CHAPTER 1

The Lazy Investor's Way to Wealth

If you're like most people these days, you would like to find a safe investment that yields high returns. You probably know that you could profit big in real estate, but you hesitate to take on the part-time job of landlording. What to do? Invest in condominiums.

In the beginning you will need to put forth some effort to learn the market. Once you're past that step, though, the condos will operate on automatic pilot most of the time. Most condo investors I know put in less than 10 to 20 hours per year for each unit they own.

How can condo owners earn high real estate returns with minimum hassle? It's easy: Because the condominium association takes care of all exterior (and maybe some of the interior) maintenance for the units.

Condominiums and townhouses offer high returns, low risk, and minimal landlording.

Condominiums Attract Better Tenants

You will gain a partner to help manage your tenants. The homeowners' association (HOA), as well as the individual homeowners who live in the other units, will keep an eye on the behav-

HOA communities attract good tenants.

ior of your tenants. Even better, as it turns out, well-run condo and townhouse developments actually attract a better class of tenants than comparably priced single-family houses and apartment buildings.

Why Condos Attract Better Tenants

Condos and townhouses tend to attract *low-maintenance* tenants because these residents actually prefer to live under the strict rules and more pleasant environment of a home-owning community. Think about it. If you were the type of person who likes to hang out at the swimming pool on Sunday afternoons and get rowdy, would you choose to live in a home-owning community or an apartment complex? If you plan to ask six of your closest friends to move in with you to help pay the rent, do you choose to rent in a townhouse community of homeowners, or would you try to rent a single-family house?

Experience shows that trouble-making tenants avoid *well-run* condo and townhouse developments because they know that they will not be able to get away with their antics.

Well-run HOAs Take note that I emphasize well-run associations. To gain the "association effect," you must carefully select the projects and buildings in which to buy your units (a topic that will be covered in later chapters).

Good tenants prefer strict rules of conduct. Bad tenants avoid them.

Early on, I learned this lesson when I invested in a cheap condo unit in a building that had slid downhill. Apathy and lack of care prevailed. Rules went unenforced. Owners moved out. More unruly tenants moved in. Property values stagnated. Vacancies and turnover increased.

Happy Ending Fortunately, my mistake turned a remarkable profit. Eventually, the investors and homeowners elected a new board of directors for the HOA. We hired a new management company. We developed new rules with teeth in them (daily accelerating fines for repeated offenses). Within three years of our project turnaround, our units had appreciated by 40 percent. In fact, for investors who are willing to accept a little more risk and put in a little more effort, the turnaround play can yield big profits within a period of a few years.

Turnaround projects can yield thousands in quick profits.

The One Easy Test: Who's Moving In, Who's Moving Out

How can you tell whether a project offers a promising future? How can you tell before you buy whether the HOA will prove to be an asset that helps you attract and retain good tenants? Again, I will go into this topic in more detail later. But one helpful way is to learn who's moving in, who's moving out, who's selling, and who's buying. In other words, before you commit to a building or development, review the demographics (age, occupation, incomes, and household composition) of the owners and the residents. From these data you can figure out whether the project is moving upscale, holding its own, or sliding down.

You will learn how to own rental properties without becoming a landlord.

Your Procedures Count, Too!

Of course, even with a watchful and well-run HOA, you can't just rent to the first person who's willing to write you a check. Later I'll tell you exactly what you need to do to enjoy carefree rent collections from the perfect tenant.

Can Investors (Lazy or Not) Really Build Wealth with Condos and Townhouses?

William Nickerson wrote the all-time classic get-rich-in-real-estate book (*How I Turned $1,000 into a Million in My Spare Time*) more than 45 years ago. Since then, hundreds of similar books have promised to show readers how to build wealth in real estate. These authors have urged their readers to buy fixer-uppers, foreclosures, apartment buildings, and single-family houses.

Condos and townhouses represent an overlooked opportunity.

Yet not one such book tells readers how to build wealth with condos and townhouses. Indeed, I plead guilty to this neglect. My own best-selling book, *Investing in Real Estate, Fourth Edition* (Wiley, 2003) focuses exclusively on single-family houses and small apartment buildings.

Why Such Neglect?

Why have real estate authors shied away from recommending condos and townhouses as investments? Presumably condos usually do not appreciate as fast as houses. "When condos become in short supply in an area and prices start to appreciate, more complexes are built and the oversupply cycle begins again. Houses, however, can't be built quickly (if at all) in most areas because very little land remains."[1]

Authors and experts fail to tell the whole story.

Although this quotation was written by other authors, it's similar to the explanation I have given over the years when my readers and seminar attendees ask about condos and townhouses. "Condos don't appreciate as fast as

1. Ralph Warner and Ira Serkes, *How to Buy a House in California* (Berkeley: Nolo Press, 1990), 3/24.

houses. Condo prices can suffer when a glut of new apartments floods the market." Okay, that's the bad news.

Experience Trumps Cliché Now here's the good news. When I reviewed the actual experience of investors (including myself), I found that total returns have often exceeded the returns from owning single-family houses. Why? How? Here are the reasons.

- Because of periodic oversupply, it's easier to buy condos at a steeply discounted bargain price.
- In nearly all markets, condos yield more cash flow than houses for each dollar invested.
- Condos typically yield more tax shelter for each dollar invested.
- Condos present less risk of cash flow shock (i.e., new roof, exterior paint job, major electrical upgrade, etc.).
- Condos/townhouses often prove easier to rent and consequently suffer lower vacancies.
- Condos require much less managerial time and effort.

When you compare investment choices, you must compare the *total* returns, not just the so-called average rate of appreciation. You must also compare the time, trouble, and energy that you will put forth to oversee and look after the investment. When you look at this total picture, you will find (as I have) that condos and townhouses can help you achieve very strong returns, an inflation-protected stream of income, and a multimillion-dollar net worth.

You can sometimes earn higher profits with condos than you can with single-family houses.

It's Your Choice! By pointing out the fact that you can make money with condos and townhouses, I am not urging you to forgo single-family houses or apartment buildings. I am not arguing that you will necessarily earn more with condos than you could with other types of real estate. No one can say for sure how *you* will do with any type of investment—real estate or anything else.

However, I am urging you to weigh the merits of condo investing against your financial goals and personal resources. Too many investors pass up real estate because they don't want the supposed hassle of landlording. Other investors who choose real estate pass up condos and townhouses because they erroneously believe that a low appreciation will make condos an inferior investment. Do you hold either of these beliefs?

If so, you're in for a pleasant surprise. In the following pages, you will gain a newfound appreciation (no pun intended) for condos and townhouses. In the end, you may choose not to follow through. But if you do pass up this opportunity, you will not be able to justify your decision with the usual reasons. There's simply no question that over the next 5 to 15 years, well-selected condos and townhouses will reward investors with very handsome returns for relatively little effort.

Condos and townhouses often yield higher *total* returns.

How You Will Profit with Condos

In the remainder of this chapter, I detail more closely the how and why of the rewards of investing in condos. Essentially, you can profit in six ways.

1. Appreciation
2. Mortgage paydown
3. Cash flow
4. Tax shelter
5. Value creation
6. Diversification

Now we look at each of these sources of profit with more precision.

Appreciation

The evidence clearly shows that over the long term, condos do appreciate. Those who argue in favor of houses over condos only allege that houses appreciate at a faster pace. No one claims that condos won't appreciate at all.

The Historical Record

I traced some condo and townhouse prices back to the 1970s and then compared the same units to the prices at which they're selling today.

As you can see from Figure 1.1, the least appreciating complex tripled in value, whereas several others have multiplied in value four to eight times over. In fact, although I researched records from all over the country, I could not find any units that had not at least doubled in value since 1980. In other words, the absolute worst record equaled an average rate of appreciation of about 3 percent a year.

But before you shout, "Three percent? That's lousy!" you need to consider that the rewards of 3 percent appreciation are really quite generous. That's because nearly all investors leverage their returns.

	Sales Prices ($)	
Condominium Development	*1970s*	*2000s*
Sabal Point (Miami, FL)	50,000	375,000
Forest Edge (Reston, VA)	25,000	180,000
Faulkner Station (Columbia, MD)	22,500	140,000
Mount La Jolla (San Diego, CA)	60,000	425,000
University Park (Irvine, CA)	25,000	200,000
Sudley Station (Manassas, VA)	26,500	180,000
Louis Park (Stockton, CA)	14,900	140,000
Treasure Isle (Foster City, CA)	29,000	245,000

Figure 1.1 A Sampling of Condo Price Appreciation.

Condos and townhouses give investors strong gains through appreciation.

To buy a $100,000 condo, an investor might invest only $20,000 of his or her own money (often less). When that $100,000 unit moves up to $103,000, the investor has actually experienced a 15 percent return on invested cash—and that's just from first-year appreciation:

$$15\% = \frac{\$3,000}{\$20,000}$$

After five years, still assuming 3 percent a year, the property is then worth $115,900. Therefore, year six appreciation equals

$$0.03 \times \$115,900 = \$3,477$$

And the rate of return on original cash invested increases to

$$17.38\% = \frac{\$3,477}{\$20,000}$$

"Low" rates of appreciation yield high rates of return.

When I read in the financial press that by registering a *total* return of 10 to 12 percent a year, "stocks outperform all other types of investments," I don't know whether to laugh or cry. As you can see, the weakest performing condo record in the country has out-earned stocks by a wide margin—*just from appreciation!*

What Does the Future Hold?

"Okay, Eldred," you might say, "you're talking history. I want to know what's going to happen in the future. Don't you understand that we're in a real estate bubble? All of the financial press is talking about it."

I realize the financial journalists are trying to compare real estate prices to the inflated high-tech stock prices of early 2000. In

The bubble theory of real estate prices is full of hot air.

fact, I am interviewed by such journalists almost weekly. I will tell you from firsthand knowledge that the great majority of these journalists couldn't value a property or calculate an investment return if their lives depended on it.

I have attempted many times to explain that the values of rental real estate are supported by a real and provable stream of income, whereas many of the high-flying tech stocks never earned a nickel of profits. Even solid companies like Microsoft, Intel, and Cisco Systems were valued at absurd multiples of 60, 80, or 100 times actual earnings. The term *bubble* means no underlying fundamentals to support the price of the investment—as in the Florida land boom of the 1920s that the Marx Brothers spoofed in their movie *Coconuts.*

Will today's housing prices stall (or even drop some) within the next year or two? Possibly. Will condo and house prices crash, as did the NASDAQ and S&P 500? Absolutely not. Will condo and home prices continue to set record high prices 5, 10, and 20 years from now? Barring economic or national collapse of the United States, positively, yes.

More Historical Perspective With talk about a housing bubble, or as the *Wall Street Journal* recently wrote, "Homes no longer are the place to put your money," you need to gain more historical perspective on the decade-by-decade performance of home prices since the end of World War II.

Among all of the lessons history teaches, none is more certain than the fact that home prices will go up. Regardless of how high you think prices are today, they will be higher 10 years from now and much higher 20 or 30 years into the future. Don't make the mistake of believing that home prices have reached their peak. Before you put faith in the naysaying of so-called economic experts, take a quick trip through some of their faulty predictions from years past:

The bubble theory for real estate first appeared in the *1940s*!

- "The prices of houses seem to have reached a plateau, and there is reasonable expectancy that prices will decline" (*Time,* December 1, 1947).
- "Houses cost too much for the mass market. Today's average price is around $8,000—out of reach for two-thirds of all buyers" (*Science Digest,* April 1948).
- "If you have bought your house since the War . . . you have made your deal at the top of the market. . . . The days when you couldn't lose on a house purchase are no longer with us" (*House Beautiful,* November 1958).
- "The goal of owning a home seems to be getting beyond the reach of more and more Americans. The typical new house today costs about $28,000" (*Business Week,* September 4, 1969).
- "Be suspicious of the 'common wisdom' that tells you to 'Buy now . . . because continuing inflation will force home prices and rents higher and higher' " (*NEA Journal,* December 1970).
- "The median price of a home today is approaching $50,000. . . . Housing experts predict that in the future price rises won't be that great" (*Nations Business,* June 1977).
- "The era of easy profits in real estate may be drawing to a close" (*Money,* January 1981).
- "In California . . . for example, it is not unusual to find families of average means buying $100,000 houses. . . . I'm confident prices have passed their peak" (John Wesley English and Gray Emerson Cardiff, *The Coming Real Estate Crash,* 1980).
- "The golden-age of risk-free run-ups in home prices is gone" (*Money,* March 1985).
- "If you're looking to buy, be careful. Rising home values are not a sure thing anymore" (*Miami Herald,* October 25, 1985).
- "Most economists agree . . . [a home] will become little more than a roof and a tax deduction, certainly not the lu-

crative investment it was through much of the 1980s" (*Money,* April 1986).

- "We're starting to go back to the time when you bought a home not for its potential money-making abilities, but rather as a nesting spot" (*Los Angeles Times,* January 31, 1993).
- "Financial planners agree that houses will continue to be a poor investment" (*Kiplinger's Personal Financial Magazine,* November 1993).
- "A home is where the bad investment is" (*San Francisco Examiner,* November 17, 1996).
- "Your house is a roof over your head. It is not an investment" (*Everything You Know about Money Is Wrong,* 2000).
- "Homes no longer are the place to put your money. With the recent run-up in prices, don't expect much more appreciation" (*Wall Street Journal,* January 20, 2003).

The federal government is creating home-buying programs to bring another 10 million individuals and families into the ranks of homeowners.

As you can see from these quotations, the financial press has warned against investing in real estate for more than 50 years. Fortunately, most Americans have ignored these naysayers. The rates of homeownership continue to set new records.

More important, the president of the United States and the secretary of the U.S. Department of Housing and Urban Development (HUD) are working to develop even more outreach programs that will push demand for homes (condos and houses) even higher. With respect to condos and townhouses specifically, the future looks especially attractive for these three reasons:

1. Favorable demographics
2. Higher affordability
3. Inflation-protected income

Favorable Demographics The overwhelming demographic fact of the United States remains population growth. Over the next 20 years, the number of people living in the United States will increase by 35 to 50 million (depending on birth rates, mortality, and immigration). But within that overall larger population, the age groups and household sizes that tend to prefer condos and townhouses will grow much faster.

Emerging population demographics favor condos and townhouses.

The demographics of condo buyers are heavily weighted among persons under age 35, persons over age 55, singles of all ages, and DINKs (double income, no kids) of all ages. Although some overlap does exist among these demographic categories, here's how each group's numbers are expected to increase by 2013.

- *Echo boomers.* Beginning in 2003, the "echo boomers" begin turning 25 at the rate of 4 million persons a year. The echo boomers follow the baby bust era of 1965 to 1977, when births averaged only 3.4 million persons a year.
- *Baby boomers.* Whereas the echo boomers exceed the baby busters by about 15 percent, the baby boomers outnumber the 1930 to 1946 generation by 100 percent. During the next decade, around 40 million boomers will turn 55—up from around 22 million during the 1990s.
- *Single persons.* More Americans are choosing to live alone. By 2013, their numbers will jump by 7.5 million to 10.0 million persons.
- *DINKs.* Americans continue to live in smaller families. Many married women of childbearing age are either deferring or declining to give birth. For these DINKs, who prefer urban action over crabgrass and suburbia, central city condos rank high among their housing choices.

When compared to the 1990s, the era that we're entering now will almost double the number of people who fit a condo buyer's demographic profile. Younger adults, older adults, and

Echo boomers, retiring baby boomers, and no-children households will explode demand for condos and townhouses.

adults without children (married or unmarried) will boost their total numbers by perhaps 40 million people. In addition, more Americans want secure, low-maintenance living. The "lock and leave without worry" attitude will draw more buyers to condos.

Overall, during the coming decade, demand for condos and townhouses by homebuyers (and second-home buyers) will break all previous records.

Higher Affordability Have you looked at the prices of single-family houses lately? Over the past five years, house prices in most cities have jumped by 50 percent or more. In the higher-cost big cities, entry-level prices for modest two- or three-bedroom houses can easily top $300,000. The entry-level price for a house sits at about twice the entry level price of a condo.

Consider the West Point Grey–Kitsalano neighborhoods of Vancouver, British Columbia. In 1980, one could buy a decent (but far from extravagant) single-family home in these areas for around $100,000. Today, that same house carries a price tag of $500,000 (Canadian dollars). On the other hand, a comparably sized condo that sold for $100,000 in 1980 would sell today at around $300,000. A bare-minimum house (essentially site value) would cost $400,000, whereas one can buy an entry-level condo for $100,000 to $125,000.

These figures illustrate two points that apply in many (if not most) cities throughout the United States and Canada.

- Unless they buy a condominium, a large percentage of potential homebuyers are priced out of homeownership in the more desirable neighborhoods.
- In most of the more desirable neighborhoods, house prices have outpaced condo prices—but this trend won't likely continue.

Millions of hopeful homebuyers cannot afford to buy a decent single-family house in a desirable location.

The first point is rather obvious. The rapid run-up in house prices has blocked many hopeful homebuyers from what were once considered middle-class neighborhoods. Even low mortgage interest rates won't make $300,000 to $500,000 houses affordable to average to above-average earners. Although house prices in your area may sit far lower than in Vancouver, San Francisco, Chicago, or Washington, D.C., I'm sure that you will find that the basic relationship holds. In the more desirable areas of town, condos and townhouses provide lower entry-level prices. In a word, condos rank higher in affordability.

The second point deserves more explanation. Suppose that you accept the premise that houses will continue to appreciate at a higher rate than condos. You estimate 6 percent for houses, 3 percent for condos. Table 1.1 shows how the numbers would evolve over periods of 5, 10, 15, and 20 years.

Someone once quipped that a trend that can't continue, won't continue. What you see here is a trend that can't continue. At different rates of appreciation, a house more than triples in value over 20 years, but the condo doesn't quite double. The house price increases by $693,000; the condo price increases by $82,075.

Even if we assume that people much prefer houses to condos, at some point condo prices become so *relatively* cheap that peo-

Purchase Price	*5 Years*	*10 Years*	*15 Years*	*20 Years*
$300,000 (6% appreciation for houses)	$404,400	$545,700	$736,200	$993,000
$100,000 (3% appreciation for condos)	$116,100	$134,935	$156,743	$182,075

Table 1.1 Why Housing Appreciation Cannot Continue to Outpace Condo Prices

Condo prices will play catch-up to home prices during the next decade.

ple would say, "Sure, we would like to own a house, but we can't afford it. And even if we could afford it, we don't think we would be willing to pay such a steep price premium."

You can play with the numbers any way you want. But the essential principle remains. Over long periods of time, houses (on average) cannot and will not always appreciate faster than condos. In fact, given the changing demographics of the population (younger, older, fewer households with kids), you might even see some real price softening in those large, 3,000-square-feet to 10,000-square-feet McMansions that became so popular during the 1990s and remain so today.

During the late 1960s through the early 1980s, condo prices actually appreciated faster than houses in many cities. Subsequently, though, overbuilding and excessive numbers of apartment conversions flooded the market. Condo prices stagnated or fell. In Boston and Houston, some owners could not sell their units for 50 cents on the dollar. Nevertheless, long-term condo investors who bought at the peak of those earlier boom-and-bust times have still seen their unit prices double or triple in value.

After this brief digression, let me return to my basic point. Whether we are talking houses or condos of an earlier boom era, never simply extrapolate the past into the future. On average, neither type of dwelling can outperform the other decade after decade without end. As to the decade that lies before us, the fundamental facts support good appreciation for well-selected condos and townhouses.

Never project the past into the future without first studying market fundamentals.

Strongly Competitive Yield: Investor Demand Up to now, you've seen that the homebuyer demographics and affordability will accelerate the demand for condos. But I also forecast a ballooning demand for condos by investors (which is why I wrote this book).

What do retirees need most during retirement? A safe, inflation-protected stream of income. In today's investment climate, where can retiree-investors obtain this needed income stream? Nowhere but rental properties—not stocks, not bonds, not annuities, not certificates of deposit. And for the great majority, not an employer pension.

- *Not stocks.* The current dividend yield on the S&P 500 sits at less than 2 percent. Put $100,000 into a diversified portfolio of stocks and you collect $2,000 a year.
- *Not bonds.* On relatively low-risk, long-term bonds that are suitable for retirees, the investor could earn 4 to 7 percent—for an income of $4,000 to $7,000 a year. That's not bad in today's market, but it is still woefully inadequate because bond interest does not protect against inflation. At an inflation rate of just 2.5 percent a year, after 10 years, the real value of that $5,000 in interest income has been sliced to $3,895; after 20 years, it offers only $3,030 in yearly spending power. Even worse, if interest rates fall, the corporation can probably call (redeem) the bond.
- *Not annuities.* Currently, many retirees are rushing to annuities because for $100,000 they can buy an income for life of $500 to $600 a month. But annuities offer a double bad deal: (1) The income stream will not grow with inflation, and (2) if the retiree drops dead tomorrow, the entire $100,000 vanishes into the insurance company's vault. The heirs of the retiree receive nothing.

The retired investors may be forced to replace their bonds with ones that carry a lower interest rate.

Okay, back to rental properties. If a retiree paid cash for a $100,000 condo, he would probably net after expenses $500 to $600 a month for the first year—about the same as an annuity. But that's where the similarity ends. For as long as that retiree lives, his net rental income will increase by around 4 percent a year (more in some years, less in others). Here's how the numbers look:

Net Income from Rental Condo (4 percent Rent Increases)

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 25
Amount	$500	$610	$745	$910	$1,110	$1,357

Income from Annuity

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 25
Amount	$500	$500	$500	$500	$500	$500

Annuities guarantee *lower* real incomes as you get older.

Now why would anyone choose an annuity that virtually guarantees that you will become poorer as you get older? It could get much worse for annuity holders relative to condo investors. The 4 percent rent increase above assumes that the Consumer Price Index (CPI) advances about 2.5 percent a year. Rents typically increase about 1.5 percent above the CPI to account for both inflation and wage increases due to gains in productivity.

Recently, inflation has settled down. But what if we returned to the 5 to 12 percent a year inflation we experienced throughout most of the 1970s and 1980s? At, say, an 8 percent increase in rents (6.5 percent gain in CPI), here's how our two retirees fare:

Net Income from Rental Condo (8 percent increases)

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 25
Amount	$500	$745	$1,109	$1,651	$2,458	$3,660

Income from Annuity

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 25
Amount	$500	$500	$500	$500	$500	$500

Although 6.5 percent inflation seems rather far-fetched right now, that's also how such figures would have seemed in the 1950s and early 1960s. Yet forecasting inflation is not the point. Rather, the retired investor needs to *prepare for an inflation-protected* income.

That retiree never needs to worry about the cost of living outpacing the ability to pay.

Retirees must prepare for the possibility of inflation.

If you believe the inflation issue to be of idle concern, revisit the experiences of those "safety-conscious" retirees of the 1970s and early 1980s who held most of their savings in 4 percent and 5 percent U.S. government bonds. Inflation devastated their wealth and standard of living.

Annuity buyers liquidate their wealth. Condo investors continue to build their wealth—even while drawing a larger monthly income.

Before leaving the topic of annuities versus investment condos, let's return to capital preservation. As noted, with a life annuity you give up your capital for a fixed monthly payment for life. How foolish is that? With a condo, you not only achieve a lifetime of inflation-protected income but your initial capital grows in value as the condo appreciates. Here's how the two retirees fare in terms of capital preservation and growth.

Capital Preservation and Growth

Year	*Condo Investor (3% Appreciation)*	*Annuity Investor*
1	$100,000	$0
5	116,161	0
10	134,935	0
15	156,743	0
20	182,000	0
25	211,501	0
30	245,684	0

Now you know what's even better. The appreciated condo passes to the retiree's children (or other heirs) completely free of capital gains taxes. Talk about a win-win situation!

Summing Up

During the next 10 to 20 years, the twin issues of demographics and affordability clearly indicate that homebuyers will boost demand for condos. In addition, retirees who want to earn an inflation-protected income and grow their capital for their heirs will also enter the investor condo market in record numbers. Together, these growing sources of buying power (homebuyers and investors) will undoubtedly continue to push up condo prices to successive new highs.

Moreover, as we move forward in the next chapter to calculating cash flows, equity build-up, and total returns, you will see even more clearly why condos really do provide the lazy way to wealth for those investors who want little or nothing to do with either property management or property maintenance.