Housing For New Life Styles

Risks And Rewards In Real Estate Investment

by Patricia Shannon

Gold, silver, equities, money-market deposits, bonds, fine art, antiques, precious gems, real estate: the accounting profession is forced to give serious consideration to an eclectic group of investments. Personal estate growth, or simply capital maintenance — the "staying even" concept — is more problematical, day by day. Accountant-client relationships are bettered when the accountant can knowledgeably discuss current market trends while leading up to ethical referral of the client to expert investment counsel, or in the case of real estate to a Realtor®. Alertness to changing conditions also awakens the accountant to opportunities for personal risks and rewards.

During the period of 1977-79, and even earlier, there was constant attention by the information media to the recession. Yes, it did finally occur in late 1979, but there was much growth in many investment areas, and especially in real estate, during the 1977-79 period. Of course scare tactics sell books, but do scare tactics make individuals so apprehensive that they avoid taking calculated risks that may furnish better returns on money? It should be remembered that calculated risk differs from person to person, according to nervous structure, age, and conditioning. Knowledge can make calculated risk manageable, not only for oneself but for one's client.

One of the ironic bits of information gleaned from stock investing in the late 1920s was that many people put their life savings into a "sure thing" without even knowing the product that their dollars would help produce, or how it would fit into the nation's economic picture. Today, even more extensive knowledge is needed as America's economic structure is increasingly affected by world-wide events. Regardless of what investment pattern is considered, action should be delayed until the base knowledge is perfected, and it often will be necessary, or at least consistent, to allot time for the continuation of knowledge. No longer can the acquisition of any profitable investment be tucked away in the back of the mind, once the purchase is made. When times change, investment patterns must also change.

It makes no difference whether investment is in the equity market, in diamonds, gold, fine arts, real estate, or some combination of these; the winnings will accrue to the knowledgeable. Along with keeping up-to-date in knowledge the investor must practice patience, and renounce greed. Patience concedes the golden opportunity lost and even though there may be a lump in the throat the mourner is consoled by the information gained in experience. Renunciation of greed affords release from sleepless nights that mark the plotting and panting after the highest possible profit.

Real estate has been one of the most talked about investments in the past few years. Everyone knows someone who has doubled or tripled money invested in a home or income property. Losses in real estate have been anomolous, atypical. What is of interest is whether the booming real estate market will continue. This article limits itself in scope to residential real estate, whether acquired for personal use or for the production of income.

Will residential real estate be a good investment in the decade of the eighties? What are the advantages, and the disadvantages?

Advantages

The good earth with the dwelling thereon represent a tangible investment, which economists advise holding in times of monetary instability. Ownership gives emotional satisfaction . . . doesn't everyone talk about "my home", or "my apartment house"? And certainly many, many more of those owners are female since the easing of credit restrictions for women. The potential for capital gains is there, and as long as income tax laws continue to favor real estate possession it makes an excellent tax shelter.

Disadvantages

Real property is a tangible asset, but unlike gold or fine art it demands constant maintenance and updating. Also, it does not have mobility nor does it have instant liquidity. It has a way of subtly tying itself into the heart strings of the owner so that there is too heavy an emotional entanglement when it comes time to sell. And, of course, the bubble in real estate values could burst. Further, there could be adverse changes in income tax laws concerning depreciation deductions and capital gains taxability. While tax changes seem unlikely they do depend on the political climate.

Advantages

When economists speak of the stability of real estate in times of an unsettled economy they are speaking in relatives, not in absolutes. A good piece of property may, indeed, shrink in value during economic

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crisis but rarely would it become valueless, as has happened to money more than once during troubled periods in the world's history.

Real estate purchases in the traditional mortgage pattern may be thought of as similar to the purchase of stock on margin. Neither transaction requires the full purchase price at its inception and, assuming that the price of the stock does not decline below its market value at acquisition date, the main difference in full payment for real estate versus margin stock is one of time. However, the recent recession and concurrent high interest rates have given lending institutions an incentive for a break in traditional mortgage patterns. There is more and more talk of roll-over interest rates, variable interest rates, longer mortgage life, and the sharing of resale profits with the lending organization. These changes, in themselves, do not necessarily paint an unfavorable picture for the investor.

Current literature of the doomsaying variety points out that real estate, like all established values, is vulnerable to sociological crisis. However, a perceptive suggested hedge is real estate investment away from hugh metropolitan sectors. Urban concentrations have great susceptibility to civil unrest and population shift, which result in the erosion of substantial tax bases and a ripple effect in the downgrading of real estate values. Admittedly, the metropolis has both cultural and business opportunities that residents may regret leaving but there is infinite potential for the good life in large towns, or the smaller cities.

To build on the thought above, the three most important words in real estate appraisal are location, location and location. Location, wherever it is, has to mean more than status. It must mean good schools, a good police department, good fire protection, and an adequate tax base to furnish those and other desired services in the future. The knowledgeable investor must chose a location that is close enough for frequent review, both as to the immediate environs and as to overall changes in the community. Even within large metropolitan areas there are suburbs that have all of the desirable service and tax base qualities. Paradoxically, the inner-city has been pooh-poohed by many but the same inner-city is considered by other well qualified investment analysts to contain the biggest potential for real estate profits, especially if energy costs continue to escalate.

In these days of so-called personality fragmentation, real estate does warm the heart and does identify the owner as a settled person. Conservative employers look positively at the home owner as having greater stability and less mobility. In fact, many corporations encourage employee home ownership and try to minimize owner distress at time of transfer to another community. Such corporations are clients of a fast growing industry, called "third party" relocation management firms. Typical of the new industry are Merrill Lynch Relocation Management, Inc., and Employee Transfer Corporation, both of whom will buy an employee's home at fair market value and then resell it.

There is abundant evidence of the heart warmed by the possession of real estate. In conversation one often hear's a person speak of *my home*, or *my apartment house*. Rarely does one hear an individual speak fondly of *my A.T.&T. stock*. Emotional attachment is a big factor in the continuing rise in real estate prices. And, as noted earlier, women who would never have considered ownership as short a time as five years ago are entering the market now, and becoming real estate owners either on a personal basis or an investors.

Tax Benefits

The rosy glow of home ownership should not for one minute distract the owner from the potential for capital gains. Income tax laws favor both home ownership, and/or ownership of rental income property, and the ultimate sale of such properties. Of course expenditures for property taxes and mortgage interest are deductible from the tax base, and for the home-owner tax laws offer exclusion from capital gains tax as long as another home, like or better, is purchased, and the additional forgiveness for over-55 owners of $100,000 capital gains on a one-time only basis. Income property owners enjoy liberal depreciation allowances on investment property and tax shelter inherent in income property is best realized with the utilization of some form of accelerated depreciation. The corollary to rapid write-off is then a prompt resale of the property. Most investors in income property are so imbued with the short-term concept that they buy with the assumption of resale in five years or less.

The new IRS installment sales law for real estate repeals the earlier 30% down payment ceiling, and is retroactive to January 1, 1980. The gain percentage continues to be applied to the down payment, even though that payment may be well in excess of 30%. If, for instance, the selling price of $100,000 represents recovery of a cost of 25% plus a gain of 75%, a down payment of $50,000 will be taxed as $37,500 gain, with the balance of $12,500 considered a non-taxable return of capital.

Disadvantages

The biggest problems with real estate are its illiquidity and immobility. If the need to sell is urgent, the timing may be bad, i.e., interest rates may be prohibitively high or mortgage money may be lacking. It may even be in those months of the year when property moves slowly. Money that is tied up in the equity of property cannot be used for any other purpose (although if enough equity has been built up the property can be financed, but this does involve additional expense in closing costs.)

Another disadvantage is related to maintenance and management, which can be a problem with a single family residence but will become a crucial trouble factor in income producing residential property unless some provision is made to solve it. It is feasible for the owner to maintain a modest apartment house but increasing the number of units will, at some point, necessitate the hiring of maintenance and managerial help. Even with owner management there must be some emotional containment of inconvenience of arranging for service and repairs. It is difficult for a potential investor to decide how big is too big for comfortable ownership of property.

The emotional aspect of real estate can be a major disadvantage. Property owners often refuse to recognize the social and/or economic factors that may contribute to the downpricing of their property, and continue to retain the property because it is home, or because it is an inherited apartment and "if this apartment house was good enough for Dad it is good enough for me."

Social changes mean changes in various kinds of desirability. For example, thirty years ago a corner lot was highly attractive. Today a corner lot is not as desirable because it lacks privacy and usually has a small back yard. The present day buyer is not interested in a one-bath home, and is dismayed if the house lacks a first floor family room. Changing traffic patterns or encroaching industry may have made an area very noisy. An apartment building may not have safety provisions that are adequate for today's conditions. An area that has traditionally been the residence of single families may gradually become a two-family residential area. Prices may deteriorate with the overbuilding of certain types of residential property such as condominums, a familiar sight of the 70s in many vacation areas. Deterioration of schools or the rise of crime in an area will diminish the value of residential property, even in the eyes of a long-time owner.

Disarming the Disadvantages

Some of the detrimental factors can be changed. Before remodeling is actually contracted, however, the owner should seek advice from a number of sources, including the advice of a Realtor. (A Realtor® is a person who is a member of the National Association of Realtors® and subscribes to this national association's Code of Ethics.) Too often an addition, such as a first floor family room, adds nothing to the sale value of a house because of its placement. In fact, it can often diminish the value of a home if it is placed too far from the kitchen, or if access to it requires passage through the living room. The addition of a second bathroom in each apartment of a multi-family dwelling is a negative investment in a neighborhood where the rents cannot be raised to accomodate this luxury. The poorly placed family room, and gratuitous extra bathrooms, or any similar addition constitute *value in use*, but mean absolutely nothing in real value and will put no money in the owner's pocket.

Doomsayers predict a break in the real estate bubble but history shows that real estate has generally risen in price over the years, and in recent years it has risen substantially. The danger of price erosion is greater for speculators because speculators, by definition, are greater risk takers. A prudent investor with consistent study of the market does not assume the same posture.

Before turning away from the scary thought of the bursting bubble it may be useful to compare the psychology of people who dream of making enormous wealth in real estate, and those who are content with a good return on their investment. There are many real estate seminars, and many more books that only appeal to greed; there are also many seminars and books on bona fide real estate transactions. It may further temper the craving for instant bounty if the buyer considers the proportionate share of investment held by the lending institution, probably a savings and loan association. Normally the title holder has contributed only 20-25% of the total purchase price. It is illogical to expect a sumptuous personal return on the investment of a second party.

While thinking of savings and loans institutions, a prospective investor might reflect on the inconsistency of parking extra money in money-market instruments, and then decrying the lack of mortgage money when the perfect property at an acceptable price does come into view. Money-market deposits do not usually supply mortgage money to the community. Savings and loan institutions do provide mortgage funds.

Mortgage money help has arrived recently from the Federal National Mortgage Association which has decided to help seller-financiers. When a seller elects to assume the mortgage at a bargain interest rate, to encourage the sale, it is hard to turn the investment into cash should the need arise, unless the seller is willing to take a large discount. Now Fannie Mae will buy the mortgage — but only if it complies with strict lending principles and is negotiated with a qualified savings institution who, presumably, made the early arrangements, and if the mortgage carries a normal 20-30 year payment plan with no balloon provisions. A mortgage broker or savings and loan association can best advise a prospective seller as to the complexities of the new program.

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Risk Taking

Real estate ties up a substantial amount of money and, like any investment, carries some risk. It is one thing, psychologically, to risk $2,000 in the equity market or in bonds and quite another to deposit ten times that amount on a piece of property, plus agreeing to pay for the balance on a mortgage plan. Women in particular have not been conditioned to accept risk as part of fortune-finding.

There are ways to make all things possible, and even to dilute the risk. "Creative financing" is a current buzzword, explored in its many angles in both popular and technical periodicals. "Co-purchasing" is a recent addition to real estate vernacular and means just that. Two couples or several individuals team up to jointly buy a condominium or urban townhouse or even a country manor that they could not otherwise afford. Any sensible person will engage legal service in drawing up an agreement as to duties, obligations and privileges, as well as disposition possibilities before investing with a

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group. A word to the wise: houses last longer than some marriages so a married co-purchaser should include a single exit provision, just in case.

One interesting risk maneuver originated by the savings institutions is known as the shared appreciation mortgage (SAM), and is designed to ease the high interest drain on home buyers, and at the same time give the lender a chance to share in the inflationary rewards on resale. It is outlined below for the affluent investor who may wish to utilize some of the monies presently on deposit and eroding in value:

1) Find a prospective buyer(s), impecunious but upwardly mobile and with an A-1 credit rating.
2) Extend a loan for the entire purchase price of a modest house in a good location, contingent upon the buyer's agreement to:
   a. resell in three years or less, and
   b. repay the loan in a pattern based on normal mortgage time horizons, at an agreed rate of interest that is *lower than the prevailing rate*, and
   c. Split the profits (losses) with the lender in a mutually agreed ratio, usually 50/50.

The reader will recognize this strategy as a real estate version of the convertible bond hedge against inflation: some interest is forfeited in expectation of a rising market and consequent conversion with a capital gain.

The Rest of the Decade

The problems of high inflation, high unemployment and dwindling energy supplies must be solved in the political arena. Other problem areas, more correctly identified as social phenomena, can present great opportunities for the real estate investor.

A Nation of Oldsters

It is evident that the population of the United States is becoming older, and not only older but far more healthy and vigorous than its ancestors. Many advertised products are promoted today not by some lissom miss, but by an older, fatter temptress. The message is to the older buyer, more often than not. Aspirin, for instance, was traditionally the remedy for headaches only; now T-V commercials regularly stress its arthritis relieving properties. Media marketeers know on which side their bread is buttered, and their recognition of major customer segments can be a productive hint for real estate investment.

What kind of housing is going to appeal to an older population? Will the elderly stay in the family home longer; will they be troubled with the continued maintenance on that home? If they are dissatisfied, what changes will they make? Can they be satisfied with a home smaller than the one to which they are accustomed? What compromises will they accept?

Will two spacious bedrooms compensate for four bedrooms of average size? Is the first floor family room expendable? During the 50s one-floor-plan houses were immensely popular although their popularity is waning today. Will they continue to appeal to older people who can no longer cope with a large two-floor home and must concede the inroads of time on knee joints and hearts? Will the elderly change their entire style of housing? Will carefree renting be a more satisfactory mode of life?

Can oldsters take to heart the message of recent books that advise spending one's own inheritance? For many, the thesis goes, their equity in their home is their savings and they should not feel guilty about spending the storehouse of a lifetime.

Proceeds from selling the homestead may be reinvested at interest then withdrawn in an annuity pattern of periodic payments, to supplement monthly social security benefits and any other assured income, such as a company pension. A quick actuarial application of life expectancy, in months, as a divider into lump sum proceeds will indicate the amount that may be safely withdrawn for one person, per month. If both members of a couple survive the divider must include both life expectancies, in months. Interest accrual on the declining balance over the years will delay exhaustion of the money reservoir, of course. Such a liquidation and withdrawal plan may not be highly popular with potential heirs to the estate but the process can change retirement from meager existence to gracious living.

So the older couple agree that home ownership is no longer for them. Where are they going to live? Will they want an apartment? Would a mobile home, with possibility of permanent installation in a tourist park, be more to their liking? Would they prefer some small communal dwelling where they, and a few congenial tenants, would each have a personal, private area but share meals and companionship in a common area? Or when only one member of a couple survives, or when age and infirmity have limited the capacities of both, will the housing solution be a senior citizen home that provides total care for the rest of life? What possibilities for real estate investment accompany this phenomenon of an aging nation!

The Young Point of View

The much discussed housing shortage stems, in part, from the post World War II baby boom. Cyclical birth rate patterns must be considered by any astute real estate investor, and in that connection one should bear in mind that 1990 is predicted as the beginning of a decidedly lower birth rate era.

Today's young adults are better educated, more highly motivated and more upwardly mobile than their parents. Most of them were reared in the tradition of home ownership. Young women today insist that they are whole persons and entitled to a full life, whether in family building or in a career, or both. Young people eat more meals out than their parents did. They segment their lives, expect to have more than one career and more than one type of housing over their life-span, and they are accustomed to instant gratification.

Given those well-known facts, the investor must estimate the probable housing pattern for young adults. Will they become house-poor, as their parents were at the same age, or will they refuse to yield on non-essentials such as extra meals out that might help pay the monthly mortgage installments? If they do acquire property will they fix it up so that it will bring a greater return on investment when it is resold? And what about young wives? Will their newly raised consciousness accommodate to the restrictions, and occasional nuisance, of home ownership maintenance?

According to statistics compiled by the National Association of Realtors®, in 1979 more than 200,000 homes nationally were bought by single women — women who were divorced, widowed or unmarried. The present trend toward home ownership by single men and women is a fast-growing phenomenon. Does that mean that they will drift away from rental property? Probably not, but if they do prefer to rent they also will expect luxurious extras such as swimming pools, tennis courts, nearness to transportation, and special provisions for safety and privacy.

Mature owners of personal homes will eventually be selling to the younger market, and will have to sell to them on their terms. If the home is outdated with out-of-fashion painting and papering, money must be spent to bring it into harmony with young decorating ideas. If the kitchen is the original one, owners who are a few years away from retirement can remodel and enjoy the results in the interim, knowing that the investment will be recouped at time of sale. Young buyers want air conditioning, so if a weary furnace must be replaced it is prudent to install air conditioning at the same time. For the next ten years there probably will not be enough good single family homes to meet the demand, unless building starts to increase.

What is the composition of the family of the 80s? Fifty years ago the home usually contained at least one grandparent, the mother and father, and all unmarried children. That is no longer the case. Grandparents still enjoy seeing their grandchildren and like to have enough room for them to stay overnight, but they neither want to live with their children nor babysit with their grandchildren on a regular basis. Parents, in too many cases, are divorced and maintaining two households. Smaller children are with one parent or the other, college age children are in their own apartments on the campus and even if they return home after graduation it will be for a limited time and only until financial independence is a reality. Even non-students in late teens are apt to share an apartment with a friend; meanwhile the youngsters of the household observe the exodus and yearn for their own freedom. From grandparents to toddler, there may well be five households where one used to suffice.

Bringing It All Together

Clearly, housing for the 80s offers a great array of investment opportunity. Appreciation of property is almost a foregone conclusion, yet immediate returns will vary according to the knowledgeability of the buyer. One can opt for rental service to the elderly and buy a trailer court close to transportation, or an almost-like-home boarding house, some units in a good senior service village complex, or a traditional apartment house. If catering to young adults seems more promising the choice must be made for a single family home, a condominium, an apartment near college, or an apartment house in a fashionable neighborhood, luxuriously equipped with extras. Risks and financing may be assumed alone, or shared with others.

The trend toward home ownership by single men and women is a fast-growing phenomenon.

Risk, as was pointed out in early paragraphs, is minimized by knowledge. A brief list of suggested reading supplements this article. When the lack of knowledge of a potential real estate investor yields to a reasonable gathering of information it is time to consult a Realtor®, and perhaps an attorney if buying and holding arrangements tend to complicate an investment program. A qualified Realtor® is recognizable by the designation GRI (Graduate, Realtor Institute), or CRS (Certified Real Estate Specialist). These people study real estate on a continuing basis and upgrade their talents regularly to match the sophistication of the 80s buyers and sellers. Ω

Patricia Shannon, B.B.A., *is a Realtor with Sibcy Cline, Inc. of Cincinnati. She is a graduate of the Realtor Institute, has done graduate study at the University of Cincinnati in realty appraisal, and has had marketing and sales promotion positions with Procter & Gamble, and Monsanto Co.*

Suggested additional reading

Weekend Real Estate Investor by Weston Hatfield, McGraw-Hill Book Co., 1978.

Crisis Investing: Opportunities and Profits in the Coming Great Depression by Douglas R. Casey, Stratford Press, 1980.

Inherit Your Own Money by Elmer Otte, David McKay Company, Inc. 1978.

How To Prosper During The Coming Bad Years by Howard J. Ruff, The New York Times Book Co., Inc., 1979.

Nothing Down: How To Buy Real Estate With Little Or No Money Down by Robert G. Allen, Simon & Schuster, 1980.

Houses: The Illustrated Guide to Construction, Design and Systems by Henry S. Harrison, Realtors (R) National Marketing Institute, 1973.