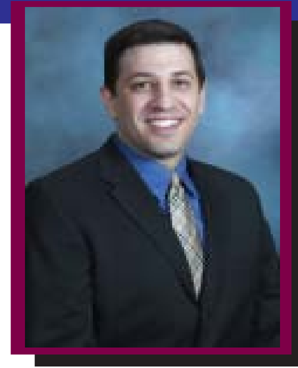
SPECIAL REPORT



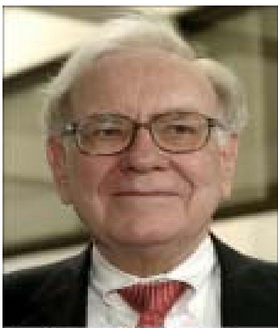
It's Never Been A Better Time To Buy Real Estate (Really!)

How real estate investment can save your retirement from the ravages of faulty banking system, a failing stock market, and theft of wealth through high inflation.

By Ken Adler

November 2008

Baron Nathan Mayer Rothschild, a 19th century British nobleman and member of the Rothschild banking family, is credited with saying that "The time to buy is when there's blood in the streets." He should know. Rothschild made a fortune buying in the panic that followed the Battle of Waterloo against Napoleon. But that's not the whole story. The original quote is believed to be "Buy when there's blood in the streets, even if the blood is your own."



"...be fearful when others are greedy and to be greedy only when others are fearful."

This is contrarian investing at its heart - the strongly-held belief that the worse things seem in the market, the better the opportunities are for profit. Most people only want winners in their investment portfolios, but as Warren Buffett warned, "You pay a very high price in the stock market for a cheery consensus." In other words, if everyone agrees with your investment decision, then it's probably not a good one.

While these quotes are often applied to stock market decisions, the philosophy applies to any type of investable market - commodities, collectables, and real estate included. Real estate in most parts of the country has seen a substantial decline since the end of 2005. Low interest rates combined with relaxed lending guidelines allowed an abnormal amount of buying pressure to be placed onto the housing markets. This led to the inflation commonly referred to as the housing bubble. Today, higher interest rates (yet still low by historical standards) and rather strict lending guidelines have left many borrowers stranded and unable to refinance their homes (or perhaps buy a new one). Potential buyers may be willing to buy, but are unable due to tighter credit markets that refuse to finance their new purchase. Not all markets suffered any meaningful declines because not all markets participated in the initial artificially induced run-up of prices.

To understand why there are opportunities in real estate at this time that could be considered "once in a lifetime" we must examine the underlying influences of pricing within the market. Using expressions like "once in a lifetime" and "never been a better time to buy" sound so cliché and worn that they have lost their impact. *Only this time they really do have meaning, and the numbers exist to prove exactly that.* While we are fortunately not in a depression, there are certain markets that currently offer investors and new home owners depression-like prices in a market that is about to turn around. The reasons are numerous and all very encouraging.

Supply & Demand

Traditionally, on a national level, the National Association of Realtors (NAR) has represented that there are approximately four to five month's worth of housing inventory available for sale. This means if no new properties were added to the market, under normal circumstances all houses would be sold within that time period. In recent

years, builders had typically pulled between 1,400,000 and 1,700,000 single family housing permits on an annual basis, peaking in 2005. These were new units being created from the ground up to replenish existing inventory.

Currently, there are over 3,900,000 units in the United States available for sale. This represents a whopping 11.2 month supply – practically 2.5 times the normal amount of houses normally available. The supply level is the highest it has ever been since this figure has been tracked – representing an inventory of homes at more than a 30 year high. While most people may not consider themselves to be economists, it is commonly understood that when any desired commodity is in short supply, the prices tend to be relatively unfavorable to the buyer. Conversely, the current oversupply on a national level has fueled low prices not seen in more than a decade.

There is no doubt that at the moment there is an extreme oversupply of real estate available to buyers, creating a true buyer's market. A fair question could be posed here: "How would a buyer know that the real estate market is at the end of the oversupply period and that the inventory will begin to contract, thus, increasing prices with reduced supply available?" There are several factors that are now coming together to create a "perfect storm" for inventory reduction. For starters, homebuilders have scaled back new home production on a meaningful scale. They are now collectively building about 500,000 new homes, a stark contrast to the 1,700,000 peak in 2005. This is the lowest rate of building since World War II. That may be bad news for people in the construction industry, but it is great news for investors seeking extreme values in real estate. By sharply reducing the rate of building, the existing home inventory should be sold off at a faster rate than without a reduction in building new homes. The inventory is only part of this unfolding story.

Governmental Bailout / Guarantee

For decades, the federal government has implied it would guarantee the loans held by Fannie Mae and Freddie Mac. These two companies alone held 50% of all mortgages in the United States. Now, in a time of financial crisis, the government has done what it said it would do: act as a financial backstop behind these two mortgage giants. The government has also protected investment banks, the auto industry, and says it will continue to provide protection until it feels the financial markets have stabilized. Critics of the plan say this is nothing more than blatant corporate welfare and will not solve the actual problems the markets face. The purpose of this article is to examine the effects of such a bailout (which is ongoing) and not the moral or political implications.

The direct expected effect these funds will have is that mortgage bankers will have more inexpensive cash available to them. This should allow borrowers to refinance terms on their existing balances or help new buyers purchase a property at very low interest rates. Inexpensive cash is supposed to increase liquidity – meaning their intention is to keep the money flowing out into the economy so individuals and businesses have access to spending power. What this means for the real estate investor is that the current cost for money is very favorable. Investors benefit by achieving higher monthly cash flows via a lower cost structure.

The net effect of a government bailout can be summed up quite simply: It's a subsidy for the housing sector. The government has used subsidies for years to help support specific industries (farming and environmentally friendly power comes to mind), and this is no different other than the sheer size of the bailout. Some policy analysts have suggested that a full bailout could cost in excess of two trillion dollars ($2,000,000,000,000) by the time they've concluded their ongoing contributions.

The problem with an invoice this large is that the taxpayers do not have enough money to pay for it. In 2005 Americans' savings rate dropped below 0% for the first time since the Great Depression. Translation: Americans were spending more than what they earn, and increased their borrowing to maintain that level of spending. While this may not be surprising news to many people, it certainly means that as a nation we do not have enough funds to cover this bill. Where does all of this bailout money come from if the taxpayers lack the required funds? Here's what surprises most people: It's printed out of thin air.

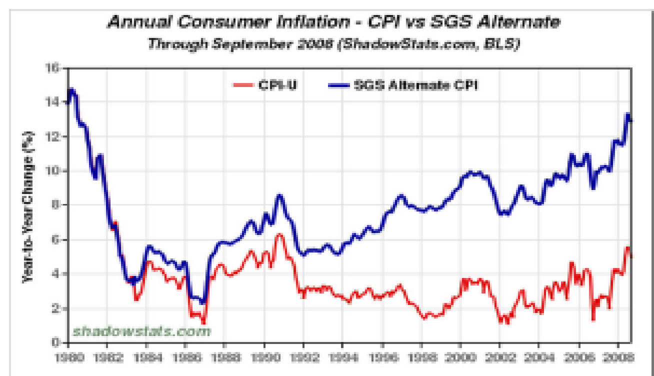
Inflation

The Federal Reserve actually creates the money from nothing to provide liquidity and equity to banks teetering on the edge. While people and politicians debate whether or not it's fair for banks to be receiving such infusions, there is a larger problem that affects everyone. When cash is created, either in printed form or as blips of code in a computer, unless it is backed by something with intrinsic value like gold or silver, it devalues the existing money via dilution.

Printing money does nothing to add value to the economy. It does not create goods or services which can then be consumed. The U.S. dollar is fiat money, which means its value derives from the government's order that it must be accepted as a means of payment. The bills or coinage Americans use are worth substantially less than the amount they are representing. One interesting exception to this is pennies minted prior to 1983. They are 95% copper and actually worth closer to one and a half cents. Hard commodities including precious metals, lumber, steel, concrete, and crops have all seen major price increases just like copper.

Fiat money has value by decree with no material value beyond the materials from which they are composed. Flooding the money supply with more new fiat money means that there are more dollars competing to buy the exact same amount of goods. This typically leads to higher prices, best known as inflation. The higher prices mean it will take more dollars today what fewer dollars could buy yesterday. In a nutshell, the dollars are worth less than before. In time the dollars will not only be worth less, they will be worthless.

The government uses the term "core inflation" to describe what it claims to be the actual rate of inflation. That figure, however, excludes items that have volatile price movements such as food products and energy. Basically, it's a lie. By excluding food and energy from the calculation, the core inflation figure skews substantially lower. This makes the government look like it's doing a better job in handling the economy than it actually is. Additionally, entitlement programs like social security have their annual increases pegged to core inflation. By keeping the number artificially low, the government is able to give a "cost of living adjustment" increase that fails to keep up with the *actual* cost of living, thereby saving the government money.



Using the pre-1980 method for calculating inflation would suggest the current real rate of inflation is 13%, not 5% per the new method.

Excluding food and energy from the consumer price index (CPI), the primary statistic used to calculate core inflation, has occurred since the Carter administration. Just how severe is this problem? John Williams of shadowstats.com suggests that had this change in calculation not been made, social security payments would be <u>double</u> what they are today. While social security was never designed to provide a posh lifestyle, most Americans would probably agree there's a substantial difference in receiving $1600 vs. $3200 when one is retired and on a fixed income.

Core inflation has fluctuated between 1% and 3% this decade. Many economists now believe that the real rate of inflation when food and energy are included is between 9% and 14%. The effects of higher inflation are far-reaching and distributed inconsistently among individuals. Not only does inflation discriminate against certain individuals, ***it actually favors others***.

Because inflation devalues dollars over time, those individuals possessing many dollars in a cash or liquid form have significant exposure to the negative effects of inflation. Ironically, this means that conservative savers of cash are harmed for their cash positions. The very people that believed they were doing the best they could to prepare for retirement by being diligent savers were in fact "punished" for their efforts.

The S&P 500, as measured in dollars. Investing in the index 10 years ago would have yielded a negative 14% gross nominal return, excluding inflation.

If a saver uses a cash account such as a certificate of deposit earning 4% while real inflation is 8%, the saver's account has actually diminished in real value though its nominal value has increased. Meaning, $100,000 would become $104,000 at the end of the first year. At the same time, the goods and services that $100,000 would have purchased rose in price to $108,000. It's clear the saver has earned $4,000, but those dollars failed to keep pace with inflation and the total investment as lost value. Being a conservative saver in a highly inflationary environment is a way to ***virtually guarantee the investment will lose value year after year***.

Inflation also affects the earnings of many companies since they face rising costs. They eventually have to raise prices which in turn can lower their sales volume. Ultimately this can translate into poor quarterly performance followed by a drop in share price. With millions of Americans invested in the stock market via their IRA's, a falling market can alter or even ruin an individual's retirement account. A market crash affects middle America, and not just a minority of active traders.

Since October 2007, the S&P 500 Index (a broad measure of stock market performance) has fallen a whopping 39%. This means that even conservative portfolios that are invested in equities have been hammered hard in the last year. Millions of Americans have lost 1/3rd of their retirement savings in a single year. Imagine the ramifications of not only having a retirement account substantially smaller than what was originally planned, but additionally a social security check that is half the size (or less) than it's supposed to be just to keep up with inflation!

Instead of using dollars as the metric, here the S&P 500 is measured in ounces of gold. When measured using "real money" inflation is revealed: The 10 year return is negative 68%!

While savers are harmed by high inflation rates, **the opposite is true for borrowers**. When a borrower accepts money today, he is able to pay back his debt using progressively weaker dollars. One way to see this principle in action is to look back in time at an old real estate purchase.

In 1970 a 1500 square foot home could be purchased in Los Angeles for about $28,000. Assume that a buyer purchased such a home with a $1,500 down payment and took out a $26,500 interest only loan at the prevailing rate of the day. Also assume that every 10 years that loan was refinanced for another 10 years of interest only payments. Today, 38 years later, that house would be worth about $520,000. The loan would still be $26,500 – the same amount owed the day it was purchased.

Whereas originally that loan represented almost 95% of the value of the property, it would now represent a mere 5% of the total value. This acquisition of 90% of the value (equity) of the house was accomplished

without ever paying a single dime to reduce principle! Had that buyer been told in 1970 to get an interest only loan with the idea of never paying off the house, they probably would have thought their advisor had lost his mind. By now the message should be clear: Wise borrowers that invested in real estate in an inflationary economic environment *are rewarded by having their borrowed dollars devalued*, and their properties' equity shifted onto their balance sheets.

While this concept is easily explained by the aforementioned house purchase example, it is often not so easily embraced. For one, most people are taught that saving is "good" and borrowing is "bad." On the surface, the current condition of our economy would seem to further reinforce that ideology and provide real world proof that it is correct. The problem with such a simplistic analysis is that it fails to address the key factors that created the current economic situation.

The current problems primarily stem from lenders providing financing on homes with zero or very little money down – often to borrowers with poor credit and unprovable income. The problems were then compounded with borrowers taking equity out of their homes and spending the cash on consumables such as cars, electronics, and vacations. In some cases the money pulled from house equity was spent on more overpriced/overvalued real estate that amounted to nothing more than buy-and-flip speculation.

No money? Bad credit? The old lending guidelines were too loose and helped create today's problems.

Purchasing consumables on credit that lose value creates what is known as *destructive debt*. It is the kind of debt that reduces wealth. Borrowing money for the purposes of earning even more money is known as *constructive debt*. This kind of debt can be used for any investment purposes. Even a student loan can be considered to be constructive debt if the purpose of the schooling is to eventually get a higher paying job. Constructive debt is "good debt" that has the purpose of building wealth. This is the concept that some people struggle with. Not all debt is bad. More examples of good debt would be borrowing money to start a new business, or perhaps funding solar panels on credit that will eventually more than make up their cost by saving energy.

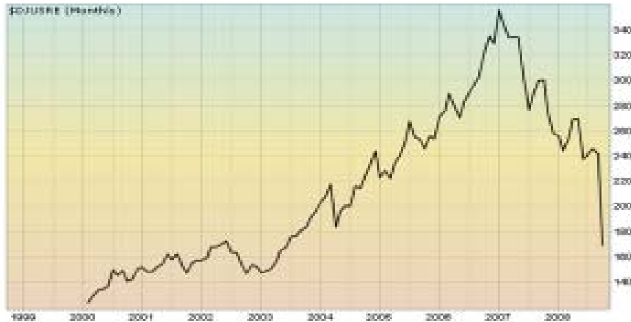
Benefitting financially as a borrower is not a question of morality as some may believe, but rather an observation of fact. Borrowers that create constructive debt tend to build wealth, and borrowers that create destructive debt lose wealth. Savers that thought they were being constructive are likely failing to beat inflation and thus losing overall value. They may feel as if they are being reprimanded for their "good" behavior. However, the various markets do not preach morality or pass judgments. They reward investors that invest wisely, and punish those that do not. Acquiring the right investment properties using constructive debt can be one of the most lucrative ways for the average American to make high returns year after year.

Experts' Opinions

One indicator of which course of action to take is to follow what is known as the "smart money." This means nothing more than following in the footsteps of a bona-fide expert. For the purposes of this article, an expert is someone who has actually earned *millions or even billions of dollars* using various investment vehicles.

Commodities investor Jim Rogers partnered with the more famous billionaire George Soros (worth $9 billion) in 1970 to form Quantum Fund. Over the next 10 years, investors in the fund saw their money grow over 3300%, compared to the S&P 500 Index advancing a mere 47%. In a recent interview, Rogers was quoted as saying, "We're in for the worst recession since World War II, as well as higher long-term interest rates, higher inflation, higher taxes, a weaker dollar, and substantially lower stock prices."

Jim Rogers is one of the most experienced, *successful* investors in the world today and his statements should not be taken lightly. He acknowledges that high inflation is on the way, and that stock prices will continue to decline. He also believes that higher taxes are going to come into play. Amazingly, real estate as a single investment class addresses all of the concerns Rogers has raised. Not only does it combat inflation through appreciation and higher rents, but it also has the ability to reduce taxes by being depreciated on the books.



Examination of the Dow Jones U.S. Real Estate Index reveals that despite the recent downtum, real estate on a national level is still at least 40% higher in nominals dollars from approximately nine years ago.

Billionaire Sam Zell earned the moniker "The Grave Dancer" for buying up distressed commercial real estate properties in the early 1990s. When asked recently by CNBC where the housing market will go, Mr. Zell responded "I don't think it's going to be anywhere as near catastrophic as people envision." But the single-family housing market, whose collapse is at the heart of the credit crisis, is close to the bottom, he added.

"I would be surprised if we don't see the bottoming out of the single-family housing market, and I make a distinction between single-family and condos. I believe that we're nearing the end of the single family (residence) problem…I really think that next spring is going to be a reasonable year," he said. When commenting on the public's currently negative opinion of real estate, Zell commented, "If you bet against conventional wisdom, you'll do terrific." Remember, Sam Zell and Jim Rogers are not talking heads reading business news off of a teleprompter. They are the real deal, and to follow their lead would be wise.

The Opportunity Is Now

It's rare to have a convergence of circumstances that create perfect investment conditions. Right now is just such a time. While financing is relatively inexpensive, not everyone can qualify with today's more strict underwriting guidelines. But for those that qualify, the conditions are about as perfect as one could hope for. To summarize:

1. The current supply of real estate is very high, creating a "buyer's market." The time to buy is when supplies are high and sellers feel hopeless. The best prices and incentives can be expected during such a period.

2. Interest rates are near historical lows. This translates to low mortgage payments which in turn help maximize the cash flow of the investment property.

3. The Government is on your side. The Government has favored real estate as an investment for years by allowing owners to depreciate their properties and minimize their taxes. As if that wasn't enough, the Government is now actually *subsidizing the entire housing sector* buy purchasing mortgages and acting as a backstop for failing banks. The Government has a vested interest in stabilizing prices and eventually leading the market to recovery. There is virtually an endless supply of money that will be used to prop up this sector!

4. While the large subsidy may be good specifically for the housing sector, the end result of printing fiat money is high inflation. By borrowing constructively for the purpose of acquiring undervalued real estate, investors simultaneously take advantage of the government support while using inflation in their favor to reduce real debt. Individuals not investing in real estate will not be sheltered from the negative effects of inflation, and will see their dollars lose value.

5. The stock market's performance over the last year has caused great damage to millions of retirement accounts. While it's certainly possible for stocks to rebound along with real estate, stocks still lack many of the benefits associated with real estate. They do not have constructive debt against them to hedge against inflation, they do not produce rental income, they cannot be leveraged 5 to 1 (putting down 20% to control the entire investment), and they cannot be depreciated for tax purposes. Furthermore, they are not "real assets" like real estate. Stock certificates, if an investor even receives them, are paper representing fractional ownership in a company. Real estate is a hard asset that directly provides value (shelter). An IRA has penalties for drawing funds outside of the set age restrictions. Real estate has no age penalty – it can be sold at any time, penalty free.

6. To further the comparison with stocks, real estate can be borrowed against with no penalty. A 401k or IRA carries a penalty for borrowing against it. Income that is taken from an IRA is taxed at the individual's ordinary tax rate. Real estate capital gains are taxed at the lower capital gains rate of just 15%.

7. Despite the excellent climate for real estate investing, not all markets offer equal opportunities. Markets most suitable for investing offer properties at *or even below* the average local cost of construction. Buying a property where the average replacement cost per square foot is higher than price of the property being sold helps create a "floor" in the price of that property. The best markets also feature relatively high rents that more easily create a positive cash flow situation for the investor. These markets also feature strong growth expectations in their economies and populations. Investors must be willing to invest in markets across the nation to acquire the best values available.

8. Using professional management companies is critical in sparing investors from minor tasks, money collection, and phone calls in the middle of the night. This allows them to focus on the "big picture." While hiring competent management will handle the brunt of managing properties, investors must always oversee the managers to ensure maximum returns.

Now is the time to capitalize on the convergence of favorable conditions. It will not be long before prices rise, dollars devalue, and perhaps even retirement accounts dwindle down further from over exuberance in the stock market. Today's conditions present an opportunity to not only protect and diversify wealth, but to grow it despite high inflation and faltering markets. Purchasing fairly priced real estate in undervalued, growing areas, can ultimately lead to steady wealth creation far beyond what any other asset class is capable of producing.

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Ken Adler has been a licensed real estate broker since 1996 in the volatile Southern California market. Originally working as a mortgage broker, he developed a systematic approach towards real estate investing that helps both new and experienced investors alike. Highlights of his techniques involve seeking out value locations and properties throughout the United States, and using optimal financing programs to maximize cash flows for his clients. He is the owner of Ideal Financial, Inc., a real estate investment and financing brokerage located in Encino, California. Call today for a free consultation. (818) 789-5500