# MARKET MONITOR

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## Bottom Line for Real Estate is its Return on Investment (Part 1)

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HGTV and DIY must be a couple of fairly high rated cable TV networks. Based on the coverage the Tarek and Christina Moussa divorce received and the high interest in the news about Chris and Joanna Gaines changing their show, you have to conclude that these personalities are household names; at least for wide swaths of viewership demographics.

Understandably people enjoy watching the successful transformation of a neglected or outdated home from an ugly duckling into something beautiful. It may also be that there is an innate appeal to the satisfaction we experience when we create something with our own hands. Whether it's a good meal or painting a tool shed, the process unfolds before our eyes and it's easy and rewarding to measure the results.

However, no one can deny the fascination that grips us when we hear about the "huge" money made on the purchase and sale of property. The success our President achieved as a real estate tycoon is arguably one of the central reasons that he now occupies the White House. Without amassing, in his estimation, a net worth of $10 billion he wouldn't have become a celebrity businessman with 100% name recognition and his road to the White House would have been an infrastructure project never funded.

Whatever the reasons for the interest in real estate as an investment, it has to be analyzed as any other investment. As with any other investment, the same rule applies: You need to avoid getting emotionally attached. Depending upon the amount of effort you put into a rental property or a house flip it might create sentimental feelings for the property which should never happen in a financial transaction. Also, you must disregard the exaggerated stories about someone's alleged success in buying a property and selling it for a big profit. Often big profits can be followed by big losses as happened in the tech bubble burst in 2000 and the real estate crash in 2007.

In this issue of Market Monitor the groundwork is laid for what's required to properly analyze real estate investments. Listed in the chart, are the essential factors you need to evaluate the attractiveness of any specific investment property.

**The next issue of *Market Monitor* will take four specific properties and juxtapose their financial metrics to allow you to identify which ones make the best investment or, if any of them do.**

| Factors When Investing in Real Estate |
|---|
| Rents Received |
| Principal and Interest Payments |
| Real Estate Taxes |
| HOA & Dues |
| Utilities |
| Maintenance |
| Insurance |
| Vacancy Allowance |

Unless you have a sizable net worth, it is difficult to build a diversified portfolio of real estate holdings as the asset requires large amounts of capital. So the idea of purchasing a rental property that will generate generous amounts of cash flow is an alluring idea but on its surface it violates the rule of diversification because you own only one property. So most of us are left with the options of either buying one or two properties in hopes of renting them or flipping the properties like Tarek and Christina do.

However, one of the key advantages that real estate offers is the ability to leverage your investment. If you're interested in purchasing a property for $250,000 the total capital that you may have at risk is $50,000 and you borrow the balance. This means that if the property generates $5,000 in profit your return on investment is 10% even though the return on the entire asset's value may only be 2%. Keep in mind that, in an odd way, the advantage of being able to borrow money to invest may work against you the longer you own the property.

Although your net income on a property may increase as your interest payments decline, in all likelihood the larger your equity stake in the property the lower your return on investment will become and the bottom line to investing is your return on investment.

Some people may have the hope that real estate might offer a more secure way to fund a retirement. If an investor has a $1 million IRA it's possible to own properties in a "self-directed" IRA and shelter the income

*See "Financial Viability" page 2*

***Note:** Hold onto this issue of Market Monitor so you can refer back to it when Part II of this topic arrives.*

# Evaluating the Financial Viability of Rental Properties

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from immediate taxation. It's a little complex, but if someone is serious about becoming a full-time landlord then tackling the nuances of self-directed IRAs is a rather small task within the overall endeavor.

Evaluating the financial viability of rental properties funding all or some of your retirement is simply a matter of accurately forecasting rental income and all expenses associated with the ownership of the properties. Then figuring out what's left over for you to spend. The trick is in the careful inclusion of all expenses that are direct and those that are little less obvious. Again, the chart provides all the immediate and recurring expenses that you'll incur with a rental property. The other costs that should not be overlooked are transactions costs and your compensation. Buying and selling properties has brokerage commissions which are substantial and a definite disadvantage of real estate as an investment. The effort in owning real estate is often overlooked too but you need to be compensated for the time and aggravation of being a landlord. After all you need to be paid for hunting for the right property, negotiating purchases and financing terms, maintaining properties, collecting rents and evicting non-payers. The alternative is a diversified portfolio of liquid stocks and bonds which can be constructed without these kinds of hassles.

As a sneak preview to the analysis that will be presented in Part II, you should keep in mind that it's important to make your property purchases at a low price. This may be even more challenging in the real estate market than it is in the stock and bond markets, but at the same time, of even higher importance.

## Market Snapshot: Tech Wave Might Be Ending but Stocks Might Find A New Wave

BY: MICHAEL ALEXENKO, CFA

November 7th looked like the end of the market correction. One of the major hurdles was crossed when the uncertainty that the mid-term election generated seemed to be satisfactorily resolved. When initial votes were tallied all partisans could declare a share in victory and the sly guys on Wall Street who like to hedge their bets and play both sides were especially pleased. The Wall Street crowd likes gridlock and that's what they believed the mid-terms had delivered. But, on November 8th the celebration ended and the selling resumed. Turned out the election hadn't resolved all the uncertainty. Layered on top of this is the trouble for large cap tech stocks, the Federal Reserve's belief that our economy can absorb several more rate hikes and a big drop in oil prices and it's no wonder that most of the relief rally was wiped away.

What the market is grappling with is a global growth picture that isn't strong. China's stock market makes our sell off look positively rosy. The worries are exacerbated by the reports that Apple suppliers are suffering from diminished demand and in fact this was then corroborated by stock analysts lowering Apple's sales forecasts for iPhones. The market has been riding the large tech stock wave for several years and if that wave is dwindling it understandably causes worry that aggregate corporate profits could get weaker. However, overall profits remain strong and the economy doesn't look to be falling off the edge quite yet. The market probably ran-up too fast in the late summer but corporate profits should still have enough fuel left to help the market catch a new wave.