Why (and how) do Real Estate Investors Invest?

Willie Sutton

All too often, inexperienced real estate investors answer this question with some variation of: "Cuz' Uncle Dave said it was a good idea."

More experienced investors subscribe to Willie Sutton's[1] gospel: "Cuz' that's where the money is." When asked why they invest, these investors cite:

- Property Appreciation
- Rental Income (Let someone else pay for it)
- Tax Advantages
- Leverage
- Risk Limitation (Or Portfolio Diversification)
- Inflation Hedging
- Asset Control

The investors' answer recognizes the fundamental objective of real estate investment. **Think of this as your mantra:**

➢ Maximize your wealth without excessive risk to your principal

Before you explore the mathematical nuances of wealth maximization in the next several chapters, let's formalize what you, experienced investors, and maybe even Uncle Dave already know intuitively[i] and look at how it applies to commercial real estate investment.

Property Appreciation: **Appreciation** is an increase in the **Value** of a property.

You (and the person you negotiate with) will measure Value, and thus Appreciation, in different ways depending on why you need to measure it.

Market Value: Investors usually measure Value as "the quantity of one thing (money) that will (or must) be given in exchange for another (the building)." This **Market Value** or **Value-in-Exchange** approach assumes:

- there are buyers and sellers in the market,
- they are free to interact and pursue their own best interests, and
- they have the resources (capital) to do so.

Most often, you will use Market Value or Value-in-Exchange to Value and price investment property.

However, if you poll several investors they may disagree, sometimes by a wide margin, about the Value of a particular property.

[1] Willie Sutton (1901 – 1980), the original "Slick Willie," robbed banks and staged prison breaks throughout his life. The Vatican ignored our suggestion that he be canonized as "Patron Saint" of investors and bankers.

They may all be right!

When you negotiate, remember that you and the person you are negotiating with may use different Value concepts to arrive at radically different Values for the same property. Your opponent is not just being stubborn. Nor are they playing the fool.[2] Think about how the person you are negotiating with views "Value" and incorporate some (or all) of their definition and Value concept in your negotiating strategy.

You just might make a better deal!

Investment Value: The phrase "different strokes for different folks" captures Investment Value's essence. Investors' motivations and opportunities differ. So may their valuations of the same property. Formally, **Investment Value** is "the estimated Value of a certain real estate investment to a particular individual or institutional investor."

In the classic illustration, consider the Value of vacant land in the path of future (but not immediate) growth to:

- Its current owner widow Jones, who needs cash flow for living costs;
- a pension fund manager with development funds, who must balance speculative opportunity against fiduciary duty, and;
- a young, aggressive speculator who uses their own funds and can allow time for the investment to mature.

Each of these investors Values the property differently. All of them are correct, within their constraints:

- Widow Jones is just trying to get by. A quick sale at a reduced price will help her do so. She considers her legacy to her children and grandchildren important, but she must look to her own survival first. Her greatest risk is delay. By fostering a quick sale, a low price (Value) accomplishes Ms. Jones' investment goal – liquidity.

- Wise pension fund managers assess risk from the "reasonable person" perspective. Informally, the reasonable person standard translates as: "Will I lose the lawsuit if this investment goes badly?" Pension fund managers must also maintain fund liquidity to pay current and anticipated future obligations to pensioners. For fund managers, the answers to: "How much Appreciation?" "How much Value?" are tempered by the answers to: How soon? How certain? and Can I get my hands on it? Our fund manager will steer a middle course – and Value (price) the transaction accordingly.

- Young investors not only have time to let their investments mature, they have time recover if the investment goes bad. Consequently, young investors tolerate more portfolio risk than older investors or investors who must adopt their risk tolerance to the expectations of their constituency. Put another way: Young, aggressive speculators assess a lower "risk penalty" when they Value the property. Theirs is likely to be the highest reasonable offer.

[2] Irish author George Bernard Shaw (1856-1950) once gave the following example of irregular declension – "I am highly principled. You are just being stubborn. He is a pig headed fool."

You probably noticed that each of our investors assesses risk in different ways, and imposes a "risk penalty" on their ask-offer price to reflect that assessment. This suggests that asking yourself four questions will improve your bargaining skills:

- Who am I negotiating with?
- What risks do they face (and acknowledge)?
- How do they assess those risks?
- How does their assessment affect their valuation of the property?

Investment Value is often subjective. Use that fact to make the best deal you can. Rest assured the person you are negotiating with[3] will be looking at you the same way!

Value in Use: Property owners are not always "investors" in the strictest sense of the term. Often, property owners are more "owner-users" than investors:

- The real estate broker, accountant or law firm buys the office building in which they occupy two of the eight floors. They lease the unused space to other tenants on short or mid-term leases. This guarantees that space will come available in the building periodically and allows the firm to expand (or contract) its own occupancy as necessary.

- The apartment building's owner lives in one of the units. This assures that there are always "boots on the ground" in the event of an emergency, provides 24/7 monitoring, and reduces operating costs {on-site manager fees, property management fees, bookkeeping, gardening, routine maintenance, and (if the owner has the requisite skills) scheduled and emergency maintenance}.

- The small retailer buys the strip mall in which their store is located. They lease the remaining spaces to other, non-competing retailers, thus increasing foot traffic for their own business and controlling space usage.

- The manufacturer builds and operates a factory *cum* research center. Many of the buildings are custom designed and fitted to the manufacturer's product, storage, and research requirements. (This, by the way, is one of the toughest properties for investors to buy or sell. Often, the cost of a good bulldozer, wrecking ball, and large quantities of high explosives must be factored into your ask-offer price.)

If selling the property reduces the owner-user's ability to pursue their livelihood, then the owner-user will demand compensation for both the Value-in-Exchange of the property <u>and</u> the loss of livelihood before they will sell.

[3] We use the sometimes awkward phrase "the person you are negotiating with" in preference to the more direct "your opponent" to emphasize the Win-Win negotiating posture we advocate and contrast it with its more adversarial cousin, the Zero-Sum approach. If you are a devotee of Zero-Sum (scorched earth?) negotiation, feel free to substitute "your opponent," "the enemy," or "that jerk across the table" for our more genteel conceit.

Reversing and rephrasing the observation, you, the investor-buyer, will have to compensate the owner-user for the property's **Value-in-Use**: "the amount of property (money) the owner-user would be willing (or able) to accept in exchange for the property without loss of wealth or well being."

Value-in-Use issues can both hinder or assist your negotiation. Often, hindrance is opportunity in disguise. Consider this (altered to prevent identification) real-life case study:

CASE STUDY

Value-in-Use Case Study: A 45 employee, closely held, video editing and computer graphics firm occupied two floors (about 30,000 square feet) of an eight story office tower. They owned the building (120,000 square feet), its parking structure (200,000 square feet, parking for roughly 600 vehicles), and an adjacent 21,000 square foot lot zoned for commercial-office use and permitted for a "twin tower" identical to the existing structure. The firm leased the unused space in the existing structure to other tenants.

Video post-production is a very risky and expensive proposition.

- Top flight editors and graphic artists earn upwards of $300,000 per year.

- Technology is expensive and obsolesces overnight – last week's "can't miss" black-box becomes this week's boat anchor. Leading edge companies typically have enough "can't use" equipment in their machine room to ballast an armada in a hurricane. The heavy debt load and debt service for these unusable *objets de arte* remains on their balance sheet and impairs their cash flow.

- Clients are not loyal – flowing toward the "flavor-of-the-month" facility. (They are also not very rigorous about paying their bills when they leave, leading to the industry maxim: "There are three ways clients pay their bill; Slow Pay, Low Pay, and No Pay.")

The editorial firm purchased the property during one of the several periods when they were the "hot studio." They intended to build the twin tower and use the cash flow from rents to stabilize their post-production cash flow during times they were not the "in-place" to edit. The project never happened. Burdened by large amounts of debt, much of it secured by obsolete "assets," they could never generate enough capital to pursue the expansion.

By now, you are probably asking yourself (just as we did): "So, what's the problem? Close or move the editing business, sell the building, take the money and live happily ever after as a Hollywood success story." As Paul Harvey[4] was inclined to say: "Here is the rest of the story."

[4] Paul Harvey Aurandt (1918 - 2009) broadcast his syndicated radio show "The Rest of the Story" beginning in 1946 (First as a segment on ABC news, since 1976, as a stand-alone syndication). His audience was estimated to be 22 million listeners. The show featured Harvey's folksy, idiosyncratic delivery and centers on stories with a quirky or surprising twist (e.g. Al Capone, ardent anti-communist). Conservative to their core, Harvey's monologues none-the-less prompted an occasional smile and a "Say, What?" from even hard-core liberals.

CASE STUDY / CASE STUDY

Each of the three principals in the business drew salaries and benefits totaling about one million dollars a year. None of them was willing to close the business unless they were compensated for the loss of income.

Moving the business was, likewise, a daunting proposition. The principals estimated there were about 160 miles of cable and infrastructure buried in the walls of the building. Estimated cost to re-engineer and reconnect it, not counting loss of business revenue, about - $1,500,000.

The firm's equipment debt was under-secured. Liquidating 100% of the equipment would yield at most 60% of the balance of the equipment secured loans. The potential shortfall – about $6,000,000. Under-secured "off-balance sheet" items added another $2,000,000.

Like the guy who bangs his head against the wall "'cuz it feels so good when I stop," the principals couldn't afford to quit but probably couldn't continue without outside help.

In total, Value-in-Use issues would have added about fifteen to twenty million dollars to an already tenuous 45 million dollar deal structure – an impossible burden to overcome.

Early in the course of our due diligence we found that the building was actually owned by a Limited Liability Company (LLC). The LLC was, in turn, owned by the editorial company's principals in roughly equal shares (though they were unaware of it and treated the building as if it were part of their core business). This suggested a new deal structure that side stepped the Value-in-use issues, made better use of our client's (the buyer's) resources, <u>and</u> provided both our buyer and the editorial firm's principals with a superior outcome:

- After negotiations with the lien-holder, the building, and our buyer's cash equity contribution funded a newly formed LLC. Interests in the new LLC were divided: 49% equally among the editorial company's principals (giving each of them a 16-17% interest), 49% to our client, and 2% to us (our commission for brokering the deal). This structure minimized the taint of some of the former owners' earlier procedural gaffes. Recapitalizing the existing LLC would have retained its operating history – gaffes and all – subjecting our client (and us) to potential liabilities we had no hand in creating. (Tax motives also influenced the transaction structure, but that story will have to wait for another day).

- Instead of using our client's cash as a down payment to purchase the property, most of it funded construction of the new office tower. This, and the previous owners' equity contribution, reduced the debt burden for the project – making it considerably more viable.

- The new LLC signed a lease with the editorial company. The firm became the new LLC's tenant. This removed the editorial firm, and its Value-in-Use issues from the equation.[5]

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[5] This part of the story does not have a happy ending. Burdened by its equipment debts, unable to update its technology, and unable to liquidate assets, the editorial company eventually failed and was acquired by a much larger firm with much deeper pockets and a more diversified business plan. The three former principals now work for the new owners, for substantially reduced salaries and perqs.

The case study could serve equally well as an ode to due diligence, an homage to the value of partners, or an illustration of Value-in-Use. The Value-in-Use concept and its potential effect on your deal suggest more arrows for your negotiation quiver. When you negotiate with an owner-user:

- What role does the property play in the owner-user's business?

- Is the property truly integral to the business (e.g. custom built factory or a medical building), or can the use and occupancy be separated without harm to the business?

- If the use is integral:

    - Can the owner-user's business continue to operate as a tenant in its current location if building ownership changes?
    - How much will it cost to terminate or move the business?
    - Is it worth it to try?

- If the use is not integral, is there a way to leverage the owner user's equity and your purchase resources to achieve a better result for both of you?

Economic Value and Highest and Best Use: Economists and (to some extent) appraisers Value property according to its **Economic Value**: "the worth of all the rights arising from ownership."

As we all found in economics class, economists' definitions, particularly those as abstract as Economic Value, are often hard to put into practice. Real estate appraisers' **Highest-and-Best-Use** approach provides a much more practical and usable benchmark that closely resembles economists' rights-based construct. Highest and Best Use can give you a negotiating advantage too. Visualize an ideal world:

- In that world, what can be done with the property other than what is currently being done with it?

    - Consider the property as-built.
    - Imagine it vacant.
    - Imagine it with newly constructed structures in place.

Dream a lot! Come up with as many scenarios as you can. Give no thought to how practical they are. That part comes after you have some ideas.

Dream big! Too often, investors lose a potentially lucrative deal because they see only the office building that exists on the property and not the mixed use, live-work, office, theatre and retail complex it could become. Don't let that happen to you!

Having visualized a number of scenarios, come back to the real world:

- In the real world, is each scenario legal, financially feasible, and physically possible?[6]

  - Consider the implications of entitlements and zoning.
  - Estimate how much it will cost to change entitlements and zoning.
  - Ask your bankers if the proposal will aggravate their ulcers.
  - Review the proposal with architects and engineers.
  - Et Cetera, Et Cetera, Et Cetera

- Reject any scenario that isn't legally, financially, and physically possible (all three).

- Using the techniques we develop later, develop financial and risk projections for the scenarios that remain.

- Choose the scenario that produces the greatest risk adjusted net return to the land and buildings over your investment horizon.

Economic Value – Highest and Best Use analysis requires a great deal of imagination and innovation, reams of computation, and often a bit of guesswork. However, it speaks to the core of your real estate investment mantra:

- Maximize your wealth without excessive risk to your principal.

Only by considering "what might be" can you hope to know if "what is" is the best you can do.

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Rental Income: In its most basic form, **Rent** is a charge for the use or occupancy of space.

Economically speaking:

- the owner of the space transfers a right (occupancy)
- to the renter
- for a defined period
- in return for a payment in cash or its equivalent.

[6] Legal challenges often have financial consequences. If the legal situation can be changed by employing an attorney to represent your case, the scenario is still feasible. However, don't forget to include the legal costs in your financial analysis.

Financial feasibility is usually the most difficult of the three criteria to assess. Remember (at least at this stage), "expensive" doesn't equate to "infeasible."

Similarly, learn to distinguish between "limitations of materials science" and "laws of physics." Buildings designed by Eames, Lautner, Neutra, Schiffren, and the Wrights are replete with examples of innovative materials used in innovative ways to overcome the limits of materials science. But, neither you nor your project is exempt from the laws of physics.

Market and Contract Rent: As with Value and Appreciation, you will have to keep more than one Rent concept in mind. Fortunately, the major variants are easy to remember:

- **Contract Rent** is the amount of rent that is specified in the rental agreement between the owner and the renter(s).

- **Market Rent** is the amount of rent that a comparable property would command if offered in a competitive market.

For properties subject to long term contracts, Market Rent often exceeds Contract Rent. Cynical investors sometimes characterize the two Rent variants as:

- Contract Rent is the rent I'm getting, and

- Market Rent is the rent I should be getting.

The cynics ignore the advantage of long-term steady occupancy by stable tenants to dwell on the "might'a beens." Their characterization has more poignancy when applied to rent-controlled properties. There are fewer landlord remedies under rent-control than under long-term contracts.

The two Rent concepts play pivotal roles in both investment management and purchase/sale analysis. Here are two examples:

Investment Management Application: If Market Rent exceeds Contract Rent by a wide margin on a property you already own, be alert for other signs of inadequate fiscal management.

Abnormally high occupancy rates (low vacancy) often go hand-in-hand with below-market rents. Ironically, Property Managers often tout a full rent roll as evidence they are doing a good job. Be deeply suspicious of any rent regime that your tenants like too much!

Purchase/Sale Analysis Application: When reviewing a property you wish to purchase, low vacancy rates (high occupancy rates or Market Rents that exceed Contract Rents) may signal opportunity: a bargain purchase.

For reasons that will be apparent when we discuss property prices, many owners and quite a few brokers believe that contract rents (not market rents) determine Market Value. If you negotiate based on below-market rental income then raise that income to market levels after purchasing the property, you win!

Be alert for opportunities to re-purpose or upgrade high occupancy properties. Often relatively small capital outlays make substantial rent increases more palatable for existing tenants. The current owner may be unaware of such opportunities, unable to finance them, or unwilling to undertake the work and expense necessary to realize them.

As with many pat generalizations, there is a catch or two:

- Your ability to compare Market Rent to Contract Rent presupposes that you know what Market Rent is in the area around your property.

- Your ability to compare your Property's Vacancy Rate to other properties in the area, similarly, presupposes that you know what the Vacancy Rate for other properties in the area is.

You will learn how to use market research, surveys, and public information to determine Market Rents in a later chapter. For now, some hints:

- A good librarian can steer you to publicly available market information (it usually isn't as current as you might like, but it is free).

- There is a wealth of information available from private/subscriber database services (it's current, reliable, and expensive). There is also market analysis software to help you digest it. Your agent/broker may have access to the data as part of their association dues.

- If you are up for a bit of do-it-yourself subterfuge, use the telephone, a phone book, and a good story to get the information you need from your competitors (accurate, current, a little time consuming, but a whole lot of fun)!

In the United States, contract rents are usually negotiated between the owner of the property (or their agent) and the renter (or their agent). All long-term or high-Value agreements are "memorialized" in a written contract signed by both parties.[7] As a bare minimum, almost all rental agreements:

- Identify the parties to the agreement,
- Identify and uniquely characterize the property that is subject to the agreement (e.g. location, size, important characteristics),
- Specify the period during which the renter may occupy the property,
- Specify the amount of rent due, and the schedule of payments,
- Specify who is responsible for operating costs in connection with the property, and how those costs will be shared,
- Limit what the renter may do on the property,
- Limit the owner's right to enter or alter the property, and
- Provide remedies in the event either party breaches the agreement

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[7] "Statutes of Frauds" applied in most U.S. jurisdictions require that contracts be in written form and signed by the parties if they either a) cannot be carried out within one year, or b) purport to transfer an interest in real property. Verbal agreements about these subjects are not enforceable. Leases clearly fall in the latter category. Long-term leases satisfy both criteria. The term "Statute of Frauds" comes from an English law passed in 1677 – more properly called the Statute of Frauds and Perjuries. That law, and the civil or common law provisions used in most states identify seven categories of contract that must be written in order to be enforceable.

We present examples of lease clauses throughout this work. <u>Do not rely on our contractual language</u>. Study and use some of the available "forms" <u>and</u> talk to an attorney to develop your own contracts.

Variations, nuances, and formality levels within this basic structure are almost unlimited! In theory, every provision of any rental agreement is negotiable – so every agreement can be different. Rental contracts may be as short as a page or two and as long as several hundred pages! The only certainty is that you, the investor (or someone you delegate), must know what is in those contracts!

In later sections, you will learn how to analyze and evaluate complex rental agreements. For the rest of the Toolbox section, you will use a simple "Annuity-Due" structure to gain facility with investment concepts, simplify computations, and minimize confusion. The Annuity-Due agreement calls for:

- Equal rent payments,
- Payable on the first day of each equal time interval
- For an indefinite period.
- Example: $500 payable the first day of each month, or
- Example: $7,000 payable the first day of each year

The Annuity Due structure is the archetype for residential rental agreements, and is often used for commercial contracts as well.

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<u>Brief Digression, Investment Decision Models</u>: For capitalist and mixed-capitalist economies (such as the United States), useful investment decision models must reflect at least two characteristics of the investment's cash flow:

- How much?

- How soon?

Two fundamental economic assumptions lie at the core of this generalization:

- In capitalist economies, private individuals (or their non-governmental proxies) own an endowment of production factors (Land, Labor, Entrepreneurship, and Capital), and

- Owners insist on fair compensation for the use of their factor endowment.

Regardless of how we view the basic merits of capitalism, or how efficiently capitalism determines "fair compensation," how fair we think the initial factor allocation is, or how closely we believe the U.S. system resembles "true capitalism," one feature of the U.S. system is indisputable: Factor owners can, and do, demand and receive compensation for their factor endowments.

- Landlords demand and receive rent,
- Laborers demand and receive wages,
- Entrepreneurs demand and receive profits from the operation of their business (or go out of business for lack of them), and

- LENDERS AND CAPITAL PROVIDERS (INVESTORS) DEMAND AND RECEIVE INTEREST FROM BORROWERS.

An elaborate network of financial markets, intermediaries, banks, private lenders, and venture capitalists has evolved to facilitate capital movement, capital pricing (yield rates), and allocation. Without exception, the pricing mechanism in these markets can be conceptualized as a bank loan. The dollar cost of capital is determined by

- the amount of capital,
- the interest rate, and
- the duration (term) of the loan.

For a given amount of capital and a specific interest rate, the longer the duration of the loan, the higher the dollar cost of the capital. It follows that in our economy,

- you will always pay more than one future dollar to borrow a dollar today, or conversely,

- a dollar today is worth more than a dollar tomorrow.

This last conclusion brings us back to our original premise: any useful investment decision model must reflect at least two characteristics of the investment's cash flow:

- How much?

- How soon?

Each of the models you will explore in this book requires that you estimate not only how much income you will receive, but when you will receive it. In the most sophisticated applications, you will analyze how the income stream changes each period and incorporate that behavior as well. Finally, you will usually specify or determine a "discount rate" (conceptually similar to an interest rate) that answers the question: "Just how much more is a bird in the hand worth than is that bird in the bush?" This latter determination is often art rather than science. You will develop your brush strokes along the way.

In the course of your analysis, expect to generate a tremendous, possibly overwhelming, amount of data. Don't let the mass of data intimidate you! The "dirty-little-secret-truth" behind much financial and investment analysis is:

- Most of the data is, at best, only indirectly relevant to your decision.

The models are constructed to answer the two basic questions: How much? How soon?

Only you can answer the real questions:

- Is that enough?

- It that soon enough?

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Tax Advantages: U.S. real estate investments enjoy almost legendary status among tax advantaged investment vehicles. Some of that reputation is deserved! Relative to earned income (wages, salaries, pensions) real estate investments enjoy several income tax advantages:

- ***Tax on your Property's Appreciation is deferred***; your property's Appreciation is taxed only when the property is sold, not as it appreciates. If you exchange property, rather than sell it, gain recognition (the formal name for "reporting the Appreciation of your property") and tax on your Appreciation may be postponed almost indefinitely (provided you adhere to a strict set of guidelines). As you will also learn later, your Appreciation is also liquidated without gain recognition when you refinance the property. Deferred taxation of property Appreciation allows real estate investors to have their cake, eat it too, and do it all without immediate tax consequences. (Rental income does not enjoy this protection. Rental income is taxed as it is earned.)

- ***Property Appreciation is taxed at preferential tax rates***; if you sell your property your gain (the formal name for Appreciation) is recognized and taxed. The tax rate that applies to the gain is lower than the tax rate that applies to your earned income. This is the notorious "Capital Gain Tax," beloved and hated, often in turn, by the same people.

- ***Depreciation Deductions offset Rental Income***; Tax rules permit you to offset a portion of the property's purchase price against the rental income the property generates each year. This offset, the Depreciation or Cost Recovery deduction, reduces taxable income from the property and may result in a tax loss in spite of positive cash flow. You can (must) take this deduction even though the property is Appreciating!

Congress institutes these tax advantages in recognition of the key role real estate plays in the economy. Economists estimated that in 2006 approximately $22.6 trillion or 41% of the country's total household wealth was invested in real estate. Non-financial corporate businesses held another $7.6 trillion (53% of non-financial corporations' net worth) of real estate. Annually, real estate related activity accounts for roughly 10% of U.S. Gross Domestic Product.

Tax policy sometimes skews investment decisions, distorts resource allocation and results in over (or under) investment in some sectors of the economy. Clever tax attorneys, accountants and citizens devise unforeseen reasons to apply any tax advantage to their own situation {they "discover (or abuse) loopholes"}. Recognizing this, Congress[8] limits the tax benefits you can derive from real estate ownership and the opportunities to abuse them. The limits on Congress' largess include:

- ***Passive Loss Limitation***; with limited exceptions, if you do not actively manage your property, your rental property losses cannot be used to offset other income. In the parlance, your passive losses are deferred until either you dispose of the property or, the investment generates passive income. "Active management" means you devote a significant amount of time to real estate activities and make most of the major decisions about how your property is run.

- ***At Risk Limitation***; if you are shielded from loss through stop-loss agreements, loss insurance, indemnification, or non-recourse financing, your rental real estate losses cannot be used to offset other income. Losses for which you are not "at risk" are deferred until you are, once again, "at risk." (Real estate enjoys some relief from the most common at-risk limitation – an exception to the exception, if you will. You will learn the details of that rule in a later section)

- ***Alternative Minimum Tax***; this "flat-tax" kicks in if you claim too many "preferences" relative to your gross income. Preferences include accelerated depreciation, percentage depletion, incentive stock options, itemized mortgage interest, itemized property tax, and a plethora of other common deductions. The Alternative Minimum Tax[9] "takes back" some of these preferences by recalculating taxable income and applying a special "flat-tax-rate" to the recomputed income.

- ***Depreciation Recapture***; when you sell your property, the "taxable gain" you report for tax purposes consists of two parts. Capital gain represents the increased Value of the property since purchase and is taxed at a preferential rate. The second part of the taxable gain, Depreciation Recapture, is attributable to the depreciation you claimed on the property while you held it. This portion of the taxable gain is taxed at a higher rate than is the Capital Gain. You will study the mechanics of this process more thoroughly in a later section.

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[8] The US Congress makes tax law. The Internal Revenue Service (IRS or The Service), a division of the Department of Treasury, interprets Congress' intent and enforces tax law. If the Service's interpretation of Congress' intent deviates too far from the public's interpretation of Congress' intent, the Courts may eventually be required to rule on specific provisions of the law. Since the passage of the Sixteenth amendment (1913) the Courts have been unreceptive to arguments that challenge the validity or constitutionality of the income tax as a whole.

[9] There has been a great deal of debate, and little Congressional action, to repeal or modify the individual Alternative Minimum Tax (AMT). The AMT was originally conceived as a way to prevent (mostly high income) taxpayers from abusing the Internal Revenue Code's more liberal provisions. Because the AMT is not indexed to inflation it has gradually ensnared more-and-more lower and middle income taxpayers. A 2006, IRS National Taxpayer Advocate's report highlighted the AMT as the single most serious problem with the tax code, noting that the AMT punishes taxpayers for having children or living in a high-tax state. Because it is complex, many taxpayers who are subject to AMT do not include it in their planning. Often, they don't "appreciate" AMT's influence until they prepare their returns or are notified by the IRS. The Advocate's report notes that, in its current incarnation, the AMT will affect roughly 25% of individual tax returns by 2010.

Income Tax Rates: The Federal government, the States, and even some local jurisdictions (New York City, several Pennsylvania and Ohio cities for example) impose income tax on your taxable income. The cumulative effect of income tax significantly reduces your investments' cash flow. Where you live, and where the property is located, affect how much income tax you pay. Federal income tax rates are uniform throughout the country (Similarly situated taxpayers have the same marginal Federal income tax rate). State income tax rates differ from one state to the next, leading to rate disparities between states. The disparity widens if your property, or you, are in a City that imposes income tax. Here are some examples:

Some Comparative Income Tax Rates

Jurisdiction	Federal Rate	State Rate	Local Rate	Combined Rate[10]
High Income Tax Bracket				
Los Angeles, California	35.00 %	9.30 %	0.00 %	41.05 %
New York City, New York	35.00 %	6.85 %	3.65 %	41.82 %
New York State, Other Cities	35.00 %	6.85 %	0.00 %	39.45 %
Las Vegas, Nevada	35.00 %	0.00 %	0.00 %	35.00 %
Middle-ish Income Tax Bracket				
Los Angeles, California	28.00 %	8.00 %	0.00 %	33.76 %
New York City, New York	28.00 %	5.90 %	3.59 %	34.83 %
New York State, Other Cities	28.00 %	5.90 %	0.00 %	32.25 %
Las Vegas, Nevada	28.00 %	0.00 %	0.00 %	28.00 %
Low Income Tax Bracket				
Los Angeles, California	10.00 %	1.00 %	0.00 %	10.90 %
New York City, New York	10.00 %	4.00 %	2.91 %	16.21 %
New York State, Other Cities	10.00 %	4.00 %	0.00 %	13.60 %
Las Vegas, Nevada	10.00 %	0.00 %	0.00 %	10.00 %

Income Tax Obsession: Because taxes absorb a large chunk of cash flow, Income Tax Obsession is an occupational hazard for real estate investors. Income Tax Obsession comes in two flavors:

- The transactional form or "tax driven investment:" tax considerations are the sole or overwhelming factor that drives the investor. The economic returns from the investment, if they are considered at all, are secondary to the tax shelter that the investment promoter promises.

- The portfolio form or "investment myopia:" The investor over-invests in real estate to achieve tax advantages, at the expense of portfolio balance and (possibly) after-tax portfolio yield. The investor disregards real estate's risk factors, resulting in a portfolio that wins the "investors' bad-news tri-fecta:" it underperforms, it is volatile and it is vulnerable.

[10] You will learn to compute combined tax rates in a later chapter. Because state and local taxes are "deductible" for federal tax purposes, simply adding together the marginal rates overestimates the combined rate.

In its mildest form, Income Tax Obsession is characterized by statements like; "Go ahead, spend the money. After all, it's tax deductible." (Translation: "Spend a dollar, save forty cents.")

In more virulent cases, Income Tax Obsession makes otherwise rational investors look favorably on any investment vehicle whose structure is complicated enough to obscure the vacuity of its tax rationale. Historical examples have included "minimum annual royalty" and other contrived devices designed to side-step the at-risk or passive investment rules. Three of the four major accounting firms were recently called on the carpet (to the tune of $50 million dollars in penalties) for selling transparently invalid tax shelters. The firms did not lack for buyers – over sixty thousand investors, including several of the richest Americans, "invested" over five billion dollars in the schemes.

So, what's our point?

- The primary consideration in real estate investment is: "Can I make a buck?"
- Once you have determined that the investment is economically sound, consider whether a more sophisticated tax structure improves the result.

If you keep these priorities in mind, your real estate investment life will be much more predictable: When you make or save a dollar, you keep sixty cents, the feds keep forty cents, and everybody but your tax attorney goes home happy!

You learn to avoid some of the most common tax-economic mistakes in a later section.

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<u>Leverage</u>: If you use borrowed money to increase your purchasing power or increase the profitability of your real estate investment, you are employing **Leverage**. Properly used, Leverage is one of the most powerful investment tools in your real estate investment arsenal. It is also one of the most frequently misunderstood and misapplied concepts in real estate investment!

Real estate brokers, those eternal optimists,[11] almost invariably provide leverage examples that resemble this one (adapted from a Realtor's website).

> Assume you have $100,000 to invest in an income property. Assume you have done your market analysis (not part of the Realtor's pitch) and you expect your income property to appreciate an average of 7% per year. At the end of the first year, your property is worth $107,000. A $7,000 increase.
>
> Now assume that you put your $100,000 down on a $500,000 income property. At the end of the first year, the property is worth $535,000. By using leverage or borrowed money to purchase a larger income property, you increased your profit by $28,000 in one year! A 500% increase!

[11] Realtors are notorious for "putting on their happy face" and finding "opportunity" in adversity. One tale tells of a property tucked between a smelter, a fish processor, a garbage dump, and an oil refinery. The Realtor's listing emphasized the obvious advantage: "You'll always know which way the wind is blowing!"

Who wouldn't subscribe to this Realtor's vision of leverage!

There are just a few little problems! The most obvious is that our Realtor didn't mention that borrowed money costs money. Let's change the example to correct this obvious oversight:

> Assume that you put your $100,000 down on a $500,000 income property and borrow the balance at 7%, paying interest only. The financing will cost $28,000 per year. At the end of the first year, the building is worth $535,000. After paying your lender, you net $7,000 – the same as if you hadn't leveraged!

The second obvious objection is that the Realtor's market prognosis may be too optimistic or you may have to pay more to borrow money. Let's assume the property appreciates only 6%.

> At the end of the first year, the un-leveraged property is worth $106,000. (You net $6,000)
>
> At the end of the first year, the leveraged building is worth $530,000. After paying your lender $28,000, you net $2,000 – $4,000 less than if you hadn't leveraged!

Finally, take a look at what happens if the leveraged property loses Value (a prospect no self respecting Realtor would ever admit, but – humor me anyway)[12]: Assume market Value falls 5%.

> At the end of the first year, the un-leveraged property is worth $95,000. (You lost $5,000)
>
> The leveraged building is worth $475,000. After paying your lender $28,000 you lost $53,000 - $48,000 more than if you hadn't leveraged and a whopping 53% of your equity in the property. Obviously, "leverage" works really well in both directions!

When you consider leverage, keep Shakespeare's admonition in mind: "There is nothing either good or bad, but thinking makes it so" (*Hamlet*, Act II, Scene ii).

Borrowing money does not automatically improve your investment return!

Borrowed money is beneficial only if it meets certain conditions. For now, remember this proposition (we will prove it later):

- Leverage is beneficial only if the property's projected Appreciation rate exceeds the loan constant (loan payment divided by loan balance) for the money you borrow.

Using our optimistic Realtor's scenario and adjusting for that reality:

> Assume you have $100,000 to invest in an income property. Assume you have done your market analysis and you expect income property to appreciate an average of 7% per year. At the end of the first year, your property is worth $107,000. A $7,000 increase.

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[12] The first edition of our manual was written between 2006 and 2008 – just before the more-or-less complete collapse of the market made everyone, including many former realtors, painfully aware that markets and leverage could work both for or against you.

> Now, assume that you put your $100,000 down on a $500,000 income property and borrow the balance at 6%, paying interest only.[13] The financing will cost $24,000 per year. At the end of the first year, the building is worth $535,000. After paying your lender, you net $11,000. By using leverage or borrowed money to purchase a larger income property, you have increased your profit by $4,000 in just one year!

Our more realistic scenario is not as "impressive' as the Realtor's. However, vast fortunes have been accumulated based on this model. You can learn to do it too!

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Risk Limitation and Portfolio Diversification: Diversification's central mantra is, "Don't put all your eggs in one basket." **Diversification** involves:

- spreading investments among broad asset classes: e.g. real estate, stocks, mutual funds, bonds, and cash.

- spreading assets between subclasses of the broad asset classes: e.g. geographic diversification in your real estate portfolio or index funds, small cap, large cap, growth funds, balanced funds, and sector funds in your mutual fund portfolio.

The majority of successful long term investors and a preponderance of investment advisors subscribe to "Investopedia's" observation that "diversification is the most important component to helping you reach your long-range financial goals while minimizing your risk."[14]

Diversification works best when the portfolio's asset volatilities are "uncorrelated:" i.e. changes in asset A's price are not systematically related to changes in asset B's price. Intuitively, this implies that the volatility of asset A will counter the volatility of asset B – resulting in a more stable portfolio. Empirically, portfolio diversification has been shown to improve the portfolio's long term yield.[ii] Thus:

- Portfolio diversification is the rarest of beasts, a financial free lunch: Lower risk - higher yield.

Real estate, especially the personal residence, has long been the center of U.S. family's financial planning: perennially accounting for 35-40% of families' net worth. For many families the personal residence is the only investment in their portfolio. Commercial real estate is a very small fraction of family holdings. Thus, for most households diversifying their real property holdings means acquiring their first commercial office space, rental property or multi-unit housing complex.

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[13] For interest only loans, the interest rate and the loan constant are equal. For amortizing loans, the loan constant exceeds the interest rate.

[14] investopedia.com/university/risk/risk4.asp The vast majority of personal net worth is accumulated using portfolio diversification strategies that recognize risk/reward tradeoffs. Ironically mega-fortunes (Gates, Getty, Walton, or Buffet) are seldom based on balanced portfolios (Peter Lynch is the only exception we could think of). "Putting all your eggs in one basket" is rewarding, but the risks are manifest. Maybe that is why there are only 400 names on the Forbes list?

New real estate investors often view real estate as a “stable and safe investment.” This attitude is memorialized in statements like, “Well, they just aren’t making any more land,” and “Nobody ever lost money by buying land.” These attitudes are not supported by the facts!

- Real estate investments have their own unique risks!

To use real estate effectively in a wealth development plan, those risks and their attendant opportunities must be acknowledged, accommodated, and attenuated.

Though we don’t develop a full-fledged real estate portfolio diversification theory in this (or any other) section, we will beat our risk analysis/risk minimization drum steadily and thoroughly.

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Inflation Hedging**:** A popular investment website[15] defines (rather circularly) **Inflation Hedge**: “an investment designed to protect against inflation risk.” It goes on to point out: “Such an investment’s Value will typically increase with inflation.”

Since the 1970’s, inflation (upward price movement of goods and services in the economy) has held center stage in economic discussions. This protracted concern animated investors’ search for assets that provide a Hedge against inflations’ worst ravages. Often, that search enshrined real estate, precious metals and other commodities as prime hedges.

Ironically, very little research explored real estate’s inflation hedging abilities. With the exception of several very limited reviews[iii] real estate’s inflation hedging abilities were more an article of faith than a documented phenomenon.

In 1989 economists finally turned their attention to inflation’s effect on real estate. A study by Reubens, Bond, and Webb published in the *Journal of Real Estate Research* partially verified what investors and financial mangers already knew intuitively.[iv]

Using time series analysis and exploring several measures of “expected” and “unexpected” inflation, the researchers found that physical real estate (farm land, personal residences, and business assets) provides some degree of inflation hedging against “expected” inflation. Errors and omissions insurers heaved a huge sigh of relief shortly thereafter.

Often overlooked in the discussion, however, the same researchers found that no asset in their study provided hedging versus “unexpected” inflation – the inflation most of us fear most!

The story doesn’t end there. In and 2000 and 2001 Simon Stevenson revisited a number of earlier studies that examined both direct real estate investments’ and REITs’ ability to hedge inflation.

Stevenson’s 2000 results cast doubt on real property’s short-term effectiveness as an inflation hedge but confirmed its long term effectiveness.[v] His 2001 research examined whether REITs provide the same

[15] Investorwords.com

degree of inflation hedging as direct investments.[vi] Verifying several previous studies, Stevenson concluded that REITs, unlike direct real estate investments, provide no effective hedge against either expected or unexpected inflation. In fact, Stevenson concludes, REITs provide a “perverse hedge” that amplifies rather than diminishes inflations’ effects.

Where does that leave us when we talk to Uncle Dave about real estate and inflation hedging?

- Direct investments in real estate confer some degree of protection against “expected” inflation over the long run. Its effectiveness as a short term hedge is debatable.

- Direct investment in real estate probably has no value as a hedge against “unexpected” inflation, but neither does anything else that has been studied.

- REITs not only have no value as inflation hedges, they aggravate inflationary effects.

More than likely, Uncle Dave will not be happy about any of this. Isn’t he the guy who once said: “Reality is a crutch for people who can’t handle denial?”

So what? Given real estate’s many virtues as an investment, do we really care that it can’t protect us from things that nothing else protects us from either?

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So, What’s the Bad News?: “Into every life, a little rain must fall.” (Queen, *The Miracle*, Album 1989, among other sources)

- Every investment has its good and bad points.

- Real estate investments are no different.

You have just spent nearly twenty pages hearing good news. What is the bad news about commercial real estate investment?

Commercial real estate is expensive: This observation is obvious (did someone say “trivial”) if you have ever read the real estate section of any American newspaper. However, its nuances are more subtle.

Real Estate’s cost per unit is high relative to the cost per unit of most assets you hold in your portfolio (one unit of “small office building” = $3,000,000, one unit of many Dow Jones 30 stocks = $30 - $100).

As a result:

- It is difficult to achieve meaningful diversification in small real estate investment portfolios.

- This difficulty limits the degree to which real estate stabilizes your portfolio.

In the extreme case, a single-asset all-real-estate portfolio, your portfolio's volatility will mirror the local real estate market's volatility, which mirrors local business cycles.

There are several ways to mitigate real estate's size-effect:

- Start with smaller properties and leverage them wisely. Smaller properties commit less of your funds to one asset. Leverage "shares" the risk and volatility of the real estate market with your lender. Both approaches stretch your investment dollars and help achieve greater diversification.

- Purchase (or sell) partial interests in property. Any Hollywood agent can tell you that a small piece of something that happens is far more valuable than a large piece of something that doesn't. If you can't bite off the whole property without help, try buying (or selling) partnership, limited liability company, or tenancy in common (TIC) interests in the property. {Caution: selling property interests to non-participating co-owners (passive investors with few management responsibilities) usually requires compliance with federal securities laws and state "blue sky" regulations. We strongly advise you to seek legal counsel before embarking down this path.} We discuss this option in greater detail in a later section.

- Purchase securities that reflect real estate interests. REITs, REMICs and "Derivative" securities such as CMOS trade through public stock exchanges. These instruments can help diversify your portfolio since unit costs for securities are generally lower than direct investment unit cost. REITs, REMICs and CMOS investments behave more like stocks or bonds than real estate – a distinction you will encounter from time to time throughout this book.

Real estate lacks Liquidity: It takes a long time to sell or refinance real estate.

At a bare minimum, selling a property involves:

1. Evaluate, price, and list the Property,
2. Market it,
3. Find and vett a buyer,
4. The buyer's due-diligence,
5. The lender's due diligence, and
6. Fund and Close

Similarly, refinancing property is a lengthy, multi-step process:

1. Evaluate and price the Property,
2. Find and vett a lender,
3. The lender's due diligence, and
4. Fund and Close

It is not unusual for commercial property sales to take a year (our in-house record is four years).

Refinancing a commercial property typically takes three to six months.

In contrast, publicly traded stocks, mutual funds, bonds, and similar securities can sometimes be liquidated in seconds, almost always within hours. Clearly:

- If you may need to liquidate in a hurry, real estate is not your best bet.

Real estate investors have devised several ways to overcome liquidity issues. Often, you will use all of them simultaneously:

- Budget and set aside reserves as part of the project's start-up capital.

- Budget for, maintain, and set aside operating income to create liquid reserves sufficient for most contingencies. This requires discipline, but is achieved by many ordinary mortals.

- Insure against catastrophic events that may require greater reserves than you have budgeted.

- Negotiate asset-secured lines of credit based on the equity in your property before you actually need them. Don't use the credit line, just negotiate it. This is the most expensive way to guard your liquidity. When combined with the other methods it is remarkably effective.

Real Estate Requires Management: Real estate investments require tactical and strategic management.

- If hard work triggers your allergens, don't even think about commercial property investment.

Tactical Management: Someone must oversee the day-to-day operation of the property. Tactical management involves every aspect of day-to-day property operations. Your task list includes:

- Advertise Vacancies,
- Interview Potential Tenants,
- Vett Potential Tenants,
- Lease Space,
- Collect Rents,
- Routine Maintenance,
- Extraordinary Repairs,
- Scheduled Replacements,
- Pay for it all,
- Meet with the Lawyer if it all goes bad,
- Et Cetera, Et Cetera, Et Cetera

Investors often delegate tactical tasks to a professional management company rather than honing their do-it-yourself skills.

- If you adopt the professional management approach, expect to pay the management company somewhere between 2% and 10% of the property's gross income.

- If you choose the do-it-yourself route, feel free to reconsider the decision every fifth time "cute little Johnny in unit five" flushes their yellow bathtub ducky at two o'clock in the morning.

Strategic Management: Even if you have a good property management firm to handle tactical operations for your property, expect to spend a good deal of time on strategic planning and "ministerial" activities (accounting, tax compliance, management and performance review). For a price, you may be able to delegate the research and preparation tasks that are pre-requisite to decision making.

- ➢ You, and you alone, make the final decision about long-term marketing or market placement for your property!

Real estate transaction costs - Buy, Operate and Sell - are High: Real Estate transaction costs are high compared to other investments.

- Closing costs paid to purchase investment property average about 3.5 % of purchase price,
- Operating costs are frequently 30-40 % of rental income for viable commercial properties – but may be considerably higher, and
- Closing costs paid to sell investment property average about 9.5 % of the sale price.

By contrast, mutual fund "front load" (commission) seldom exceeds 4.5% (many are lower). Mutual fund operating costs are generally between ¾ % and 2 %.

Unless you are the ultimate hyphenate (real estate broker-lawyer-appraiser-financial advisor-building inspector) and you own your own title and escrow companies there isn't much you can do to limit closing costs. You can, to some extent, negotiate a lower price for closing services, but you will seldom be able to do without them or perform them yourself.

Many owners mitigate operating costs by performing their own tactical management. If you have the requisite skills and time, you can save a good deal of money this way. If you only think you have the requisite skills, you can waste a good deal of time and money this way! If you choose this route:

- ➢ Take some classes and practice your maintenance skills at home before you try them on your rental property.

The most practical and cost effective approach to operating cost containment is usually somewhere between do-it-yourself and full-service management: do what you are good at, delegate what you are not good at. Make friends with your rolodex and keep it up-to-date! Join your local Apartment Association[16] or BOMA[17] affiliate and find out who does what (and how well) for your fellow owners.

[16] The National Apartment Association maintains a list of state and local affiliates on its web site – www.naahq.org – Local affiliates hold frequent meetings and educational events, and maintain lists of local service providers. Local affiliates and their members are generally glad to help you get started. NAA and its affiliates are also a very good source of compliance information and assistance.

[17] BOMA, the Building Owners and Managers Association International, is a network of professionals involved in building ownership, management, development and leasing. Their bailiwick includes commercial and industrial properties of all kinds, but they are especially proficient at providing office building information. Their web site also lists local affiliates: www.boma.org/Membership/FindYourLocalBOMA/

There are sooooooooooo many rules to follow: Even a partial (not very detailed) list of compliance concerns can be daunting:

- Age discrimination
- Anti-trust regulations
- Building codes
- Disability statutes
- Earthquake preparedness
- Fair Housing
- Hazardous materials disclosures
- Licensing regulations
- Megan's Law
- Rent Control
- Securities registration requirements
- Sexual Discrimination
- Tax codes
- Unemployment coverage
- Zoning regulations

Once again, there is not much you can do to reduce the requirements. So, why not make it your goal to attend as many continuing education classes as possible? The National Apartment Association and BOMA are a good starting point, as is your nearest university extension. Get out, meet people, learn a few things, and have some fun dissing your tenants (without naming names) in front of a receptive audience! As you do that:

- ➢ Put together a checklist and calendar of compliance, disclosure, and notification deadlines so you don't have to keep them all in your head and you don't miss one.

Real Estate Markets are Cyclical: Like other asset markets, investment real estate markets are cyclical.

The best of times often follow the worst of times. The despair of winter ushers in the spring of hope. (With apologies, Charles Dickens, *A Tale of Two Cities*, 1859)

The investment real estate market is actually three markets – each with its own driver and dynamic:

- ➢ *The Leasing Market*: Demand for rental space is driven primarily by local business conditions and demographic shifts, secondarily by national (and increasingly, global) business conditions and demographic shifts. Hence, demand for rental space correlates well with local and national business and demographic cycles. As a "derived demand," rental space demand usually "lags" business cycles.

- ➢ *The Purchase Market*: Demand (and pricing) for finished, occupied buildings is driven by demand for rental space and correlates well with both interest rates and money market liquidity. Often, local rental space supply and demand conditions are the primary drivers of purchase demand. Recently, however, liquidity and interest rate concerns have limited the supply of investor funds and impaired realty investors' effective demand,[18] underscoring the role of interest rates and investor liquidity.

- *The Construction Market*: Activity in the construction market often seems like a nightmare out-take from *Field of Dreams*: "If you build it, they will come; but don't bet on it." Because it takes so long to conceive, plan, entitle, develop, construct, and market commercial space, it sometimes (often) seems that construction decisions are completely out of synch with business conditions. Ultimately however, new construction determines the supply of purchasable and leaseable space. Demand for leased space determines construction priorities. The Conference Board index underscores construction's powerful "multiplier effect" and pivotal role in the business cycle: The Board classifies "Number of Building Permits Issued" as a "leading" (as opposed to coincident or lagging) indicator of future business activity.

Now that you have an idea of what drives commercial real estate markets, what can you do to influence the market. Once again, the truthful answer is: "Not much." Unless you enjoy a local monopoly (which is more common than you might expect – think "company town" and "rich southern grandee"), your individual influence on local business cycles and commercial real estate markets is limited. Your influence on national and global economic and demographics is probably even thinner.

If, like Cricket, "you have already learned well," you know the mantra and the answer: "Educate, Anticipate, Respond, Repeat."

- Take classes (as general background), read local business publications and news papers (to learn what's going on now), join and attend local business organizations (to get your news before the newspapers do), and frequent your planning commission's meetings (to see what might be happening later).

- Analyze what you learn. Devise a plan (and several contingency plans) that addresses your knowledge, analysis, and instincts about market trends.

- Effectuate and monitor the plan. Don't be afraid to change the plan as conditions change, but make sure that conditions have changed before you adjust your plan.

- Repeat the process: a continuous loop.

As a real estate investor, and unlike Dickens' "lords of the state preserves of loaves and fishes," you cannot assume that "things in general are fixed forever."

[18] As we wrote this, in early 2008, the "Mortgage Meltdown" was in full flood. Defaults and uncertainty in the residential housing market reduced lenders' willingness to supply funds and raised interest rates. Thus, despite continuing demand derived from a generally positive economic outlook and a robust leasing market, investors "effective demand" (their ability to close transactions as opposed to their desire to close them) for commercial real estate began to show signs of impending weakness. By 2010, the full flood of recession and joblessness had taken hold… buyers disappeared, pricing collapsed AND funds dried up. This condition persists (in slightly alleviated form) in mid-2014. However cash buyers have been able to convert others' catastrophe into opportunity. Artificially low interest rates do not seem to have increased investor appetite for debt, or loosened lender purse-strings. Stay tuned for further developments.

Part Existentialist / Part Prophet: you must pay attention to both the "messages on the order of earthly events" and "any communications received through the chickens of the Cock-lane brood."

Performance Measurement: Ironically, in a section devoted almost entirely to performance measurement and evaluation we are forced to admit up-front that there are few reliable (and virtually no absolute) statistical benchmarks you can compare to your real estate portfolio's performance. Relative market risks are equally difficult to gauge.

The irony reflects two realities of the investment real estate market:

- The investment real estate market is economically "imperfect." There are few suppliers, few purchasers, no interchangeable or fungible product, no mobility, and local knowledge is both highly valued and closely guarded.

- Investment property "uniqueness," local/regional market segmentation, and the paucity of transactions in any given market make statistical estimates unreliable.

Market Imperfections: In contrast to classical economists' ideal market models (in which consumers' optimizing-profit maximizing behavior and markets' static equilibria play major roles) investment real estate market "consumers" often exhibit "satisficing" and a high tolerance for dynamic dis-equilibrium.[19]

- In the absence of reliable performance benchmarks, investment real estate consumers identify a yield and risk profile that is "satisfactory" or "will suffice" (they "satisfice") and gear their purchases and operations to meet that target, and

- They accept that they will be wrong a good deal of the time.

In short, you have to be both self-confident and thick skinned if you want to join this club!

The rest of this section provides some tools to bolster your self-confidence.

You'll have to decide if you are thick skinned enough to stay the course.

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[19] While formulating his "behavioral theory of the firm" Herbert Simon coined the term "satisfice" to describe (potentially) sub-optimal goal-directed economic behaviors. Simon postulated that in the absence of sufficient information or when they lack enough capacity to analyze information thoroughly, economic entities (firms and consumers) set targets and goals that are "satisfactory" and "sufficient" rather than "optimal" or "profit maximizing."

Simon's approach aids our intuitive insight into goal directed economic behavior. Its mathematical representation, however, lacks the straightforward elegance of the classical Walrasian model. Put bluntly: Its mathematical representation is UGLY! Mathematical models of economic behavior derived from Simon's hypothesis often wallow through obtuse dissections of set theory, function spaces, homeomorphism and topology. See, for example, publications (mostly in the *Journal Of Economic Theory*, circa 1976-1982) by Richard Day, Henri Grandmont, Guy La Roque, and Steven J Roy (co-author of this work).

End Notes and References

[i] Definitions used in this section are adapted from *Dictionary of Real Estate Terms, Sixth Edition*; Jack P Friedman, Jack C Harris, and J Bruce Lindeman; Barron's Educational Series; New York, 2004

[ii] Richard A. Brealey; *An Introduction to Risk and Return from Common Stocks;* M.I.T Press; Boston, 1969 is probably the first work to document this empirically. The observation lies at the core of the Asset Allocation Model employed by most personal financial advisors.

[iii] E. Fama. Stock Returns, Real Activity, Inflation and Money. *American Economic Review* 71 (1981), 545-565 and E. Fama and G Schwert. Asset Returns and Inflation. *Journal of Financial Economics* 5 (November 1977), 115-146

[iv] Jack H Rubens, Michael T Bond, James R Webb. The Inflation Hedging Effectiveness of Real Estate. *Journal of Real Estate Research*, Volume 2, #2, (1989), 46-55

[v] Simon Stevenson. A Long Term Analysis of Regional Housing Markets and Inflation. *Journal of Housing Economics*, Volume 9, #1, (2000), 24-39

[vi] Simon Stevenson. A Re-examination of the Inflation Hedging Ability of Real Estate Securities: Empirical Tests Using International Orthoganalized and Hedged Data. *International Real Estate Review*, Volume 4, #1, (2001), 26-42