



Real Estate Investment Newsletter – June 2004

Investment Management for Retirement

If you are like most people, you dream of investing well and living off your investment returns. Sometimes this can be accomplished by luck but prudent people prefer to take the luck out of it by proactively managing their portfolio of stocks, bonds, and real estate. In this newsletter I will identify the key factors that you need to understand to optimally manage your portfolio at retirement and how this strategy differs from the strategies you should use to build your capital before retirement.

Objectives: Cash Flow versus Total Returns

Compared to your younger years, when you are retired you will want a portfolio with relatively lower risk and higher cash flows. Over time, therefore, you will want to reduce financial risk and build up regular cash flows to support you once your paycheck stops. In order to properly frame this discussion, let's look at the composition of total returns. Mathematically, $\text{Returns} = (\text{Operating Cash Flow}^1 + \text{Appreciation} - \text{Taxes}) * \text{Leverage Effect}$. Although cash flow is a part of returns, the strategy that maximizes returns over time usually does not maximize cash flow. This is because there is usually a trade off to be made between appreciation returns and cash flow returns. Generally a strategy that increases the cash flow component of returns also reduces the risk of returns since it reduces your dependence on future events.

The first trade off between cash flow and appreciation comes at the property selection level when you must choose either a high yielding property with low growth potential in cash flows or a low yielding property with larger expected growth in cash flows and appreciation. For example, a triple net leased (NNN) property will generally have higher yield but lower growth potential than apartments. The choice of locations for apartments also requires

¹ Net Operating Income less Capital Expenditures or Reserves

a choice on this trade off: Oklahoma provides higher yield but lower potential growth than Las Vegas or Phoenix.

The other source of trade off between cash flow and appreciation comes when you choose how much of the property value to finance with a mortgage versus equity. This is because more borrowing on a property tends to increase the overall return on equity but the additional debt service usually reduces the cash yield on the investment. We will discuss leverage effects in greater detail later. The point here is that these tradeoffs generally imply that higher after-tax returns go with lower cash flow returns and higher risk.

The timing of an investor's needs for cash flows is very important for deciding what to buy. If an investor has already retired and needs cash flow returns to pay living costs, they must either buy properties that can supply those cash flows immediately or hold a larger portion of their wealth in liquid investments (i.e. stocks and bonds) for use in paying living costs while the real estate's cash flows grow. On the other hand, an investor with 5 or 10 years to retirement can afford to buy a property with low current cash flow so long as there will be enough expected growth in cash flow to either supply the needed cash flows at retirement or allow for a refinancing transaction that provides the liquidity needed to fund retirement costs. In order to make these decisions you need to forecast cash flows and appreciation over a long time horizon to determine if the property will meet your needs.

In the U.S. appreciation returns can go completely untaxed so long as you take advantage of the exchange provisions of the tax code when selling a property. Cash from refinancing transactions is completely tax free. Operating cash flow returns, on the other hand, are taxable to the extent they are not sheltered by interest payments and depreciation. Furthermore, triple net leased commercial property has a lower depreciation rate than apartments. The result is a much higher effective tax rate on higher cash flow properties. Therefore high cash flow properties will have lower after-tax returns than a property with the same pre-tax return that has more of the return coming in the form of tax-free appreciation. So again we see a trade off between overall after-tax return and cash flow return. Of course the actual taxes will depend on your other income; retirees will usually be subject to much lower tax rates than investors still earning high wage income. Thus the interaction of retirement timing and taxation effects will significantly impact the optimal real estate investment strategy.

Portfolio Strategy

A key task in retirement planning is to figure out when cash will be needed to pay for living expenses, taxes, and major expenditures (vacations, down payment for the kids, etc.). Once you know your cash needs, you must

make sure that your investments will produce cash flows to match your expected expenditures. If this forecasting exercise is neglected, you may find yourself in a situation where you need to sell real estate quickly. Later I will discuss how to address the overall liquidity and risk management strategy in more detail. Matching of portfolio cash flows is a key component of your overall investment strategy.

Another key component of portfolio strategy is what I will call risk allocation. By this I mean allocating your capital across risk classes to achieve an optimal mix of risk versus return. This allocation should change through time because you should be reducing your risk exposure as you age. This may not apply if you have done so well that even large losses will not affect your lifestyle. Assuming you are near, or just starting, your retirement (and you have enough capital to hold several properties) you should probably own some combination of low risk NNN commercial property and higher risk apartments. The apartments give you higher potential returns and some tax shelter; the commercial property gives you low risk cash flows to live on.

See Exhibit A for an example of a suggested total portfolio allocation for someone in their 40's with net worth of \$1,000,000. This is a relatively high risk profile because this person still needs to build significant capital and has plenty of time to do it.

Leverage Effects

Earlier in this newsletter I said that increasing debt (leverage) on a property will generally reduce your cash yield on invested cash². In order to be specific about when leverage decreases cash on cash return I need to review some terminology. Recall that the Cap rate on a property is the net operating income (NOI) divided by price; it is the cash yield on the asset before financing costs. The Debt Constant is the annual loan payments as a percentage of the original loan amount. For an interest-only loan, the Debt Constant and the interest rate are the same. Otherwise, since payments include principal, the Debt Constant will be a bit larger than the loan's interest rate. For example the Debt Constant for a loan with interest rate of 7% and principal amortized over 30 years is 7.98%.

Whenever the Debt Constant exceeds the Cap rate, increasing debt will decrease the cash yield on the investor's cash. Thus, if you finance a property with the loan mentioned above and the property has a Cap rate less than 7.98%, then your cash on cash return will be lower the more debt you put on the property. Because of competition for properties and their returns, Cap rates tend to move with financing costs so that they are almost always less than Debt Constants. You can find Cap rates higher than Debt Constants on

² Also known as cash on cash return.

properties with little or no prospect of cash flow growth. For example, a commercial property that is leased for 15 years with no rent increases for the term would be likely to have a Cap rate higher than its Debt Constant. In this case most returns must come from the current level of cash flow and so the Cap rate will be high to entice cash flow seekers to buy the property. Such properties can be a good fit for a retired investor who needs relatively high cash on cash returns to support living expenses.

We've seen the cost of leverage; now let's look at the benefits and how they tie into long term strategic investment planning. When you borrow to buy a property, you will want to take out a fixed rate loan so that your payments are constant for at least 5 years. If you are trying to maximize returns, you will put on as much debt as the bank will allow. As a result, most of the property's NOI (cash flow) will be used for loan payments. The leftover cash flow that goes to the investor will usually be less than 8% of NOI. Because this is so small relative to NOI and gross rents, even small increases in these will cause large percentage increases in cash flow for the investor. For example, you raise rents by 3% and this raises NOI by 4% (because expenses grew by less than 3%). If your initial cash flow was 8% of NOI, then you've just had a 50% ($= 4\% / 8\%$) growth in cash flow. Because of this magnifying effect on cash flow growth, properties with relatively low initial cash flow returns but good growth potential can be purchased by investors who are willing to wait a few years for rapid growth to take the cash flows to the desired levels.

As mentioned earlier, the amount of debt put on a property can be used to determine how much return comes from appreciation as compared to cash flow. Effectively, increases in debt on a property convert cash flow returns (taxed) into appreciation returns (not taxed). Leverage dramatically magnifies appreciation returns by reducing the amount you invest in a property. If a property is financed with a loan for 50% of value, then 3% appreciation will translate into a 6% ($= 3\% / 50\%$) return on your investment. If you borrow 80% of the value, that same 3% appreciation now becomes a 15% ($= 3\% / 20\%$) return on your investment. Cash flow is reduced by the debt service and taxable income is reduced by the interest portion of the debt service so that the portion of returns lost to taxes decreases as leverage is increased (and appreciation returns are substituted for cash flow returns). Conversely, in retirement you may wish to use less than maximum leverage to leave more cash flow available for meeting living costs. This is especially true when you have excess tax losses on other property and/or you wish to reduce the risk in your portfolio.

Liquidity and Risk Management

Although leverage increases expected returns, it also increases risk inherent in any asset because debt payments are fixed even while asset yield can fluctuate. Fluctuations in cash flows on real estate can cause big problems for investors who do not have enough cash to pay the bills while they solve the property's problems. In an extreme case an investor may be forced to sell the property at less than market value to prevent foreclosure from wiping out his equity entirely. Investors should mitigate these "liquidity" risks by maintaining a substantial investment in liquid assets: stocks, bonds, and cash. A line of credit could also serve this purpose. Your target amount of liquidity should probably be 4 months of expenses with a minimum of \$50,000. It may seem counterintuitive but it actually makes sense to borrow more than you really need against your real estate in order to hold the excess in liquid securities. It will also be profitable so long as the return on your securities portfolio exceeds the interest rate on the loan. Alternatively, if you don't think you can earn returns that exceed the interest costs, you could arrange an unused credit line backed by the real estate.

Conclusion

Investors who wish to retire and live off their investments can greatly increase their chances for building the cash flows necessary to fund their living standards by planning their investment strategy to fit their changing need for cash flow and risk tolerance. By maximizing growth in capital early and then managing portfolio cash flow to match retirement needs later, an investor can ensure a timely and comfortable retirement. The key choices in an optimal strategy include asset allocation, property selection, leverage, and liquidity. Berkeley Investment Advisors can help you put it all together in a realistic plan that fits your circumstances and goals. Let us show you how.

Featured Investment Opportunity

This 40 space mobile home park includes a house and 27 park owned mobile homes on 5.6 acres just north of Tampa Bay. The median income within a mile is \$60,000. Based on the \$950,000 asking price and estimated NOI of \$87,000, this has a 9.2% Cap rate! The park owned homes will reduce the bank loan offered on this to \$510,000 but the potential for seller financing may allow a buyer to put up as little as \$260,000. Without seller financing the cash on cash would be 10%! With Seller financing total return should be 18% in the 1st year. There is upside available by filling the 13 empty spaces.

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Exhibit A

Recommended Capital Deployment assuming a net worth of 1,000,000:

Investment Category	\$1,000's	After Tax		Notes
		As % of Total	Expected Return	
Residence Equity	100	10%	12%	Assuming 90% LTV initially
Low risk marginable equities	100	10%	7%	Conservative Portfolio with low turnover
Speculative Securities	100	10%	18%	International, Contrarian plays, Sophisticated Strategies
Speculative Real Estate	240	24%	20%	Development, Land, Special Situations
Residential Income Properties	300	30%	15%	Assuming no liquidation without exchange
Triple net lease retail propertie	160	16%	12%	Assuming no liquidation without exchange
Total	1,000	100%	15%	