriented mutual fund shares. The company's management buys shares in companies considered to be good growth stocks. If the mutual fund's management is right, your shares will grow over time.

With either direct purchase of stock shares or mutual fund shares, you depend on the quality of management to achieve your goals. With many different choices on the market, you accept certain risks in the selection process, and that is always a part of the investment equation. These same risk elements apply to real estate as well. You always accept risk when investing, and real estate, like other alternatives, comes with specific risks. In real estate, these risks include three possibilities:

1. The property investment may lose value or fail to appreciate according to your expectations. All investments contain this risk. Even insured savings accounts can deteriorate when interest rates are lower than inflation. The basic market risk is the best known and, for most people, the primary form of risk. It is fair to say that, in most regions, real estate has to be held long enough for appreciation to occur, and the real risk is that you do not know in advance how long that will be.

2. You may not be able to find tenants or to charge rents adequate to cover your monthly expenses. When a large number of rentals are available and there are relatively few tenants, market rates

riskless transaction
any transaction in which the actual risks are transferred to someone else; for example, lenders and mortgage brokers who, when they underwrite and then sell loans, transfer the risk of lending to investors in mortgage pools.

risk tolerance
the level of risk or type of risk a person is able to stand, based on experience in the market, knowledge about investments, personal income and available capital, investing goals, and the ability to keep capital invested for periods of time.

growth stocks
stocks expected to increase in value over time.

level out or drop. To avoid vacancies, you may have to reduce rents. The opposite is true in periods of high demand. With too few units and many tenants, your market rates will rise.

3. Your tenants may not pay the rent that is due or may not care well for the property. In real estate, tenant problems are frustrating because such problems force you to confront matters at once or lose money. Invariably, that means dealing with people who are having problems beyond the landlord–tenant relationship, who are immature and irresponsible, or who simply want to avoid paying the agreed-on rent. Proper screening and review, and checking of references, reduce these problems dramatically and should be requirements of being a landlord.

These basic risks are not the whole story, but they are major considerations when you are evaluating the possibility of investing in real estate. These problems will not seem as formidable when you actually buy a property and begin managing it. With patience, caution, and maintenance, property will appreciate over time when it is carefully and intelligently selected. You will also learn by experience how to screen tenants, set fair rents, and confront problems before they turn into crises. Just as parents learn on the job, landlords have to discover the problems that arise with tenants and learn how to avoid these problems in advance.

Risks are manageable, as long as you are aware of them. A common mistake is to look for ways to eliminate risk, when, in fact, smart investing calls for awareness and risk management. Some risks can be mitigated. For example, buying fire insurance protects you against a loss of a rental home; not to carry such insurance is to assume more risk than you can afford. You need to evaluate the different types of risks involved with investing in real estate, and then determine how much risk—and what kinds of risks—you are willing to assume. The speculator is willing to take the risk that the real estate market may not support the strategy of buying and selling homes in a short period of time. If the speculator's timing is off, the strategy will result in a loss, or the property will have to be held longer than intended.

Most people begin their real estate investments by studying and comparing prices. You should always keep in mind the risk rule in real estate: *The greater the risk, the lower the price*. For example, real estate in a poor location will naturally cost much less than real estate in a prime location. The risk in such a case has to do with the potential for appreciation. The price in the poor location is less likely to rise at the same rate as prime property and, in fact, could even fall. As average market prices rise, the tendency is for better-than-average properties to rise faster than average and for poorer-than-average homes to lag behind. Good investing requires foresight. In addition to estimating and calculating the risks and potential profits, you need to become adept at identifying the good and bad points about all of the factors affecting price and value: location, timing, and local economic conditions (now and in the future). This is exactly the same type of analysis all investors need to perform. However, instead of studying financial statements of companies and looking at market index trends, the real estate investor has to be able to read social, political, economic, and demographic trends within a city and region.

This book assumes that your goal is to invest for future appreciation. Certainly, speculation is one alternative, but that profile does not fit most people in terms of available capital, financial goals, or market expertise. The main focus here is showing you how to get started by buying one or two rental houses, then how to build up equity while managing property and coping with tenants and, ultimately, how to create a profitable investment for your future financial security.

Long-term investing requires a commitment longer than two or three years. In fact, "long-term" generally means 10 years or more because it takes that long to create *seasoned real estate*. As you make monthly mortgage payments and as property gradually increases in value over time, seasoning occurs.

seasoned real estate
real estate that has been owned long enough for market value and equity to accumulate.

The Real Estate Cycle

Real estate investments react to economic cycles, as do all investments. The major points in the cycle—falling and rising prices, for example—are characteristics of *supply and demand*. The tendency dictated by this basic economic idea—that prices rise and fall according to levels of supply and demand—is the guiding force in selecting investments, timing purchases and sales, and selecting one investment over another.

supply and demand
the economic conditions in the market that affect prices. When demand is greater than supply, prices tend to rise; when supply is greater than demand, prices tend to fall.

market economy
a market in which prices are not set but vary with purely economic factors, specifically supply and demand.

In a pure *market economy*, prices rise and fall in accordance with the dictates of supply and demand. Higher demand places pressure on the supply, and prices rise; lower demand softens the market, so that prices fall. The same features are found in the stock market, which often is called an "auction marketplace." This means that prices change specifically because the mix of sellers and buyers changes. When more buyers want a limited number of available shares of stock, this drives up the price; and when the number of sellers grows, this forces down the price of the stock. An ongoing auction is underway when the market is open.

Real estate does not change hands in an auction marketplace. Stock exchanges are public, and millions of individual trades result in tremendous share volume every day. In real estate, brokers are not bidding and negotiating from moment to moment; and real estate sells in large, single units rather than in millions of small shares. Offers are placed in writing through real estate agents and based on asked prices. Prevailing market conditions determine whether a potential buyer makes a full-price offer or tries to negotiate a lower price. The same conditions also affect the seller's response. A firm seller sticks to the asked price or stays close to it, but when the market is soft, sellers have to accept lower bids or their properties will not sell.

Although the rules of contracting for buy and sell prices and making and closing a deal are the same for stocks and real estate, methods are different. In the minds of most investors, the rules are different as well. For example:

- Many people who can afford to buy 100 shares of stock would be faced with much more demanding financial arrangements if they were to bid on real estate. Accordingly, the stock market is available to many more investors, and trading can occur frequently and in relatively small increments.
- Stocks are often bought and paid for in cash, whereas real estate more likely involves financing.
- Real estate prices are naturally higher than shares of stock, so the entire process of buying and selling—comparing, negotiating,

bidding, offering, and closing—tends to be more formal and take longer.

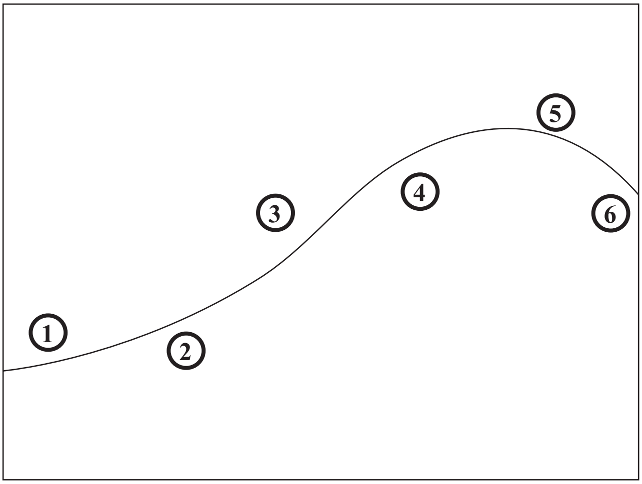
- Real estate does not trade hands as frequently as stocks, so the trading volume in real estate is much smaller, and indicators based on sales volume tend to cover periods of months and years rather than tracking methods used in the stock market, such as hour-to-hour or day-to-day volume.

motivated seller
a seller who is very anxious to sell, meaning that the seller is more willing than a firm seller to negotiate on price and other terms.

real estate cycle
the trends in real estate values, affected by ever-changing levels of supply and demand. The cycle describes changes in construction activity, available supply of real estate for sale, credit available for financing, interest rates, population and job demographics, and attitudes among buyers and sellers at any given point.

Reasons for selling are different as well. Sellers of stocks often want to take short-term profits and move on to other issues, or simply want to move their money to another stock, which they believe would make a better investment at that moment. The real estate seller may be anxious to sell for a number of different reasons. A *motivated seller* wants to find a fast deal in order to get the equity out and move on. Motivated sellers may have made an offer on another house, be moving to another area, or be making other major life changes. The degree of anxiety to sell will dictate how much negotiation the seller is willing to undertake. In a very soft market—in which many homes are for sale and few buyers are available—it may simply be impossible to sell a property, at least immediately. In the auction marketplace of the stock market, there is always a ready buyer. The price may be low because demand is low, but shares of stock on a public exchange can be bought or sold at the current price at any time.

The events and conditions influencing real estate values are referred to as the *real estate cycle*. Although many factors affect the cycle, including population, the job market, interest rates, financing, construction levels, and many other economic changes, the real estate cycle moves in a fairly predictable sequence over time. The stages vary in length of time and rapidity of change based on the



1. Demand begins to rise.
2. Construction activity increases.
3. Demand slows.
4. Supply exceeds demand.
5. Construction activity decreases.
6. Demand bottoms out.

FIGURE 1.1. The real estate cycle.

collective changes in market conditions; however, six distinct points can be identified in the course of the real estate cycle. These are summarized in Figure 1.1.

1. *Demand begins to rise*. Demand rises for many reasons—often for a combination of reasons. The fact that more buyers are looking for property now than a year ago is a symptom of rising demand. It may be caused by growing population, job creation, and other factors. The forces that create demand cannot be isolated or easily identified; demand is usually a general trend involving many parts. One element of demand results from a decrease in construction activity, leading to housing shortages. In a truly efficient economy, developers always build exactly the number of new homes required to meet the needs of the immediate future, while maintaining supply and demand in a healthy balance so that values gradually rise with moderate inflation. But, that is the ideal world, and the real world rarely acts that way.

2. *Construction activity increases*. Why do developers increase their rates of construction? At the beginning of the cycle, the general perception is that demand is on the rise. At that moment, the perception is correct. The trick, however, is to know when to stop building new homes. Construction activity is responsive. As demand increases, so do the construction rate and pace. That pace often exceeds actual demand, so that as the cycle tops out, the consequence is oversupply.

3. *Demand slows*. When we say that demand slows, we could mean that demand actually decreases or that the rate of new construction accelerates beyond a more moderate demand curve. As long as construction and demand are moving at the same pace, there is no relative change in the real estate cycle. When demand slows for either reason, this event signals that the top of the cycle is approaching. You will recognize this point by an increase in the time required for listed property to sell. In some markets, homes under construction are sold literally faster than they are built. But if builders start accumulating an inventory of finished homes that are not selling right away, this is a sign that demand is slowing (or that construction has outpaced demand).

4. *Supply exceeds demand*. The cycle tops out and begins to decline at the point when property available and on the market exceeds demand. This does not mean that no real estate is selling. It does mean that supply is larger than it needs to be and that demand is not high enough to move the inventory of available property. As a consequence, prices tend to level off or fall. The cycle may stall—meaning, new construction is meeting demand, but prices do not rise because the inventory is perpetually higher than it should be.

5. *Construction activity decreases*. No market can sustain a holding pattern for long. When inventories of available property are too high, construction eventually falls off, at least temporarily. Builders and developers, like everyone else, do not always recognize the point in the cycle until it is too late. So, at the point where prices have become soft and supply is too high, builders realize that they cannot continue to develop the market at the previous pace. Another problem in trying to watch and predict cycles, whether in real estate, the stock market, or other markets, is that you do not know whether specific signals indicate changes tomorrow, next week, or next year. Timing is the difficult part.

6. *Demand bottoms out*. At the end of the cycle, demand is at its lowest; construction activity has stopped for the most part; and no changes are in sight. A cycle may remain at its bottom for a few weeks, a few months, or many years. No two cycles follow identical wave patterns, and there may be numerous false starts along the way. The word "doldrums" appears in financial articles, and experts proclaim that the opportunities in real estate are over, once and for all. This statement is one of the predictable events at the bottom of the cycle. Remember, however, that such categorical predictions—like predictions that inflation is gone forever—are always wrong. The end of one cycle is also the beginning of another one.

In practice, cycle length varies considerably. The downtrend from 2006 to 2008 was exceptionally long and widespread compared to previous cycles. Although cyclical trends vary by region, the complexity of cyclical movement and the many varied underlying causes of accelerated or slowed change cannot be simplified.

Key Point

No two economic cycles are identical. Real estate cycles vary in duration and severity owing to a variety of supply and demand influences, as well as conditions in other markets, such as the credit market.

The effects of supply and demand are easily understood, but the general economic theory remains unchanged. By remembering that cycles are all different from each other, it is possible to make a basic observation:

1. Supply rises and demand falls.
2. Demand rises and supply falls.

This cycle, like all cycles, involves the cause and effect of supply and demand. (Please see Figure 1.2.) You are aware of the variables in the cycle and the complexity of influences that have to be added into this, but the basic equation remains the same. One way to better understand why cycles move the way they do is to understand that, in the first half of the cycle—when prices are rising—the price curve tends to run ahead of the demand curve. On the other side, when prices are falling, the price curve lags behind the demand curve. The trends run out, and the cycle begins again—thus, the wave effect.

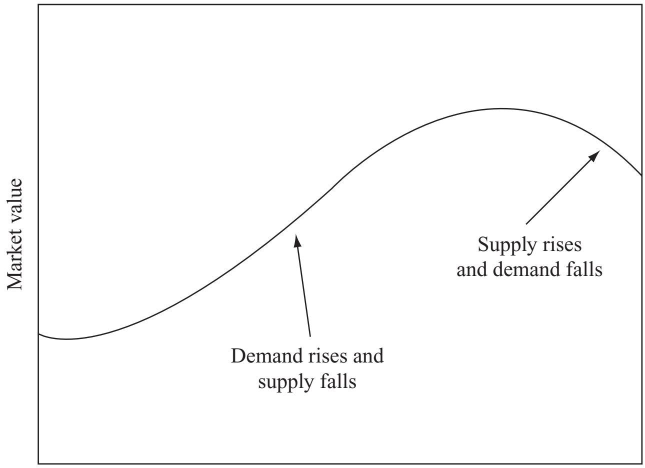


FIGURE 1.2. Supply and demand.

Changes in relative levels of supply and demand are nothing less than the sum of all influences in the market at that moment. If developers ceased building altogether because of excess supply, demand would eventually use up that inventory, and the cycle would be forced to begin anew. If employers came to town, demand for new housing would accompany new jobs. However, we can never have absolutes, such as construction levels stopping altogether or a complete turnover in the job market. Such influences tend to occur incrementally rather than in single motions. So, in reality, when we talk about supply and demand, we are really describing a trend that involves all of the complex economic, social, and intangible influences at work in the community.

Real Estate Rules of Thumb

The factors that influence real estate values are complex, as they are in most markets. Just as determining why a particular company's stock sells for $80 per share whereas a comparably capitalized competitor's stock is worth $60 can be elusive, so does the same difficulty apply to the real estate market. You simply cannot compare between regions. Thus, a single-family home of 2500 square feet, less than five years old, may be priced at $1.2 million in San Francisco but at $165,000 in

Indianapolis. Even with a thorough understanding of all the influences creating variances in supply and demand, differences in price cannot be easily explained. This makes an important point, however: Before buying real estate, it makes sense for any investor to study the local market and to attempt to understand the kinds of growth rates likely to occur in coming years. This involves analysis of historical price changes, the local economy, available land, costs of construction, and migration trends.

Key Point

The more research you perform about your current real estate market, the better. This defines how well you will time your decision to enter the real estate market.

For example, as the baby boom generation has grown and begun to retire, population levels in that age range have grown in Florida, Texas, and Arizona, while shrinking in the Northeastern and Great Lakes states. A 2005 study estimating a shift in Electoral College votes by the year 2030 demonstrated how this population shift will dramatically change not only voting trends, but overall population age, notably in Florida, Texas, and Arizona.

Table 1.1 is a breakdown of the estimated change showing the largest gainers and losers:

TABLE 1.1. Estimated Electoral College Changes by State[a]

State	*Total*
Florida	+ 9
Texas	+ 8
Arizona	+ 5
New York	− 6
Ohio	− 4
Pennsylvania	− 4
Illinois	− 3

[a] The Brookings Institution, *The Electoral College Moves to the Sun Belt*, May 2005, at www.brookings.edu.

TABLE 1.2. Total Increases in Electoral Votes for the Sun Belt Region[a]

Year	*Total Votes*
1970	271
1980	288
1990	303
2000	313
2010 (est.)	322
2020 (est.)	331
2030 (est.)	342

[a] The Brookings Institute, *The Electoral College Moves to the Sun Belt,* May 2005, at www.brookings.edu.

The study also estimated the overall change in Electoral College votes by region, estimated to occur by the year 2030, combining historical data with estimated future increases. Please see Table 1.2.

This long-term perspective of population trends demonstrates that influences on real estate are best viewed as long-term in nature. Whereas trends in the stock market tend to move rapidly and turn quickly, real estate is likely to demonstrate more consistent and long-term change over years and decades, rather than over months or weeks.

Key Point

The reality is that population groups migrate over time. The retirement of the baby boom generation may be the most significant factor in determining where real estate values increase in the next few decades.

Although analysis of long-term trends in demographic and economic terms provides valuable information, it also makes sense to be aware of real estate rules of thumb:

1. *Real estate is a long-term proposition*. It is not realistic to expect that you can make a killing in real estate in a very short period of time. Whereas some people have profited from fast speculation, the opportunities are much clearer in hindsight. In fact, the most successful speculations are made at the moment when virtually everyone else is doing the opposite. You buy when everyone else is selling, for example. Going into real estate with the goal of getting rich quick is a risky idea, and the odds work against you in that case.

2. *Real estate markets are strictly regional.* You have probably read in national magazines or wire service stories at various times about "the plight of real estate." You may also be aware that a lagging real estate market described in such stories does not necessarily describe what is going on in your town. That is because real estate is always subject to regional factors, and rarely is local real estate drastically affected by national trends. For example, Northwest prices move for Northwest regional causes, and not because of population and employment trends in the East.

Employment is a good example. Changes in the job market directly affect real estate supply and demand; and yet, employment varies greatly from one place to another, often in places separated by only a few miles. Many people automatically assume that real estate conditions are the same everywhere, but this is a mistake. The assumption applies stock market thinking to real estate. However, whereas the stock market is national, real estate is strictly regional, so the rules are different. Never make up your mind about what is going on in your area based on a story written by someone living somewhere else. Depend only on regional news and statistics, and talk to real estate agents and bankers in *your* area before deciding the condition of the real estate market.

3. *The big run-up is never really over*. When real estate prices soar in a relatively short period of time (five years or less), a period of pessimism follows. We are told that we have missed the chance if we did not buy real estate several years ago and, even worse, the opportunity will never come again.

None of that is true. If, in fact, a recent run-up has peaked, this is only the end of one cycle; and the end of a cycle is also the beginning of the next cycle. By waiting for the right signals, you will still be able to time your investment decisions to approximate the bottom and top points. Even if you did miss the "big" run-up of the recent past, you still have time to get in at the bottom of the next cycle.

Why do cycles repeat? Despite the recurring predictions in the financial press that yesterday's opportunities are gone forever, there remains a constant and growing demand for real estate. The initial demand is for housing due to a growing population, and housing demands spur related demands in manufacturing, industrial, and other sectors. But, can we depend on such demands increasing into the future? Yes.

The population continues to grow. Even though the baby-boomer generation may stop buying homes, their children (and grandchildren) will continue the demand. There is no reason to expect the demand for housing to decline in the future. The U.S. Bureau of the Census projects that the population of the United States will grow more than 35 percent between 2010 (308.9 million people) and 2050 (estimated 419.9 million).*

Much of the growth will be attributed to two primary factors. One is a continuing trend in immigration. The second involves people born between the late 1960s and the late 1970s and their moving into home-buying age by 2010. This block of the U.S. population is expected to grow by 1.8 million new households between 2010 and 2020.†

Demand coming from population growth, whether due to changes in growth rates, immigration, or migration, is only one important reason creating ever-growing demand for real estate. This simply means that, as people move into the typical home-buying age, beginning at about age 30 on average, new demand for homes is created. Thus, the greater the increase in population, the higher the demand and, consequently, the more likelihood of continued long-term growth in real estate values.

Key Point

Real estate values do not grow for no reason. The clear effects of new demand are a primary driver for prices. Except for false demand (e.g., that created by speculation and predatory lending), future growth is predictable based on a simple understanding of the sources for new demand.

With these economic realities in mind, it is clear that any specific run-up in real estate prices is not a singular event. A specific price trend is going to end as the cycle turns, but the same pattern will recur in the

*U.S. Bureau of the Census, Projected Population Growth of the United States by Race and Hispanic Origin, 2000 to 2050 (2006 midrange prediction), at www.census.gov/population.

†John F. Kennedy School of Government, Harvard University, The Joint Center for Housing Studies, The State of the Nation's Housing, 2008, at www.hks.harvard.edu (growth between 1995–2010 was 12.6 million, compared with estimated growth from 2010 to 2020 of 14.4 million, for a net increase of 1.8 million new households).

near future. With the previously cited estimated 35 percent increase in the U.S. population by 2050, it is obvious that future demand for housing will be higher than it is today.

Also consider the nature of real estate. The costs of construction and replacement grow with inflation, meaning that materials prices add to the cost and market value of property. Homeowners themselves work to maintain and increase values—not only because they want to profit from their investment, but also because growing values are good for everyone: individuals, families with children, and the community as a whole. However, homeowners do not think like investors in many important respects. Long-term homeowners do not worry about relative price fluctuations, even when their property values fall because they buy property and remain in one place for other reasons—quality of schools, safety, lifestyle, and proximity to work. To the homeowner, these are the important considerations. These are important to investors as well, although the investor's perspective is different. The investor is much more aware of the cyclical change in real estate, that 7- to 10-year fluctuation in supply and demand within the community.

4. *It is impossible to identify exactly where you are in the real estate cycle*. Investors invariably have trouble estimating where they are today. Their historical perspective is always clearer. Because "value" is a relative term, perceptions about today's real estate market have to be based on cyclical indicators other than price. This cannot be overemphasized.

Price is only one way to measure cycles. When you are estimating future movements in the cycle, you see price as one of the least dependable methods to use. You can learn much more by running comparisons of other cyclical indicators, including:

- Number of housing starts in your area (compared to the past).
- Length of time housing is on the market between list date and sale date.
- Percentage differences between list price and sale price.

These, by no means, make up the whole list, but you can see the value of these statistical indicators. All are designed for comparisons between periods. It is the same type of analysis performed in the stock market, where analysts are concerned with trading volume, high and low records for the 52-week period, changes in an issue's volatility, and other such indicators not directly related to prices. In real estate, price seems to be used all too often as the single indicator of the cycle, and it is not reliable as a means for developing the actual trend and identifying the place within a longer cycle.

Cycle identification is never an exact science because duration and strength of movement in the cycle vary greatly. If cycles were predictable, it would be a simple matter to get rich in real estate, given a small amount of patience.

If you are troubled by the complexity of changing real estate cycles, you should take comfort in one broad fact: For the most part, *real estate prices rise over time*. This may not be true within one specific region over a lengthy period of time, but for most regions experiencing growth in population, expanding economic opportunities, or other changes, real estate generally keeps pace with inflation, and often exceeds it.

5. *Real estate is not a liquid asset.* Investors are always concerned—and rightly so—with the question of *liquidity*. This is the degree of speed at which an investment asset can be converted into cash. A savings account, shares of stock or mutual funds, or money market accounts, for example, are highly liquid. Real estate, by comparison, is considered an *illiquid asset*. Some portion of every investor's total funds should be kept in liquid accounts, so that any emergency can be paid for without creating a problem. To get cash out of real estate, you have to sell or borrow against equity, and neither of these choices are desirable at any time. With liquid assets, you can always cash in or sell a portion of the total investment with little trouble and without harming the strategy or being forced to sell everything prematurely.

liquidity
the condition of an investment asset in terms of how quickly it can be converted into cash.

illiquid asset
any asset, such as real estate, that cannot be converted to cash within a short period of time.

Because real estate is such a large-ticket item, you will probably have to finance the majority of the purchase price. Investors sometimes find that they need to scramble to find enough cash to cover their down payment and closing costs on investment property, for several reasons. Lenders generally want 30 percent down on investment property, whereas home buyers often can get by with only 10 percent down, and sometimes even less. So real estate investors are sometimes forced to give up liquidity for a while to make the deal work. Hopefully, they will be able to build up their "rainy day fund" within a few months so that emergencies that arise can be managed without taking drastic action.

6. *If you select real estate diligently, you will make money—eventually*. When you make an investment and it falls in value, you naturally think you have made a terrible mistake. But in real estate, as in other markets, a decline in price may be only temporary. It is rare that residential real estate loses value permanently. If you can afford to wait, chances are good that the investment will pay off. This claim, of course, comes with a series of "if" statements: if history is right, if you buy residential property, if you can afford to wait, and so forth. You also need to consider that a profit itself cannot be viewed simply—if you had placed your money elsewhere, you may have made *more* money. So, real estate, even though profitable over the long term, may prove to be a relatively poorly performing investment compared to other choices.

It is also inaccurate to make absolute comparisons because risks vary so much between investments. When you buy stock, you have no insurance whatsoever, although returns may be high in the short term. When you buy a certificate of deposit, you have insurance automatically, but returns are predictably disappointing, perhaps, lower than inflation. So a true comparison has to be made with risks and return levels in mind, both actual and potential.

It is always desirable to buy real estate following the basic maxim of "buy low and sell high"; however, if you miss the absolute bottom of a cycle, this does not mean that the opportunity has been lost. Real estate is one of the few investments that produces income at a considerable level, through rent. (Savings accounts come with interest, and stocks pay dividends, but these are nothing compared to rents, which often are enough to pay your entire mortgage payment each month.) Rather than compare real estate to other investments with dissimilar risk/return features, you may do better by setting goals and then determining whether you are reaching those goals. As long as your tenant is generating enough income to cover your monthly mortgage payment, taxes, insurance, and other expenses, you can afford to wait out the market. Even with marginal cash income versus outflow, you need to consider tax benefits as well. Ultimately, the only value that really counts is the value at the time you sell (or refinance), compared to the value at the time of purchase.

As an investor, you will consider these matters and, when the time comes to sell, you will calculate a profit or loss on some basis. Forgetting for the moment the pretax and after-tax calculations that are possible, the calculation of profit on real estate is somewhat complex—not because the numbers are difficult to find, but because it is not clear which numbers should be used. To illustrate this problem, ask yourself: Should you base the calculation on the price of the home and the profit realized or on the amount of money you actually invested?

Example

You bought a rental property two years ago and paid $100,000. However, your down payment was only $40,000 and you financed the balance of $60,000. You recently sold the house for $120,000 (not counting closing costs). What is your net profit?

If we base "profit" on the price of the home, then the net profit is $20,000. It was purchased for $100,000 and sold for $120,000, so the profit is 20 percent (on the investment):

$$\frac{\$20{,}000}{\$100{,}000} = 20\%$$

However, if we base the calculation on the amount of money put into the investment, the outcome is quite different. The down payment in this example was $40,000, and the profit was $20,000. That is a 50 percent return (on the equity):

$$\frac{\$20{,}000}{\$40{,}000} = 50\%$$

Another complication in the examples above is that the entire transaction took two years. So if you want to calculate the *annualized return*, you need to divide the results by two. This is necessary because returns will be different based on how long it takes to earn them.

Example

You bought two homes exactly six years ago. The first one was sold two years later for a return on the investment of 20 percent. The second home was sold after being held five years, and the return on investment was 35 percent.

annualized return

a rate of return expressed for the average 12-month period. When a return occurs over a period other than one full year, it does not reflect an accurate annual rate; the annualized return enables consistent comparisons between investments by expressing all returns as though earned in a single, average year.

On the surface, you may believe that the second home, which yielded a 35 percent return, was the more profitable investment. But, that is not the case. Let us look at the average *annual* rate of return:

Home	*Holding Period*	*Return on Investment*	*Annual Return*
1	2 years	20%	10%
2	5 years	35%	7%

Even though the overall return on investment was greater for the second home, the real annual return was higher on the first. This becomes important if, by selling after two years, you freed up capital to reinvest. The calculation for annual return is done by dividing the rate of return by the number of years in the holding period:

$$\frac{20\%}{2\text{ (years)}} = 10\%$$

If the holding period involves partial years, the same calculation can be done using the number of months instead of years. The result of that calculation is then multiplied by 12, representing one full year.

Example

You held an investment for 76 months and sold it, realizing a return of 31 percent. To annualize:

$$\frac{31\%}{76\text{ (months)}} = 0.4079\%\text{ (monthly interest rate)}$$

$$0.4079\% \times 12\text{ (months)} = 4.89\%\text{ (annualized rate)}$$

These calculations become valuable for comparisons between different real estate investments. To evaluate your past performance or set investment goals for yourself relating to future performance, it is important to arrive at a consistent method for measuring return. Annualizing that return is especially important for real estate, which tends to be long term. Accordingly, you will need to measure annualized returns on an averaged basis to have a meaningful comparison.

Real Estate Investment Performance

Any investment can be studied in historical perspective, and it is easy to see where great opportunities were missed. For example, you could have doubled your money last year by timing the purchase of a number of stocks, but this does not guarantee that the same thing will happen again this year. Most investment markets are uncertain, even in the long term.

Real estate is an exception to this rule, especially over the long term. As an investment, real estate has beaten inflation almost every year, a claim that no other investment can make. So even while increasing in value, real estate also exceeds inflation most of the time. Moreover, property values grow not only from changes in supply and demand, but also from equity. So, the longer you own property, the more equity you accumulate from monthly payments. This is because, in a long-term mortgage, very little goes to principal during the earlier years; instead, most payments are toward interest. For example, in a 6 percent, 30-year mortgage, only one-half of the loan is paid off in the 20th year.

Key Point

New demand is not the only factor that increases real estate value. Paying down a mortgage loan also "grows" equity over time, so the longer you own real estate, the more equity you create.

As an investor, if you hold a property for five years and then sell it, how much of your total payments would go to principal? With a 6 percent, 30-year mortgage of $100,000, less than 7 percent, or about $6,900, goes to principal. The rest of your payments, or $29,000, all go to interest. So, the longer you own a rental property, the more of your payments would go to paying down the loan, as opposed to just "renting" the money over three decades. This reality becomes significant because of the fact that the typical American home changes ownership every five years.*

Over a 30-year period, interest costs more than twice the amount of the property itself. For example, with a 6 percent loan, the total of payments over 30 years is $215,838 for a mortgage of $100,000. During the same period, however, real estate is likely to grow tremendously in value and to beat inflation. A comparison of increases in housing

*U.S. Census Bureau, Survey of Income and Program Participation, 1996 (latest available), at www.census.gov (average duration of ownership was 5.7 years for nonmetropolitan homes and 4.5 years for metropolitan homes).

existing home
a home built during a previous year but sold during a reported year, distinguished from a new home or one built during the reported year.

new home
a home built and completed during a reported year, distinguished from an existing home in statistical studies.

prices from 1977 through 2006 and the annual Consumer Price Index (CPI) makes this point. In that period, growth in property values was higher than inflation in all except eight years. The worst periods were between 1980 and 1982 and between 2005 and 2006, the two latest years in this 30-year term. This means that housing underperformed 27 percent of the time but outpaced or matched inflation 73 percent of the time. For many investors, keeping pace with or exceeding inflation is considered a worthy goal.

These historical results show that long-term investment in real estate is profitable, assuming you pick properties wisely, based on good, basic investment criteria (see Chapter 2). Table 1.3 summarizes the 30-year results from 1977 through 2006. The *housing increase* represents the median prices of existing homes nationally. An *existing home* is a home built in any previous year but sold during the reported year. In comparison, a *new home* is one built and completed during the reported year.

In the table, CPI is the reported annual rate of inflation published by the Bureau of Labor Statistics. The last column, "Difference," is the net percentage derived by subtracting CPI from housing. This is the percentage at which housing exceeded (or fell below) inflation. The same results are also shown graphically in Figure 1.3.

Of course, past performance cannot be used to predict future trends in real estate or any other investment. However, this long-term chart demonstrates the overall trend in real estate values. You can also spot the most recent upswing in price changes, showing the faster than usual run-up and creation of the price bubble, followed by the decline in the last two years. Please see Table 1.3.

Prices of real estate rose every year during this 30-year period, an impressive record that no other market can match. When the stock market moves through its own cycles, primary trends move up and down, with markets losing value during some years. Housing, however, rose every year and beat inflation most years.

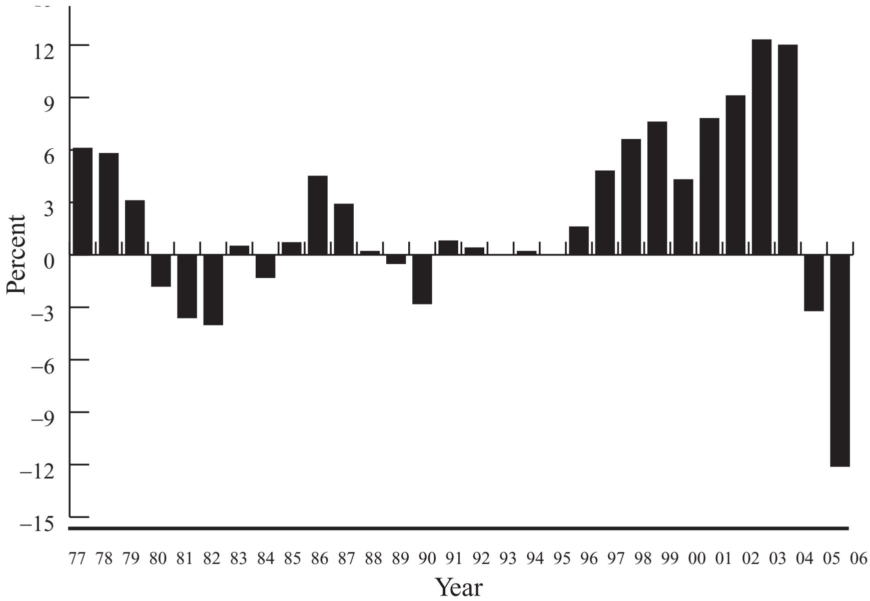


FIGURE 1.3. Real estate investment performance.

Percentages reflect the net differences between existing home price increases and annual CPI.

Source: National Association of Realtors and Bureau of Labor Statistics.

Key Point

Beyond the comparison of increases in housing values and inflation, remember this important point: In the 30-year period—from 1977 through 2006, housing values grew every year (even when growth was lower than inflation).

Part of the reason for this trend is that housing itself is part of the CPI. So the two elements—existing home prices and the CPI—are not really distinct and separate. However, because beating inflation and maintaining purchasing power of capital are such widespread investment goals, this exercise makes the point that real estate offers a triple benefit: (1) its consistent growth in value; (2) its beating inflation most of the time; and (3) its being a low-risk product with tax benefits.

Another distinction between the stock market and real estate is found in the nature of real estate itself. It is a necessity. Everyone needs

TABLE 1.3. Housing Values and CPI, 30 Years

Year	*Housing Increase*	*CPI Increase*	*Difference*
1977	12.6%	6.5%	6.1%
1978	13.5	7.7	5.8
1979	14.4	11.3	3.1
1980	11.7	13.5	−1.8
1981	6.8	10.4	−3.6
1982	2.1	6.1	−4.0
1983	3.7	3.2	0.5
1984	3.0	4.3	−1.3
1985	4.3	3.6	0.7
1986	6.4	1.9	4.5
1987	6.6	3.7	2.9
1988	4.3	4.1	0.2
1989	4.3	4.8	−0.5
1990	2.6	5.4	−2.8
1991	5.0	4.2	0.8
1992	3.4	3.0	0.4
1993	3.0	3.0	0
1994	2.8	2.6	0.2
1995	2.8	2.8	0
1996	4.5	2.9	1.6
1997	7.1	2.3	4.8
1998	8.2	1.6	6.6
1999	9.8	2.2	7.6
2000	7.7	3.4	4.3
2001	10.6	2.8	7.8
2002	10.7	1.6	9.1
2003	14.6	2.3	12.3
2004	14.7	2.7	12.0
2005	0.2	3.4	−3.2
2006	−8.9	3.2	−12.1

Sources: Housing increases are national median prices for existing homes (from National Association of Realtors [NAR], at www.realtor.com); CPI increase are from The Bureau of Labor Statistics at www.bls.gov.

shelter, but in difficult economic times, not everyone holds onto stocks. So, there is a considerable difference between paying for a necessity versus buying stocks. Whereas stock values grow or shrink due to a variety of factors beyond supply and demand, the real estate market is truly the result of supply and demand.

Consider, for example, what occurred just before the 2006–2008 bubble burst. The price trend was strongly upward, reflecting an excess of demand over supply. The *causes* of this strong economic weighting are understood by most people. The two big influences were speculation and ill-advised liberal lending policies. These were artificial, but they created demand, which contributed to the rapid growth in prices. Once those artificial demand factors ran their course (by the beginning of 2006) and the bubble was acknowledged by most people, it burst, and prices fell. In the stock market, trends come and go rapidly, often without any specific economic reason other than "irrational exuberance."

Every investor can fall victim to irrational exuberance and poorly timed investments. The key to smart investing is not only to pay attention to cyclical price movements, but also to apply common sense. As long as the price you pay for investment property is attractive, rental demand is high, and rental receipts cover your mortgage payments and other expenses, you can afford to wait out a weak market. In other words, it is often necessary and prudent to enter a real estate investment for the long term, meaning five years or more.

Key Point

Irrational exuberance can lead investors to pay too much for real estate or to enter the market at the worst possible time. This is why it makes sense to perform extensive analysis and to ignore what "most people" think. Remember, the majority is often both irrational and exuberant.

If you are willing and financially able to accept the risks of investing in the real estate market, you will prosper over time. Looking at any five-year period over the past 30 years, you will realize that most were quite profitable. Even with the few exceptions, where growth over inflation was small or falling, the overall market remained strong. Real estate prices for existing homes rose every year during the 30-year period, as shown in Figure 1.3.

As long as market realities are digestible, the big question most first-time investors ask is: Where do I find the money for a down payment?

For many, affording the family home is a stretch, so affording extra investment property is likely to present an initial hurdle. Many first-time investors will consider using the equity in their family homes as seed money to begin a real estate investment plan.

Your Home as an Investment

Investors find that real estate outperforms many other choices. The main reason to *not* pick real estate is the high cost and low liquidity (i.e., the ability to get money out, especially compared to stocks). Real estate is also a *tangible asset,* meaning that it has physical value. In comparison, shares of stock are not tangible but represent indirect, partial ownership in a much larger corporation.

tangible asset
any asset with physical value, such as real estate. In comparison, intangible assets, such as shares of stock, lack physical value.

The fact that real estate has physical value is a positive attribute. As an investor in real estate, you are able to see it, fix and maintain it, insure it, and create increased value through caring for the property. Every homeowner understands this feature merely by keeping the roof in order, clearing out gutters, painting inside and out, and maintaining the yard.

Key Point

There is no investment that offers so much direct control as real estate. Its tangible feature means you can *see* what needs to be fixed, painted, or replaced. With stock market investments, you cannot *see* problems in management, markets, or capitalization.

Homeowners know better than anyone else how valuable their equity is and how crucial it is to let that equity grow. However, some homeowners use their home equity to begin an investment program. By refinancing to free up cash, you can gain a down payment for an investment property. However, this also increases overall risks, both personal and investment-wise. Your home mortgage payment will probably increase when you refinance, as you are then using borrowed money to put down on an investment, requiring even more borrowing. Before using your home equity in this manner, it is important to understand the level of risk involved. Five critical questions should be asked first:

1. *Is there high demand for rentals in your city?* It only makes sense to borrow for investment real estate if you are reasonably sure that you are going to be able to keep the property rented. Thus, you need to judge the local demand level for rentals, remembering that houses and apartments often attract different demographics of renters. For example, in an area with a larger than average college population, demand for apartments may be quite strong; however, this does not mean that demand for houses is equally as strong. If vacancy rates are high, it may not be a good time to buy rental houses.

You can find information about rental demand by checking with local property management companies, lenders, real estate agents, and rental agencies (i.e., companies that sell lists of available properties to tenants). You can also tell a lot by driving around and counting the number of "for rent" signs in the area where you want to buy and by determining how long it takes for these houses to get rented.

2. Can you afford to continue making mortgage payments on your home *and* rental property, even if the investment property stays vacant for two or three months? Even in areas with strong rental demand, it is possible that a house will remain vacant for more than a month. This is especially true if you need to make repairs between tenants or if your property is on the high end of the rental spectrum (which is often the case for houses, compared with apartment rent levels). If you cannot afford three months of mortgage payments without rental income, you probably are not ready to invest in rental property.

Remember, too, that demand levels change. So, although demand may be strong today, it may decline next year. Demand may also be seasonal. If your city or county has a high level of seasonal employment or tourism, the off-season market will experience a reduced demand level. In college towns, the summer months are probably going to have higher vacancies as well. Plan for the worst-case situation and develop a contingency plan. For example, you may need to set aside cash in a reserve fund to pay for investment property mortgages during slow seasons.

Some property may also create a negative cash flow, meaning that the combined cost of the mortgage, expenses, and maintenance exceeds monthly rental income. In this case, you need to be able to afford a shortfall each month for as long as you own the property. This negative cash flow may be mitigated by tax benefits, at least to some degree. But negative cash flow only makes sense if you are confident that property values are rising to a greater degree than your annual cash outlay.

3. *Does real estate investing fit within your long-term personal financial plan and goals?* Not everyone has the same set of goals over the long term, so it is important to make sure that real estate is a good match for you. For example, if you expect to pay for a child's college education in two years, it does not make sense to tie up all of your available capital for the next five years.

This same caveat applies when you consider using home equity to begin your real estate investment program. You have to make sure you can afford to carry greater personal debt for at least five years (or more) as part of your plan. This means you need to have enough income to make higher payments on your home, as well as carry your investment mortgage during short-term periods of vacancy or monthly negative cash flow.

4. *Are you willing to work with tenants?* Many first-time landlords do not realize the potential maintenance levels involving tenants (see Chapter 11). Although many problems between landlords and tenants can come up, these can be reduced or avoided with a thorough screening process, including taking written applications and checking all references. Even then, you will have to deal with tenants for a range of issues.

In some states, the law favors tenants to such a degree that landlords are at a clear disadvantage. An online search by state for "tenants rights" will provide links to the agency overseeing landlord and tenant law in your state. Links to each state are also located on www.rentlaw.com. You should also check with people who rent out property in your city or county. Also check local ordinances. Many states or counties provide "tenants' rights" pamphlets, and it is wise to obtain these and be familiar with local rules and restrictions.

As long as you thoroughly screen potential tenants and act fairly, you have an excellent chance of a positive relationship with your tenants most of the time. Most people respond to fair dealings. Remember that landlords operate both an investment and a business. So, if you substitute the word "customer" for "tenant," you will see how this dual role applies. At the same time, customers have to pay for their purchases in a timely manner, and as a landlord you should not be expected to act as a lender, a parent, or an understanding friend. You have to make your mortgage payments on time, so you also have every right to expect tenants to pay their rent on time and in full every month.

5. *Do you believe that real estate values are going to rise in your city or county in coming years?* Investors want to put their money into investments that will increase in value; this is common sense. But some real estate investors have clouded judgment, believing that "real estate values always go up." This is not true everywhere or every year.

With your money at risk, you need to also examine the driving forces that cause values to rise. For example, strong employment growth and new construction in your city are positive signs for real estate (even though it may take several years for values to appreciate). However, if employment is falling in your area and no new construction is underway, then there is no justification for believing that values are going to rise. A good test is to perform an online search for one- to two-year-old homes for sale by ZIP code. Check www.realtor.com and enter your ZIP code, then go to the advanced search and specify that you want to see properties that are only one to two years old. If none comes up, it means there is little or no new construction activity going on. In other words, there is low demand for *new* housing, meaning that the local market is not growing. This is only one of many ways that you can develop sound opinions about your local market.

Expanding Your Portfolio

One of the pitfalls in buying investment real estate is the possible enthusiasm of first-time investors. Getting rental property can be exciting and promising, with wealth-building potential and an expanded portfolio. But, it is unlikely that you will "get rich quick" in real estate despite what many promoters claim. It is more likely that you will build wealth through diligent research and smart property selection.

Making money in real estate requires an appreciation of your potential *and* limits. For example, your income is going to limit the amount you can borrow on an investment property, as well as the number of properties lenders will allow you to carry at the same time. You will also discover that managing property takes time, and the more property you own, the more demand you will experience. For example, even if your rent agreement requires tenants to maintain the yard, this does not mean they will follow the rule. So, you may end up mowing lawns and weeding yards on the weekend, even while charging tenants more rent for the extra work. You will also be expected to perform minor repairs and maintenance on your property.

Many landlords have discovered that their weekends and, often, their evenings, are not their own when they have rental properties to care for. If you end up with four or more property rentals, you should plan on always having to deal with at least one crisis each week.

Key Point

A reality check: Just because a landlord includes a requirement in the rental agreement does not mean that the tenant is always going to comply. You need a back-up clause, such as higher rent for nonperformance.

So, expanding your investment portfolio is not as easy financially or practically on a personal level as you may desire. Many books propose that you can get into the market with little or nothing down and expand your real estate "empire" until you own 30 or 40 properties, raking in profits within a few months. This outcome is unlikely, and most of the programs offering these concepts make their money selling expensive how-to kits or seminar attendance fees. In these programs, nothing is ever mentioned about the unexpected costs of investment: unpaid rent or vacancies, leaking roofs, broken windows, outdated septic systems, or pest infestations.

seller financing
a financing arrangement in which the property owner agrees to let the buyer purchase the property partly with cash and partly with the seller providing a mortgage. The seller assumes the role of lender, and the buyer agrees to make monthly payments to the seller, with interest.

The point is that the landlord business can be very profitable and satisfying, but it may also have pitfalls. You are going to need to know about the worst-case possibilities before you expand beyond your means for managing (and affording) multiple properties. Landlord operation is highly satisfying as long as you are able to stay in control, and this usually means limiting the number of properties you own at any one time. Only through direct experience will you discover the right number for yourself. You may be happy with only three or with as many as 10, all depending on your willingness to dedicate time, your financial resources, and levels of rental demand.

If you want to expand your holdings but lenders will not grant you more loans, you have a few choices. You can use home equity or even savings or credit cards, but this involves extraordinary levels of risk. The repayment demands of using money or lines of credit beyond your means is not appropriate for most people. Another approach is to find property with *seller financing*. This means the seller is willing to *carry* a loan for you and that instead of making payments to an outside lender, you pay the seller directly. You get your financing, and the seller closes the property while creating an income stream from interest.

carry

a term referring to a seller's holding a note for part of the debt owed by the buyer. The seller helps a buyer close the deal by providing part of the purchase price as a loan.

A word of caution: When sellers are willing to carry a loan as part of the deal, it may be because of their interest in generating interest income. However, it may also be because the seller knows that conventional financing cannot be obtained due to a structural problem with the house. For example, lenders may require a foundation on homes and refuse to finance properties with post-and-beam supports. Making this change is expensive, so sellers may not have enough equity to be able to afford the change. Remember, however, that any such problems are going to become *your* problems when you want to sell the house.

Key Point

When a seller is willing to carry a loan to make the sale happen, be careful. Remember, any problems you accept as a buyer are still your problems when you become a seller.

As a general rule, the more a seller is willing to carry financing, the more the likelihood that there are problems with the house. It could mean that the value is not there, at least that it is not equal to the selling price. It could also mean that the house has a high degree of *deferred maintenance*, repairs that are needed but have not been made. This reduces the current value because those repairs have to be made at some point. It is also often the case that putting off deferred maintenance even longer adds to the eventual costs involved.

Example

A buyer was looking for seller financing because he knew he would not qualify for a bank loan. One seller was willing to carry up to 80 percent of the purchase price. But on close examination of the property, the buyer decided not to go for the deal. The house had thousands of dollars of deferred maintenance: a leaking roof, an inadequate foundation causing slanting floors, leaking plumbing, unsafe electrical systems, and many other problems. These costs were far too high. The "bargain" was not really a bargain at all.

deferred maintenance

work required (that has accumulated over time and has not been done) to properly maintain or upgrade a property. Examples include old, chipped paint; broken windows; leaking gutters; unrepaired pest damage; sagging foundations; outdated plumbing, electrical, or heating systems; and leaking roofs.

The fact that a seller is willing to carry part of the financing does not always mean that there are big problems. However, it often happens that seller financing indicates problem houses and attracts buyers with poor credit. This is just one potential trap to look out for and avoid. Be aware that deals requiring the degree of deferred maintenance that goes far beyond cosmetic repairs are the most likely ones to involve seller financing. You may end up acquiring a big headache and no real market value rather than a good deal. In setting a price, take into account the amount of work required to fix those problems and, if you do make an offer, discount the price with these repairs in mind.

Remember, every investment buyer eventually becomes a seller. Evaluate every potential investment property in terms of the problems you will encounter when you want to sell. The methods you can use to find the best values in real estate are the subject of the next chapter.