



Ruminations on Real Estate

People sometimes ask us for our opinion on individually-owned real estate as an investment (as opposed to publicly traded Real Estate Investment Trusts (REITs) or purchasing a home to live in). There is no right answer for every situation; different people will weigh the factors differently. Here are some items to keep in mind (in no particular order):

- People like real estate emotionally. The fact that it is tangible and substantive, gives them comfort. The danger is, however, that these emotions will get in the way of an objective decision.
- Recently (2006), returns have been very good, and it should be noted that behavioral finance research has demonstrated that people tend to overweight recent data. Long-term returns on real estate (longer than the past few decades) have been just above inflation (0.4% above inflation according to one study), though this ignores income or expenses of the real estate. Income-producing investments can have very high returns (similar to stocks) if unleveraged (no debt) and potentially even higher if levered (debt financed), but flipping is probably not a successful long-term strategy.
- Real estate is a good inflation hedge particularly when financed with a long-term, fixed-rate mortgage. Thus it can be a risk-reducing part of a prudent financial plan, though it is difficult to get proper diversification due to limited personal resources except for the very wealthy. Also, people typically don't diversify because of comfort with "known" types of real estate and the local area (e.g. they tend to buy single-family residential rentals in their area rather than warehouses in another part of the country).
- High leverage (debt) frequently used exacerbates cash flow issues if properties are vacant temporarily. (This is ameliorated of course by not using leverage.)
- There are some tax advantages to real estate as an investment.
- It can be more work than people realize, and they rarely factor the value of their time into their basis when computing their returns. It is also generally illiquid, and transaction costs are generally high. Because of these factors, publicly traded REITs may be a more appropriate alternative.
- It is a relatively inefficient market (i.e. mispricing can happen and can be large); so there is opportunity to outperform based on skill. Even assuming skill exists however, it is difficult to have the requisite number of transactions for it to evidence itself. See the detailed explanation of this below.
- The riskiness of real estate is frequently not recognized due to artificial smoothing of prices reducing the standard deviation of the data. See the detailed explanation of this effect below also.

I would like to dilate further on the last two points because they are important in areas other than real estate as well.

It is not enough to have skill; there must be adequate opportunities to evidence that skill. This is one of the primary problems with attempting market timing with traditional investments – even assuming some people have skill, they don't get to exercise it often enough. To illustrate, suppose I have a coin that has a 60% chance of coming up heads and a 40% chance of coming up tails. Would you bet \$1,000,000 on one coin flip that it would be heads?

If the flip comes up tails you pay \$1,000,000 and if it comes up heads you get \$1,000,000. The expected return is $\$1,000,000 \times 0.6 - \$1,000,000 \times 0.4 = \$200,000$. Few people would be willing to make that wager, even though on *average* you would win \$200,000. However, you would almost certainly be willing to bet \$1 on that coin flip and do so 1,000,000 times, even though the expected return is the same. The difference is the outcome becomes practically guaranteed because of the volume of wagers. You will almost certainly have a profit of close to \$200,000 at the end (99% of the time you would be between \$197,476 and \$202,524). In real estate, even presupposing superior skill, many transactions are necessary to eliminate bad luck and evidence that skill with high certainty.

Real estate may look less volatile than it actually is for two reasons: First, properties don't trade every day, so prices between trades are estimated. These estimates tend to be based on the last transaction and/or the last estimate, which tends to smooth the volatility (hedge funds with illiquid holdings have this same artificial reduction of volatility). Second, when prices "decline," many people exhibit typical loss aversion, and pull the property from the market until it recovers rather than selling. Thus, while the true price is a loss, volumes simply slow dramatically rather than showing up as a loss in the data.

Finally, we occasionally have people ask about purchasing real estate in their IRAs (individual properties, not REITs). We wouldn't recommend buying real estate in an IRA for the following reasons:

- The fact that someone is using an IRA for the investment generally would indicate they don't have the financial resources to buy it without using retirement funds. Since frequently the vast majority of an individual's non-retirement assets are tied up in their primary residence (i.e. real estate), investing retirement funds in a similar asset in most cases would mean they are very undiversified (and possibly leveraged).
- Individually owned real estate (the buildings, not the land) can be depreciated for current tax savings and capital gains (above depreciation recapture) get a special (low) tax rate. Neither of these benefits are available within an IRA.
- Investors should avoid using leverage on IRA investments because it creates UBTI (Unrelated Business Taxable Income) which is taxed at trust (i.e. high) rates in the IRA. Further, this taxed income does *not* create any basis in the IRA and thus will be taxed a second time when it is distributed from the IRA to the owner. This is very unfavorable.
- Investors cannot use any "sweat equity." Doing work on the property is an IRA contribution and prohibited since IRA contributions may only be made in cash.
- Using the property personally constitutes an IRA distribution and is taxable.
- Enough liquidity must be maintained within the IRA for unexpected expenses. Because the investor needs to avoid debt and thus UBTI and because they can't just arbitrarily contribute extra funds to an IRA when needed, an adequate cushion of liquidity must be maintained.
- A similar need for liquidity exists in retirement when RMDs (Required Minimum Distributions) must be taken. There must be enough cash or other investments to make the distribution, or the taxpayer has to distribute a portion of the property. For example, suppose a house is worth \$548,000 and the taxpayer turns 70 ½. There is a 3.65% RMD so \$20,000 of the house is distributed from the IRA and put into different (individual) ownership. Every cash flow is now split 96.35% and 3.65% between the two entities. Needless to say, this creates a great deal of complexity.
- Related to the previous point, since RMDs are based on the value of the IRA, each year a qualified appraisal will have to be done each year to determine the current value.

Notes:

The analysis in this report has been prepared by David E. Hultstrom, MBA, CFP[®], CFA[®]. Mr. Hultstrom is the president of Financial Architects, LLC, a financial planning and wealth management firm. Questions or comments are welcome. He may be reached at (770) 517-8160 or David@FinancialArchitectsLLC.com.

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