

The DILLAGER

NEWSPAPER

December 27th, 2007

OUR READERS SPEAK:

Pros, cons of real estate investing

Submitted by Albert B. Woodward, Jr., CFP



Whatever its role in your portfolio, real estate offers the potential for two major benefits. The first is diversification; real estate is an asset class that doesn't behave the same as stocks or bonds. Second, as you likely will invest with borrowed money, you benefit from leverage. That is, if you buy a property for \$400,000, you put \$80,000 down, but you benefit from the future appreciation on the full \$400,000 value. According to the *World Wealth Report 2007* by Capgemini, global direct real estate transaction volumes reached \$682 billion in 2006, up 38 percent from 2005. Global real estate investment, including direct real estate and investments in Real Estate Investment Trusts, totaled \$900 billion in 2006, the strongest-ever performance.

Significantly, the Capgemini report notes that in 2006, in what it surmises is a "temporary tactical move," our nation's high net worth investors shifted their allocations from "alternative investments," which includes hedge funds, foreign currencies, and commodities, to seek high returns from real estate opportunities. Specifically, the report estimates that in 2006, high net worth individuals increased their real estate allocations from 12 to 20 percent of their portfolios.

What were the drivers? According to Capgemini, the vacancy rate for office space was at 13.5 percent, its lowest rate since the third quarter of

2001. Another contributing factor was that in 2006, for the seventh year in a row, the FTSE National Association of Real Estate Investment Trusts U.S. Real Estate Index outperformed major market indexes, with 34.4 percent gains in the FTSE NAREIT ALL REITs Index, up from 8.3 percent returns in 2005. The S&P REIT Composite index rose 35.4 percent in 2006, compared with 15.8 percent for the S&P 500 index.

Clearly, real estate offers potential for solid returns. What's more, especially in times of market volatility, there's a certain comfort to buying a bricks and mortar investment. However, for many of us, buying and owning real estate can be more complicated than investing in stocks and bonds. Investing in real estate requires everything from tax and budgeting expertise to people management skills. And, particularly as the sub-prime lending mess sorts it out, beneficial real estate opportunities may be more difficult to gauge. Below are the pros and cons of various real estate investments.

Homeownership

Of course, the most common real estate investment is homeownership. For first-time homebuyers attempting to decide if such a purchase is the right financial move, Freddie Mac, one of America's biggest buyers of home mortgages, offers a detailed analysis of benefits and potential snags. Freddie Mac points out the obvious benefits as having

a place to call home, possibly paying less than you would to rent, and locking in a monthly payment with a fixed-rate mortgage. As far as those intangible pluses, a recent Harvard University paper, "The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research" found strong evidence that homeowners are more likely to be satisfied with their homes and neighborhoods; participate in volunteer and political activities; and stay in their homes longer, contributing to neighborhood stability. The risks cited by Freddie Mac include potentially facing an increase in monthly housing expenses with an adjustable rate mortgage, a monthly mortgage payment that's larger than rent and not offset by a tax benefit at the end of the year, and the responsibility of property maintenance and upkeep. In addition, there's the possibility of losing value in your home during a recession or a future drop in a neighborhood's value. It's also worth noting the trouble with considering homeownership as a real estate investment. The fact is that while you could sell a stock when you deem the financial timing is right, there are physical and emotional ties that will prevent you from doing that with the home you live in. It's simply not practical to plan to move every time the market goes up or down.

Rental Properties

For many investors hoping to generate steady profits from

real estate investments, buying rental properties and becoming a landlord is a good option. In an ideal world, you buy a reasonably priced, well-maintained property in an ideal location that attracts the world's best tenants. In addition to setting a rent that covers your mortgage, taxes, and includes a profit, your property appreciates in value over the course of the mortgage. That translates into a reliable income stream that's fairly inflation-proof. Of course, in the real world, you can end up with a money pit of a property, a bad tenant who damages the property and skips rent payments, or an empty unit. And all that might cause you to have to scramble to cover your mortgage payments.

If you are thinking of becoming a landlord, it's first and foremost vital to have some financial reserves for that unexpected \$10,000 for a new roof. You should also think carefully about your own skill set and the amount of time you can dedicate to managing your investments. If you are a landlord, and the furnace stops working in the middle of the night, you'll get a phone call. If you like handyman work, this may not bother you; otherwise, a professional property manager would be glad to take the problem off your hands, for a price.

If you aren't willing to roll up your sleeves, a real estate investment group might be more attractive. These are companies that buy or build a set of

apartment blocks or condos, for example, and then allow investors to buy them through the company. One investor can own multiple units, but the operating company collectively manages all the units, from advertising for tenants to taking care of maintenance. Of course, the management company takes a percentage of the monthly rent, but it may be worth it because you avoid day-to-day property management and tenant issues.

REITs

If you want to remove yourself another step from managing your real estate investments, Wall Street has found a way to turn real estate into a publicly traded instrument. Real Estate Investment Trusts invest in commercial properties such as office buildings, shopping centers, apartment complexes, and hotels, and are bought and sold on the major exchanges just like any other stock. Notably, a REIT must pay out 90 percent of its taxable profits in the form of [dividends](#) to keep its status as an REIT. By doing this, REITs avoid paying corporate income tax and, like regular dividend-paying stocks, create an option for investors who want regular income. It's worth noting that a regular income and diversification, not spectacular returns, have been the traditional selling points of REITs. However, the last seven years of strong performance has focused investors too much on return. And, as REITs have taken a major hit in the last few months due to declining property values and the credit woes sparked by the sub prime crisis, many investors have learned an important lesson: all things in moderation. Investing in real estate and REITs involves special risks, such as potential illiquidity, and may not be suitable for all investors.

Do Your Homework

Although one of the fastest ways to build wealth is through real estate investing, there are a lot of misconceptions and pitfalls. There's more to success than the old adage "location, location, location." If there's advice that holds true in any market, it's to do the

research required, be patient in your efforts to identify a great deal, diversify by class and location, and stay attentive to the market. As with adding any asset class to your portfolio, you must first decide what you want to accomplish. What role do you expect your real estate holdings to play? Based on your other assets and your overall financial goals, investing in real estate might be a wise move, but only if it fits your investment strategy and you're willing to put in the time and effort necessary to do it right.

Al Woodward, a principal at Woodward Wealth Management Group, Greenwood Village, CO may be reached at abw@woodwardwealth.com.