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ACHIEVE A PROSPEROUS FUTURE: 22 WAYS YOU CAN EARN PROFITS WITH PROPERTY

For at least the past 20 to 25 years, financial planners, mutual fund sales reps, Wall Street promoters, and various cheerleading professors of finance (most loudly, Jeremy Siegel of the Wharton School) have championed the mantra, "Stocks for the long run"; "Stocks for retirement." These advocates of equities assert that over the long run, stocks outperform all other types of investments. "If your retirement still sits at least 10 years into the future," they advise, "place 100 percent of your nest egg in stocks." (Admittedly, the 2011 bull market in bonds converted a few of the stock market enthusiasts to a more balanced view—but the majority seem undaunted.)

In his widely read (and praised) book, *Winning the Loser's Game*, Charles Ellis encourages investors to place all of their money in stock index funds rather than property because (according to Ellis),

> Owning residential real estate is not a great investment. Over the past 20 years, home prices have risen less than the consumer price index and have returned less than Treasury bills. . . . Own a home as a place to live, not as an investment.

Leave aside for a moment how Ellis arrived at his long-term house price figures—no data that I have seen (even if we factor in the recent downturn) report that long-term housing prices, relative to incomes or consumer prices, have become cheaper. However, Ellis errs most egregiously in another way. He does not understand how investors should measure the total potential returns that property offers.[1]

Neither Ellis, stock market enthusiasts, financial planners, nor you should evaluate property returns (past or future) simply on the basis of historical or expected price growth.

Frequently, even advocates of real estate investing often err in a similar way. I often read property investing advice such as, "Always buy from a motivated seller"; "Never buy unless you can buy at least 20 percent below market value"; "Always buy in an area poised for growth (or experiencing rapid growth)." Unfortunately, this stock market mentality that focuses upon price growth has infected the way too many people think about property.

22 SOURCES OF PROFIT FROM INVESTMENT PROPERTY

No question about it. I love price gains and will elaborate on this point as my next topic. Nevertheless, as you evaluate properties as investments, expand your perspective. Apply each one of the potential returns listed in the prologue and explained with examples in this chapter. You can achieve stock market–beating returns from property—at much lower levels of risk—in many different ways. When you fail to evaluate the *full* potential of a property, you not only bypass properties that could yield great profits (albeit in ways you may never thought of), you also slight the full range of profit possibilities that lie within the properties that you do buy.

Will the Property Experience Price Gains from Appreciation?

Passive price gains (as contrasted to gains from actively creating value) can arise from two unique sources: (1) appreciation and (2) inflation. Yet, in everyday conversation, most people do not differentiate between price gains that result from appreciation and those that result from inflation. Appreciation occurs when demand for a specific type of property, location, or both, grows faster than the supply of competing (substitute) properties, whereas inflation *tends* to push property prices up—even if demand and supply remain in

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[1]His two-decade time horizon also fails as a representative period because it includes the late 1970s and the 1980s—Treasuries paid record-high interest rates during those years. Today, Treasury bills pay close to zero.

balance (although in cities such as Detroit or Buffalo, demand may slide so much that property prices lag the Consumer Price Index by a wide margin).

Homes in Central London, San Francisco's Pacific Heights, and Brooklyn's Williamsburg have experienced extraordinarily high rates of demand growth during the past 15 to 20 years. And since 1990, houses within a mile of the University of Florida campus have more than doubled (and in some cases tripled) in market price—primarily because UF students and faculty alike now prefer "walk or bike to campus" locations.

Areas Differ in Their Rate of Appreciation. Although properties located in Pacific Heights and Williamsburg have jumped in price at rates much greater than the rise in the Consumer Price Index (CPI), some neighborhoods in Detroit have suffered price declines of 60 to 90 percent. Appreciation does not occur uniformly or randomly. You can forecast appreciation potential using the right place, right time, right price methodology discussed in Chapter 15.

Likewise, you need not get caught in the severe, long-term downdrafts in prices that plague cities and neighborhoods that lose their economic base of jobs. Just as various socioeconomic factors point to right time, right place, right price, similar indicators can signal wrong place, wrong time, and wrong price.

Today's property markets seem to offer a best-of-both-worlds opportunity: You can earn good returns from cash flow—and good returns from appreciation when the economy and property supply and demand balances return to normal. In the past, in markets strong in longer-term appreciation potential (for example, coastal California or as with urban Vancouver now), investors had to sacrifice cash flow as a trade-off for expected price gain. Fortunately, that trade-off no longer exists to the degree that it used to.

You Do Not Need Appreciation. Should you invest in properties that are located in areas poised for above-average appreciation? Not necessarily. Some investors own rental properties in deteriorating areas—yet still have built up multimillion-dollar net worths. My first properties did not gain much from price increases (appreciation or inflation)—but they consistently cash-flowed like a slot machine payoff. With one of my early apartment buildings, a $10,000 down payment grew into $100,000 of equity over 10 years—just through mortgage amortization.

When you choose a quick turn, fix, and sell strategy, appreciation isn't needed. You achieve gains in equity that are unrelated to market temperature. Appreciation isn't necessarily required, either, when you buy at a price 15 to 30 percent *below market value.* Savvy buying can reward you with five years of appreciation-like price gains—instantly upon purchase. Throw out the popular (but erroneous) belief that you can't make good money with property unless its market price appreciates. Appreciation represents one highly rewarding goal to achieve, but by no means is it the only goal that counts.

Will You Gain Price Increases from Inflation?

In his book, *Irrational Exuberance*, the oft-quoted Yale economist, Robert Shiller, concludes (as does Charles Ellis, cited earlier) that houses perform poorly as investments. According to Shiller's reckoning, since 1948, the *real* (inflation-adjusted) price growth in housing has averaged around 1—at best 2—percent a year.

"Even if this $16,000 house [bought in 1948] sold in 2004," says the eminent professor, "at a price of $360,000, it still does not imply great returns on this investment . . . a *real* (that is, inflation-adjusted) annual rate of increase of a little under 2 percent a year." (Note that Shiller also omits rental income from his supposed investment results.)

Shiller Thinks Like an Economist, Not an Investor. Every investor wants to protect his wealth from the corrosive power of unexpected inflation. Even if we accept Shiller's inflation-adjusted rate of price growth—and I believe it reasonable (on average—though savvy investors need not accept average), yet certainly not beyond critique—even Shiller's data show that property prices have kept investors ahead of inflation in every decade throughout the past 75 years.

[Side Note: Not true for stocks (or bonds). Consider the most inflationary period in U.S. history: 1966–1982. In 1966, the median price of a house equaled $25,000; the Dow Jones Index (DJIA) hit 1,000. During the subsequent 18 years, the CPI climbed steadily from 100 to 300. In 1982, the median price of a house had risen to $72,000; the 1982 DJIA closed the year at 780—below its *nominal* level of 18 years earlier.]

Inflation Risk: Property Has Protected Better than Stocks. No one knows what the future holds. Will the CPI once again start climbing at a steeper pace? At the runaway rate at which the U.S. government prints money and floats new debt, the odds weight the scale in that direction. During periods of accelerating inflation, most people would rejoice at staying even. In fact, the popularity of Treasury inflation-protected securities (TIPS) reveals that goal (and worry).

Imagine that in the early to mid-1960s you were a true-blue stocks for retirement kind of investor—and you were then age 45. In 1982, as you approach age 65, your inflation-adjusted net worth sits at maybe 30 percent of the amount you had hoped and planned to accumulate. What do you do? Stay on the job another 10 years? Sell the homestead and downsize? Borrow money from a wealthy friend who invested in property?

Property Investors Do Not Buy Indexes and Averages. Economists calculate in the nether land of aggregates and averages. Investors buy specific properties according to their personal investment objectives. An economist's average does not capture the actual price gains (inflation plus appreciation) that real investors can earn—when they set price gain as their prime financial objective. Investors apply some variant of right time, right place, right price methodologies (see p. 315). If you want to outperform the *average* price increases of real estate—even though the long-term averages themselves look good—you can. And today's housing markets (especially) offer the right time to greatly outperform with long-term price growth (appreciation plus inflation).

Earn Good Returns from Cash Flows

Unlike the overwhelming majority of stocks, income properties typically yield (unleveraged) cash flows of 5 to 12 percent per year.[2] If you own a $1,000,000 property free and clear of financing, you can pocket $50,000 to $120,000 a year (mostly tax sheltered; see the following discussion). If you own a $1,000,000 portfolio of stocks, you might pocket cash flows (dividend payments) of $15,000 to $30,000 a year (fully taxable—although at the time this chapter was written, the income tax rate on dividends was just 15 percent, many in Congress would like to increase this rate).

Historically, the largest source of return for unleveraged properties has come from cash flow. Remember, too, rent increases add to the profit potential of cash flows. To grow a passive, inflation-protected stream of income, own income properties.

Economists and financial planners greatly embarrass themselves when they slight or ignore this critical source of return. Before Charles Ellis, Robert Shiller, and others of their ilk again take up their pens to write on real estate returns, they might set aside their misguided claims of expertise and first learn the actual practice of investing in real estate. If they did, they would also learn that nearly all property investors magnify their returns (cash flows and equity buildup) with leverage.

Magnify Your Equity Gains with Leverage

Misguided economists, financial analysts, and various media-anointed experts claim that property provides investors real (inflation-adjusted) returns of 1 to 2 percent a year. In doing so, these advisors omit the

[2]Yields in the United Kingdom, Asia, and most of Europe often fall somewhat below those available throughout the United States (which is one reason why U.S. property is attracting record amounts of international capital).

return-boosting power of OPM (other people's money—typically, bank or seller financing).

Low Rates of Price Gain Create Big (Inflation-Adjusted) Returns. Assume you acquire a $100,000 property. You borrow $80,000 and place $20,000 as down payment. During the following five years, we experience inflation similar to the late 1970s. The CPI advances by 50 percent. Your property's price, though, lagged the CPI. It increased by only 25 percent. Your real (inflation-adjusted) wealth fell, right? That's what Shiller, the economist, would conclude. But no, your real wealth increased.

You now own a property worth $125,000, but your equity wealth—your original $20,000 cash equity in the property—has increased more than 100 percent—to $45,000 (not including repayment of principal, that is, amortization). You more than doubled your money. To have stayed even with the CPI, your equity needed to grow from $20,000 to only $30,000 (a 50 percent increase to match the gain of the CPI).

Acorns into Oak Trees. Real estate investing builds equity because it grows acorns (relatively small down payments) into free and clear properties worth many multiples of the *original* amounts of invested cash. Let's go back to Shiller's house purchase example.

The homebuyer paid a price of $16,000 in 1948. Did that homebuyer pay cash? Not likely. Ten to 20 percent down then set the norm—say, 20 percent or $3,200 (.2 × $16,000). At Shiller's hypothetical 2004 value of $360,000, the homebuyer multiplied his original investment more than 100 times over. Even if the 2004 property value comes in at $180,000—the homeowner enjoyed a nearly 60-fold increase of his $3,200 down payment. (Of course, in 1948 some homebuyers could have used a nothing-down VA loan or a 3 percent down FHA mortgage. Their gains from OPM would have paid back much greater multiples of their original investment.)

What about stock gains during that period of 1948 to 2004? In 1948, the Dow Jones Industrial Average (DJIA) hovered around 200 (by the way, it was then still about 40 percent below its 1929 peak of 360). In 2004, the DJIA stood at about 8,000—a 40-fold gain. Not bad, but still less than the equity gains from property ownership (and much, much less when we bring cash flows and tax shelter into the return comparison). [Note: When I wrote this chapter in late 2011, the DJIA still sat at around 11,500, whereas property prices (in all but the most distressed areas) are still way up from 1999, which is the year that the DJIA first hit 11,500.]

Magnify Returns from Cash Flows with Leverage

Traditionally, investors not only magnify their equity gains from leverage (mortgage financing), they also magnify their rates of return from cash flows. You pay $1,000,000 cash for an apartment building that yields a net income (after all operating expenses) of 7.5 percent (no financing). Quite good when compared to CD interest rates of 1 to 2 percent, dividend yields from stocks of 2 percent, corporate bond interest of 4 to 5 percent, or 10-year Treasuries at 2 to 2.5 percent interest. Yet it gets better. If you finance $800,000 of that $1,000,000 purchase price at, say, 30 years, 5.75 percent interest, you invest just $200,000 in cash. Your net income equals $75,000 (.075 × 1,000,000) and your annual mortgage payments (debt service) will total around $56,000. You pocket $19,000 ($75,000 less $56,000). You've boosted your cash flow return (called *cash on cash*) from 7.5 percent to 9.5 percent ($19,000 divided by $200,000). You can achieve positive leverage with cash flows whenever your cap rate exceeds your mortgage loan constant (see Chapter 2).

Build Wealth through Mortgage Payoff

Assume for a moment that from your $1,000,000 apartment building, you pocket no cash flows. You pay every dollar of net operating income (and future rent increases) to reduce your mortgage balance of $800,000. After 20 years, you have paid off (fully amortized) your loan and own your property free and clear (a workable strategy). This apartment building experienced no gain in price. At the end of 20 years, its value equals your original purchase of $1,000,000.

No price gains from inflation, no price gains from appreciation, and no money pocketed from cash flows. Quite pessimistic, right? Yet, just from amortization over a 20-year period, you grew your equity from $200,000 to $1,000,000—a five-fold gain and annual compound growth rate of more than 8 percent. In today's low-rate world, an 8 percent return sounds pretty appealing. After 20 years, you pocket 100 percent of your net operating income—quite likely enough to live on comfortably.

Your tenants just bought you a $1,000,000 property. That's why I tell my college students, "Rent or buy?" asks the wrong question. Everyone buys—the real question is one of ownership. If you rent, you pay your landlord's mortgage. Your landlord reaps the rewards of ownership—while tenants pay the costs. Seems to me a good deal for property investors.

Over Time, Returns from Rents Go Up

Most property owners raise their rents. Maybe not this year. Maybe not next year. But over a period of five years or more, increasing rents yield increasing cash flows. If you've selected a right time, right place, right price property, demand will push rents up as more people want to live in the neighborhood where your property is located. Or perhaps, as government floods the economy with paper money, inflationary pressures force rents up. Either way, you gain. In fact, you can gain even if your rent increases fail to match the inflationary jumps in your expenses.

Return to our apartment building example. Gross rent collections equal $125,000; net operating income equals $75,000; mortgage payments equal $56,000; your cash flow equals $19,000.

Gross rents	$125,000
Vacancy and expenses	50,000
Net operating income	75,000
Annual mortgage payments	56,000
Cash flow	19,000

First, assume your rents and expenses each increase by 8 percent. Here are the revised amounts:

Gross rents	$135,000
Vacancy and expenses	54,000
Net operating income	81,000
Annual mortgage payments	56,000
Cash flow	25,000

An 8 percent increase in rents and expenses boosts your cash flow by 31 percent:

$$25{,}000 \div 19{,}000 = 13.1$$

If expenses had increased by 12 percent and rents stepped up mildly by just 6 percent per annum (p.a.), you would still increase your cash flow:

Gross rents	$132,500
Vacancy and expenses	56,000
Net operating income	76,500
Annual mortgage payments	56,000
Cash flow	20,500

$$20{,}500 \div 19{,}000 = 1.08$$

Caution: Engage your brainpower. Run multiple outcomes with these figures and other numbers presented throughout this chapter (and following chapters). No one guarantees the results that you want or expect.

Through market and entrepreneurial analysis, you estimate, negotiate, execute, and create the potential returns for the properties you buy. (Nevertheless, these examples do illustrate the time-tested principles and advantages of property investing.)

Envision each return possibility that property investing offers. Then as you evaluate markets, properties, and the outlook for your geographic areas of interest, figure the probabilities. Which of the listed (p. xxvi) sources of return look most promising? Which sources of return seem remote?

What risks could throw ice water against your expectations? What if interest rates increase? What if a local employer lays off hundreds (or thousands) of employees? What if tight local government budgets drive up property taxes? What if vacancies increase or rent collections fall, or both? Even though you can build your net worth with property with more safety and certainty than any other asset, such wealth does not accumulate automatically—or without some turbulence along the way. Anticipate potential storms: safety belts and life jackets are mandatory.

In a majority of cases, today's foreclosures have resulted because many unwise borrowers projected that blue skies and smooth flying would last forever. It never does. As Chapter 2 discusses, the property mentors, gurus, loan reps, banks, and authors who widely promoted "No cash, no credit, no problem" actually promoted their own immediate profits at the expense of their naïve and trusting customers.

Refinance to Lift Your Cash Flows

Increase your rents (or decrease your property's operating expenses, or both) and you increase your property's cash flows. But you also gain additional cash flow when you refinance your loan at a lower interest rate or for a longer term than the years remaining on your current loan. When might a refinance pay off with a lower interest rate?

First, if market rates fall—perhaps not likely from today's low levels. Yet, that's what most experts said when mortgage interest rates fell back to 6 percent during the early 2000s. So, who knows? Moreover, at some future time, we might again see mortgage interest rates of 7 to 10 percent. Under those market conditions, a refinance of a property purchase as those higher rates come back down becomes ever more attractive and cash generating.

Second, not everyone qualifies for the lowest interest rates available. Credit counts. Many credit-challenged investors accept higher interest rates at the time of purchase, then refinance as they build more equity in their property; establish a higher credit score; or the credit-damaging, adverse events (bankruptcy, foreclosure, late payments, judgments, and so on) are dropped from the credit bureaus' reporting files.

Third, LTV (loan-to-value) ratios influence interest rates. To maximize leverage, finance with a higher-interest-rate, higher-LTV loan. Then, as you build more equity in the property (inflation, appreciation, creating value, amortization, and so on), refinance your loan's existing balance. With more equity (which means a lower LTV), the lender may grant you a lower interest rate.

In addition to reducing payment amounts by refinancing into a lower interest rate, you can increase your cash flow (decrease mortgage payments) by refinancing into a longer term. Say your loan shows a current balance of $435,000 with 14 years remaining. Extend the term of your new loan to 30 years and your payments drop by 20 to 35 percent. (The exact amount of reduction depends on the terms and amount originally borrowed.)

Some investors want quick loan payoffs. Others want to maximize cash flow and cash-on-cash return. It's your call. But the point is that refinancing can place extra cash income into your pocket—if that's what you prefer. (We go through some payment examples in Chapter 2. For now, we explore possibilities that you can use to boost your returns.)

(*Additional Possibility for Profit:* Chapter 2 introduces a technique called a *wraparound mortgage.* Using this technique, you obtain the benefit of a lower-than-market interest rate by combining purchase money financing from the seller with an existing loan on the property. Wraparounds provide buyers a reduced interest rate and, at the same time, create another source of return for sellers; cf. p. 40–41.)

Refinance to Pocket Cash

Buy a property today and within 12 to 15 years (possibly sooner—depending on the speed of market recovery and your skill in selecting or improving the property), you can sell it for 50 to 100 percent more than the price you paid. You earn a large capital gain. But what if you do not want to sell? Can you still place some of that large equity that you have built up into your pocket? Absolutely. Arrange a cash-out refinance.

Here's how this possible source of return works. Say after 10 years your $1 million property has grown in price to $1.5 million. You've paid down your loan balance to $650,000. Your equity has increased from $200,000 to $850,000 ($1.5 million less the $650,000 that you owe to the mortgage lender). You obtain a new 80 percent LTV mortgage of $1.2 million. You pocket $550,000 tax-free! (Cash from a sale may be taxed as a capital gain, but cash into your pocket from a refinance remains free from the IRS.)

You can spend that extra cash (albeit a poor choice) or, much smarter, reinvest it. Buy another income property. You now pay higher amounts on your first property's mortgage each month and your cash flows from that property will decrease. But with the additional cash flows from your second property, your total cash flows will go up. How's that for having your cake and eating it, too?

Buy at a Below-Market Price

When the economists and financial planners (mis)calculate the returns that property investors can earn, they fail to note that savvy buyers can acquire properties for less than their *current* market value. Opportunity (grass-is-greener) sellers, don't-wanter sellers, ill-informed sellers, incompetent sellers, unknowledgeable sellers, and—most importantly in today's markets—banks and financially distressed sellers will all sell at below-market prices. Today's markets not only offer properties at much-reduced market values, savvy buyers can find or negotiate purchases at even steeper discounts.

And unlike during normal times, the financially stressed and distressed today include not only individual property owners but also mortgage lenders. Banks, Fannie Mae, and Freddie Mac (and other lenders) now hold an inventory of perhaps 2 million foreclosures (real estate–owned—REOs) that they must sell as quickly as they can line up buyers to take these properties off their books. Builders of new homes and nondistressed would-be sellers blame bank REOs for driving down property prices for all sellers.

How do you find and buy these properties for less than they are worth? See Chapters 5, 6, and 7.

Sell at an Above-Market-Value Price

Sometimes you can *buy* a property for *less than* its market value. Sometimes you can *sell* a property that you own for *more than* its present market value. How do you achieve this gain? Surprisingly, such a feat is neither rare nor difficult: Sell to a buyer who lacks knowledge about a property; or perhaps a buyer who is not well-informed about the local market; someone who's incompetent, or pressed by time. Offer seller financing, a wraparound mortgage, or a lease option. Apply your skills of promotion and negotiation (see Chapter 13). Match the unique features and benefits of the property to the unique needs of the buyer. Sell the property with a below-market-interest-rate assumable (or subject-to) loan.

Occasionally, buyers pay more than market value because they don't know (or do not care) what they're doing. Sometimes they pay more to obtain a much-desired feature or terms of purchase or financing. Whatever their reason, exploit this possibility and you've created another source of return.

Create Property Value through Smarter Management

Manage your properties *and* your tenants more intelligently. You increase a property's net operating income (NOI) and, correspondingly, its market value—without the need to (necessarily) raise rents; you reduce tenant turnover; you increase prospect conversions (that is, converting lookers to tenants); you spend more effectively for maintenance, promotion, and capital replacements. You enjoy peaceful, pleasant, and productive relations with your tenants.

Fortunately for you (and me), most (yes, most!) owners of small investor-size (as opposed to institutional-size) rental properties manage their investments poorly. Their shoddy or uncaring management creates opportunities for us. After you buy the ill-managed property, you execute a more promising and competitive management strategy. (I improve the management—and hence value—of every property that I purchase. Indeed, I especially seek out undermanaged and poorly managed properties. This opportunity leads to one of the surest means to create value and build your equity.)

How can you achieve maestro-like performance? Rely on Chapter 11 to develop your profit-maximizing management *and* market strategy.

Create Value with a Savvy Market Strategy

Although investors tend to ill manage their properties, they show even less skill as savvy marketers. Go to the property websites loopnet.com, and craigslist.org. Click through a sample of listings. Look at the listing promotional information provided. Look at the property photographs. Does the seller or agent tell a persuasive story about the property? A message that rings true? Does the sales message position that property against the tens of thousands of competing properties that also beg for attention? Do the photographs of properties reveal a well-cared-for property—a property that invites tenants to call it home?

I will provide you the answers. No! No! No! The implication? More opportunities for you to gain competitive advantage. When you combine the management know-how and marketing strategy lessons of Chapters 11 and 13, you earn higher cash flows; you provide a better home for your tenants; and when the time to sell arises, your property will command a higher price.

Create Value: Improve the Location

True or false? "You can change anything about a property except its location." A false and silly cliché. As Chapter 8 shows, you can improve a location, and doing so offers one of your most powerful sources of return.

Think for a moment. What does the concept of location include? What makes the location where you live desirable (or undesirable)? Accessibility and convenience, appearance, quiet, good public transportation, cleanliness, the character and lifestyles of people who live in the neighborhood, school quality, parks, shopping, nightlife . . . the list could go on and on. What's the best way to improve any or all of these attributes? Community action. Examples of improvement are available from throughout the United States and throughout the world (South Beach, SOMA, SOHO, Williamsburg, Lakeview, Hyde Park, to name just a few).

Convert from Unit Rentals to Unit Ownership

Buy wholesale, sell retail. A grocer buys a 48-can box of tomato soup and then sells each can individually along with a retail mark-up. Property investors execute a similar wholesale-to-retail strategy.

Buy a 48-unit apartment building. After completing legal approvals and documentation, sell each apartment individually. In principle, you can apply a similar condo-conversion strategy to office buildings, neighborhood shopping centers, self-storage warehouse units, mobile home parks, hotels, marinas, boat storage facilities, private aircraft hangars, and other types of rental real estate in which potential users might prefer to own versus rent. In each case, you pay less per unit (or per square foot) for an entire building than individual retail buyers are willing to pay for the smaller quantities of space that will meet their needs.

Opportunities for conversion profits run in cycles. As property markets change, potential profit margins swing from "make an easy million" to "call the bankruptcy lawyer" and back again to profit possibilities.[3] Orlando, Florida, during the boom years, seemed like the perfect condo conversion market to make that easy million. Today, the bankruptcy and foreclosure lawyers are working overtime. But the cycle will turn. To profit with this possibility, monitor your property markets for both conversion timing and product potential (see Chapter 9).

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[3]In such distressed market conditions, you might profit from reverse conversions. Buy a fractured condo and operate it as a rental property.

Convert from Lower-Value Use to Higher-Value Use

Assume that because of undersupply in your city, single-family homes (SFRs) rent for, say, $2 per square foot (psf); offices rent for $1 psf (due to an excess supply). Five years from now, the market has reversed. Single-family space rents have fallen to $1.50 psf (due to excessive new housing construction), and because of a strong economy and high rate of job growth, office space rents have increased to $3 psf. What might you do (if zoning permits)? Convert your single-family house into offices.

To succeed with conversions of *use,* renovate (at least to some degree) the old, lower-value space to fit the market needs of the tenants for the higher-value use. When relative prices or rent levels grow progressively wider, conversion from lower-priced use to the higher-priced use can generate a lucrative source of returns. In the Wall Street area of Manhattan, various buildings with vacant office space found new life (and profitability) as million-dollar condominiums.

Subdivide Your Bundle of Property Rights

When you own a freehold estate in property, you own *divisible* property rights. Divisible means that you can sell or lease each of these rights to different persons. In some instances, the sum of the parts greatly exceeds the value of the whole. Such divisible rights may include (but are not limited to):

- Air
- Mineral
- Oil and gas
- Coal
- Access
- Subsurface
- Development
- Water
- Leasehold
- Grazing
- Timber
- Solar/sunlight
- Easement
- Life estate

When Donald Trump built his United Nations World Tower, a few lucky nearby property owners pocketed several million dollars. Why? Because Trump paid these owners to transfer a portion of their air rights to him. After purchasing their air rights, the City of New York permitted Trump to build 80 stories instead of 40 stories, the maximum height zoning then allowed. These owners could sell additional air space to Trump because their buildings had not maxed out their height allotment under the then-current zoning law.

After selling to Trump, these owners lost the right to rebuild their sites to the maximum height otherwise permitted [e.g., the owner of a 30-story building may have been able to build a new 40-story building on that site (or perhaps add 10 stories to the existing building). The owner instead sold those air rights to 10 additional stories to Trump. Unless the zoning law changes, 30 stories represents the most that can now be constructed on that site.]

When you are in Hong Kong, notice that high-rise apartments tower directly above some of the Mass Transit Railway (MTR) stations. Developers paid the Hong Kong government for the right to lease that airspace—even though the government retained ownership and use rights of the land beneath the apartment buildings.

Does a neighboring landowner need access to the beach through your property? Sell (or lease) him an easement. Do you own property near a stadium or popular event location? Grant short-term parking rights. Do you own a rental condominium or house with parking or storage spaces? Lease these spaces separately from the residence. Does your city recognize the right to sunlight? If so, sell this right to your neighbor when he wants to build an upper-floor addition onto his house that will place your backyard in the shade most of the day.

Timber, oil, gas, minerals, life estates—these and many other rights may offer profit possibilities. Match up advanced knowledge of local property law with the particulars of a given property. Stir in your fertile imagination. You can come up with some good ideas for parceling out your property's divisible package of rights.

Subdivide the Physical Property (or Space within a Property)

Condominium conversions represent one form of subdividing. But subdividing usually refers to selling or leasing land or buildings in smaller parcels, most commonly, a developer who buys, say, 500 acres, and then sells half-acre lots to homebuilders. Alternatively, consider a permanently closed Kmart store. A thriving big-box retailer might pay $10 per square foot to lease the entire now-vacant building. But subdividing (partitioning) the interior space might bring in higher rents.

A property entrepreneur could master lease the old Kmart property and partition the interior space into a variety of uses such as child care, offices, or smaller retail merchants. Each small tenant pays a higher price per square foot rental rate than would the Best Buy or Lowe's that might otherwise lease the entire building. If the new space users require lower parking ratios than the old Kmart, the entrepreneur might subdivide some of the parking lot area for additional retail or restaurant uses (outparcels).

Thoughtful entrepreneurs steeped in market knowledge and possibility thinking persistently search for properties to subdivide or partition. The sum of the parts may exceed the value of the whole.

Create Plottage (or Assemblage) Value

You create plottage or assemblage value when you combine smaller parcels into a larger parcel of land or space. Say you discover a perfect site to build a new neighborhood shopping center. Zoning and planners require a minimum of four acres for such a development. The site equals four acres but it is owned by eight different persons in one-half-acre lots. Individually, the lots are worth $10,000 apiece—or $80,000 in total.

However, as a four-acre shopping site, the land would sell for $250,000. You now see how to earn a good profit. Persuade each of the current owners to sell you her lot at its current market value (or even at a price that sits somewhat above market value). One of the most famous and profitable assemblages (Disney World) involved the Walt Disney Company. Over a period of 10 years, Disney secretly put together the smaller tracts of hundreds of landowners to accumulate a total of 25 square miles of Central Florida land at agricultural-valued prices. Once Disney had completed this assemblage, the value of the aggregated raw land probably exceeded their per acre purchase costs by a factor of 10 (or more).

Obtain Development or Redevelopment Rights

Return to the four-acre neighborhood shopping center example. You succeed. You acquire all eight lots at a total price of $130,000 (several of those owners did not want to sell—so you raised your offer). Can you start building the center? No. You must first secure a long list of government permits and approvals. So, the current site value of $250,000 applies only to the assembled parcel—devoid of permitting.

With development and construction permits approved, the land might command a price of $500,000. You could sell now for $250,000 and take your profit. Or you could stay in the action. Spend $50,000 (more or less) for lawyers, soil tests, public hearings, environmental clearance, traffic studies, and whatever else the city requires. This permit process might (with luck—and no unanticipated delays) continue for 12 to 24 months. Then, if all goes as planned, you sell for $500,000 and earn $320,000 ($500,000 less [$130,000 + $50,000]).

In real estate, government approvals add to the value of any property that is suitable for development, redevelopment, renovation, conversion—or even destruction.[4] Obtain those permits and the value of the subject property goes up.

Tax Shelter Your Property Income and Capital Gains

To build wealth, protect your income and capital gains from the grasp of government. Fortunately (under current tax law), investing in real estate provides you more opportunity to avoid paying taxes than any other asset class.

Depreciation (noncash) deductions might shelter all (or nearly all) of your positive cash flow. A Section 1231 exchange shelters your capital gain as you pyramid into larger investment properties. The $250,000/$500,000 capital gain exclusion provides you tax-free gains from the sale of your personal residence(s). A cash-out refinance (that your tenants will repay for you) deposits tax-free cash into your bank account. And if you buy a first-time home, you may qualify for a mortgage (tax) credit certificate.

Some naïve investors might remark, "I can build my stock market wealth tax free through my 401(k), 403(b), and IRA plans. That tax break beats real estate."

Unfortunately, those retirement programs do not provide tax advantages that are as favorable as most people think, because when you begin to draw on that cash during retirement, the government will tax every penny as ordinary income. Even though (if you invested successfully) much (perhaps most) of your withdrawals will have accumulated through capital gains, the IRS does not permit you to claim those withdrawals as a capital gain and therefore pay the much lower capital gain tax rates.

Another costly disadvantage: if you withdraw money from your retirement plan before you attain age 59½ (as nearly 50 percent of Americans do), the IRS will take 35 to 50 percent of those amounts (taxes plus penalties). If you die before you withdraw your benefits, the IRS still reaches in and pulls out its share from your estate.

To minimize loss of income and wealth to the IRS, buy investment real estate. But do not misinterpret my point. I own a 403(b) account that is exclusively invested in stocks and bonds. Diversity of assets has merit (see the following discussion). My property investments, however, generate more effective tax-avoidance possibilities (as will yours). (See Chapter 14 for a discussion of property taxes and income tax laws. In addition, many

[4]Yes, government even requires permits to tear down buildings. In Sarasota, Florida, the Ritz Carlton fought a four-year battle to obtain permission to tear down a historic house located on part of the site where the Ritz planned to build. In compromise, the Ritz eventually paid to move the house to another site.

investors today are switching to a self-directed IRA—within which you are permitted to hold investment real estate and many types of alternative assets other than stocks and bonds.)

Diversify Away from Financial Assets

Although some investors prefer stocks, those investors would prove themselves wise to diversify part of their portfolio into property. (And similarly, property enthusiasts are smart to own at least some stocks and bonds.)

During longer periods of expected and unexpected inflation, property prices have kept pace with (or exceeded) the rate of growth in the CPI. Even better, leverage transforms small price gains into double-digit rates of increase in your equity wealth. With smart financing, you can earn above-inflation returns with below-inflation gains in price.

Historically, property values have experienced less volatility than stock prices. The recent depression, surfeit of foreclosures, and price downturns for many properties seem less serious when compared to the precipitous periodic drops in stock prices. Even in the hard-times property markets, prices have only fallen back to their 2004–2005 levels. When I wrote this chapter, major stock indices (S&P 500, DJIA, NASDAQ) were sitting below their levels of the year 2000.

And do not forget income. During our continuing financial crisis, rent levels increased and vacancies decreased in most cities. In contrast, stock dividends fell significantly—especially the dividends paid by banks (which until the crisis accounted for 35 to 40 percent of all dividends paid by S&P 500 companies). If you want your investments to fund your retirement *income,* own investment properties.

Today, most financial planners encourage asset diversification. Historical as well as recent experience supports that view. The mantra "stocks, stocks, and more stocks for retirement" does not meet the test of experience. Add property to your investments—if not for its superior returns, then to reduce portfolio risks. As long as my tenants pay their rents, short-term paper gains or losses in property prices mean little to me.

IS PROPERTY YOUR BEST INVESTMENT CHOICE?

I referred to Jeremy Siegel (*Stocks for the Long Run*) as chief cheerleader for stocks. But some people think that I serve as head cheerleader for investing in real estate.

In one sense, they are right. The record shows that more average people have built sizable amounts of wealth through property than any other type of savings or investment. Despite the huge growth in IRAs and 401(k)s—and despite the downturn in home prices—home equity still provides the largest portion of household net worth.

However, I do not say, "Property will beat stocks or bonds any time, any place, at any price." As early as 2005, I told my investor audiences that I would not buy property in the then-current hot spots such as Las Vegas, Miami, Barcelona, Dublin, or Dubai. Hot money and speculative frenzy drove those markets—not reasoned fundamental evaluation of risks and rewards. I advocate *investing* (not speculating) in property. Be wary of any market or asset class that has attracted large amounts of hot money. When that speculative asset (whatever it might be at the time) begins to lose its glow, hot money leaves even faster than it arrived. [In Dubai, hot money built its momentum over a period of 4 years. That flow virtually disappeared within a period of three months after October 2008 (the market peak).]

When people ask me, as they often do, "Which asset provides the best returns—stocks or real estate?" I answer, "It all depends." (In fact, since 2007, in a general sense, quality corporate and government bonds have provided higher total returns than either stocks or property.)

Yes, it all depends. In 1989, I would rather have invested in the S&P 500 index fund than Tokyo real estate. In 1993, I would have preferred the DJIA to property in Berlin. In 1997, I would rather have bought Apple Computer stock than a Hong Kong condominium located on the Peak. (In fact, if you can identify the next Apple Computer–like company, please e-mail and let me know. I will gladly buy its stock—and even sell properties to do so.)

To choose assets wisely, rely on investment and market analysis. Investors do not always make more money with property than they do with stocks or bonds. I have never said otherwise. But that begs the question, "Which investment offers the best possibilities and probabilities today?"

Given today's real estate bargains relative to where property prices will likely stand 5 to 10 years from now; given the fact that you can build large increases in property wealth (equity) without big gains in price; given the relative income yields of property versus stocks (or bonds); given the tax advantages of property relative to all other investments; given the multiple sources of returns that property offers; and last—but far from least—given the entrepreneurial talents that you can apply to property to increase its price and cash flows; then, yes, in today's market, I am willing to lead the cheers for smart investing in real estate.