Seldin On Change
A TIME TO BUY, A TIME TO SELL

by Maury Seldin, CRE

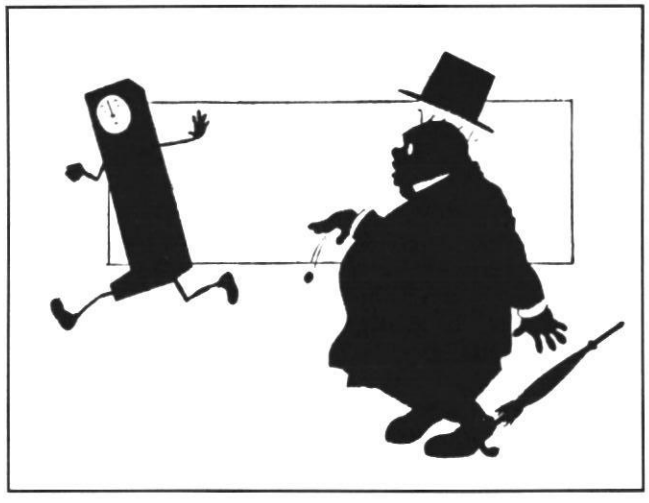
Timing and location are the two most critical variables in an investment decision. If one is able to pick the right time and the right location, one can absorb any loss associated with most errors and still do quite well.

A substantial body of literature about location exists. A close look at current analyses, however, reveals an inordinate amount of stress placed on numerical analyses rather than spatial analyses. Little hard analysis of the location and the reasons that it is expected to get better exist. Although the spatial aspect is a favorite topic of mine, I intend to deal with the variable of timing here.

Most discussions on timing deal with the question of when to get in. The stock market was in the doldrums for a decade. Within the last year, prices have skyrocketed. The question is: "Is it too late or still just the beginning?" Obviously those who were acquiring stock heavily near the end of the doldrum period had exquisite timing. Hindsight in these matters is 20/20 because the data for stock are so good.

Judging Location, Timing Factors On Real Estate

In the case of real estate, it is not so easy to know exactly what the pace was because we don't have the same array of indexes from which to choose. The existing indexes do not have the breadth of coverage of the Standard and Poor's 500. One cannot obtain the details by segments of the real estate market comparable to segments of the stock market, that is, by industry.



In general, land prices had been increasing for a long time before the recent turndown. Just how long it will be before there is a resurgence is anybody's guess. It could take some time before a long upward trend takes place. It is probable that some locations are not going to improve substantially and that land investments are not appropriate. Indeed, opportunities exist today but timing was better a quarter century before the recent downturn. During that time period, one could hardly go wrong since most locations actually did improve.

In the 1970s housing prices skyrocketed. The expectation of continued inflation induced many people to buy. Environmental regulations made additions to the supply more expensive. Demographic projections indicate changing markets such as housing for smaller sized

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This article is the sixth in a series by Dr. Seldin, which will focus on the problem of change in the real estate industry.

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households. If one is able to pick the right time to enter a submarket or the right submarket at a given time, then one can do well.

Rental housing has had its heyday. In the early 1960s there was a tremendous increase in apartments because lenders had a lot of money to push out and developers could mortgage out. There was also a market to serve at that time. The numbers for new rental construction, which is nonsubsidized, simply don't work very well. This type of construction is not profitable if one looks at the rent and cost relationship, especially the cost of money. This situation may change as interest rates decline and rents rise.

Currently, however, when one looks at the relationship between rent and financing cost, it is only the favorable depreciation rules and the hope of inflation that give such investments a chance. Many small investors have entered the condo market looking to get in on the action, and have paid high prices relative to rents, with the expectation of continued increased prices.

Many condo investors are disappointed because what has really happened is that apartment investors have been buying apartment units wholesale while condo investors have been buying them retail—one at a time.

Other changes in nonresidential markets have taken place over time, but these illustrations in land and residential investments are sufficient to point out those times in which it is easy to get winners and other times in which it is very difficult.

Some factors are related to society's fundamental need for real estate: The demand for housing because of household formation; the demand for more shopping facilities because the location of those households has shifted, and the demand for office and other employment space because employment is increasing. Other factors come into play in regard to this timing. The importance of the cost of money has been driven home in recent years. Part of this volatility in the cost of money lies in the inflationary expectation.

Effect Of Interest Rates On Buying Decisions

It was a great time to buy when money was cheap. For decades lenders were taking short-term deposits and lending long with only a modest spread. They took the risk of rising interest rates. As the rates for money rose with inflation, lenders increased the rates they charged for money, but they could only increase the rates on new loans. They did not charge enough to be adequately compensated for the risks being taken.

Many S&Ls did not survive the rush of rapidly rising rates. The value of their loan portfolios depreciated so rapidly that many of these institutions were counting the days until their net worth would be negative. When money was cheap, it was the time to borrow. Real estate was good security for borrowing, so one really didn't have to buy a fantastic real estate investment in order to make money. A good loan would make more money than a mediocre selection in real estate. It was only necessary for the income-producing ability of the real estate to keep pace with inflation. The long-term low interest rate loan would turn out to be a more valuable asset and could produce more benefit than the inflation adjusted profit from the real estate investment itself.

Lenders have learned to shy away from the risk associated with interest rates. Using variable rates or call provisions, they try to pass on the risk to the borrower. As an alternative, they go to the long-term capital market and issue pass-through securities, so that those who were willing to lend long-term funds are matched off with those looking to borrow long. The survivors typically avoid borrowing short and lending long without some form of protection.

If one believes that the current long-term rates of interest are really low, then one may decide to borrow lots of money and hope that the rates really do turn out to be low. The rates could be low if there were a resurgence of inflation, and definitely would be if there were hyperinflation.

At current rates of inflation, however, the real rate of interest is high. Borrowers are paying substantial premiums to lenders for long-term funds because lenders are wary of taking the risk of interest rate again. One might argue that an explanation for the premium at the shorter end of the market is that lenders who have been burned by inflation are taking an opportunity to recover from losses or obtain compensatory profits.

Many real estate investors who don't think that this is the best time to borrow a lot of money are putting down a substantial portion of the purchase price and, in some cases, they are paying in cash. This practice is aside from pension funds which by their nature are required to buy for all cash. A look at the changing mix of benefits indicates why higher down payments are required.

Advantages Of Investment

The benefits of investment may be classified as cash flow, tax shelter, and proceeds of sale. The cash flow relative to the down payment has been diminished substantially over the last quarter century due to the substantial increase in the cost of borrowed money. The rapidly rising annual constants (ratio of mortgage payment to loan) take away much of the operating income.

Although the benefit of cash flow in the case of heavily financed properties has been diminished, the benefit of tax shelter has increased due to the change in the tax law. Under current tax law, one may recover an investment in depreciable real estate over 15 years, whereas in the past one might need to use as much as 40 to 50 years. Furthermore, when one pays the tax, the long-term capital exclusion is up from 50 to 60 percent and the marginal tax rate is down from 70 to 50 percent. This means that in general one can deal with a maximum 20 percent effective tax rate instead of substantially higher marginal rates. The tax saving is so great that many investors will give up some or all of it in order to offset the negative cash flow

from heavily financed properties. In other words, they count the tax savings as an offset to the negative cash flow. It is obvious that they are looking for the benefit of proceeds of sale where the big profit is. In an inflationary economy, the increase in the price level results in the high proceeds of sale.

This situation leads me to a major point: More attention needs to be directed toward the time to sell. Many investors who bought real estate at peak prices in the past, now find that inflation has abated and prices have receded. These investors may wish that they had not bought, and the would-be sellers may wish that they had sold.

Foresight is not 20/20. However, some intelligent guesses as to what will happen in the future can be made even though accurate guesses are becoming more difficult all the time. The best advice I can give to a professional forecaster is to make lots of forecasts and keep all your own records. The investor is advised to make his/her best forecast and be prepared to defend it in case it's wrong.

Real estate should not be so financed that the investor might be forced to sell since the conditions forcing one to sell are the same conditions that make it the wrong time to sell. One must be able to choose the time to sell. Making a good choice may be hard because the future is uncertain. One way to deal with this situation is to sell when one feels that he/she will be under pressure to sell anyway but at a later date.

One may choose to sell now rather than at a later time if it is necessary to recoup the money for other investments or commitments. Some real estate empires have crumbled due to a domino effect: First of all, a bad deal forced the increase of money at a very high cost. But the money to repay the loan was tied up in real estate. Then a series of sales were forced at exactly the wrong time. Even investors with small investments can be put under that type of strain. For example, a young investor with small children can save for the college education of his/her children by buying rental property which just carries itself. Given enough time, the mortgage on the property will be nearly, if not all, paid off, and presumably the value of the real estate will have risen enough to pay for the rising costs of education. Many investors will start saving for such a purpose when the children are teenagers and only five years are left in which to accumulate the money. With such a short time period in which to dispose of the property, there may be unfavorable markets. Thus, timing elements should be planned on well in advance since it may take years for a market to shift.

I believe that real estate investors currently face another risk which potentially could be as hazardous as the decline in the rate of inflation. This risk is the change in the tax law. If one runs the numbers through on the extent of the benefit that one receives with a 15-year depreciation period as opposed to a 40-year period, one will find a substantial difference in annual depreciation. If the difference in tax savings with a 60 percent exclusion is compared to savings with a 50 percent exclusion, one will see that some real estate investments produce a substantial portion of their income because of the favorable treatment of the tax law. That tax law can change.

If a change to less favorable tax treatment does take place, the mix of benefits will change. There will be less shelter in real estate. If the inflation problem is really solved or abates for a long period, then the proceeds of sale are not going to be boosted up by rapidly growing price levels. Now might well be a good time to sell.

Importance Of Well-Structured Investment Portfolio

This is not to say that I am recommending that investors immediately run out and start selling real estate because the battle against inflation is being won and the favorable tax treatment of real estate will be removed after the next election. It may happen, but then again it may not. What I am suggesting is that the real estate investor have his/her total investment portfolio (real estate and non-real estate) so structured that those changes will be tolerable.

The risks that one might not find tolerable on a single investment might well be acceptable if one has sufficient diversification. Furthermore, if the prices do not continue in their upward trend due to inflation, and if the tax shelter is diminished so that the next round of purchasers would pay less, it may make little difference to the investor if he/she has no need to sell. If one is really prepared to live with the investment for a long period of time, that is, if the cost of financing doesn't turn out to be too high and if there is no particular reason to sell, then one can be protected from the changes in the marketplace in the timing of a sale because one doesn't have to sell.

Real estate investment portfolios should be designed so that the investor can afford not to sell. If one is running out of depreciation, it might not be a bad time to make a move. If one has a balloon mortgage coming due in two or three years, it might not be a bad time to recast the financing. If one is going to need the money in a few years, it might not be a bad time to sell.

An investor should not get into a position where he/she really needs to make the decision to sell a particular property at a particular time. The property should be an attractive investment even without the depreciation, due to the income that the property produces. An investor should have no interest in selling and paying the tax on a property or in trading up and taking on more debt. The balloon payment may be of little concern to the investor who has marketable securities in his/her portfolio and can meet the call.

Similarly, if an investor is going to need substantial amounts of money and he/she has alternative investments which are liquid as almost all alternative investments are, then one could afford to wait it out.

One may hope for the best, but one should plan for the worst. Instead of just focusing on a time to buy, more thought should be given to a time to sell.