What Makes Real Estate The World's Best Investment?

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SPECIAL REPORT

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I. Introduction

As the "baby boom" generation ages, concern about adequately funding retirement has reached a fever pitch. Social Security looks less and less likely to provide any semblance of former benefits in the near future, driving individual investors to take charge of their own financial future. Investors are looking for the simple answer, the "magic bullet," to funding a long and happy retirement. What type of investment will give the best performance over the long haul?

Many financial "experts" argue that over the long term, the stock market has outperformed all other investments. This claim is based on the assertion that from 1926 to 2005, the S&P 500 returned an average annual 10.46% gain. Putting aside for a moment the veracity of that assertion, we'd argue instead that real estate has been and, in fact, remains the world's best investment.

The ownership of small income properties (such as single family homes, duplexes, and small apartment buildings) is a path to wealth building that you can count on. A real estate investor uses small properties to grow wealth in six key ways:

1. Collecting a dependable and growing income (rents)
2. Value increases (appreciation)
3. Mortgage payoff (amortization)
4. Value creation (property improvement)
5. Instant gain (bargain purchase price)
6. Government benefits (tax credits, tax deductions, rent vouchers, advantageous loans, etc.)

In the pages that follow, we'll take a brief look at the components of a "good" investment. What factors must you consider as you strategically try to grow your wealth and build your retirement nest egg? How can you evaluate an individual investment opportunity? We'll then use these criteria to compare a typical investment in small income properties and investments in stocks. You will see how real estate can offer you a clear path to prosperity.

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II. What Makes a Good Investment?

No specific class of investment is *always* better than another. A shrewd investor looks carefully at several aspects of each investment opportunity and considers relative price, yield, and risk. While market trends and indices can provide some helpful information, you certainly shouldn't base your investment decisions on such broad markers. Your goal as an investor is to protect and grow your wealth by making *individual* investment decisions that help you achieve your own unique goals.

Let's examine the factors that help determine what kind of a return you'll earn on a particular investment and how likely that investment is to help you achieve your personal investment goals:

- Income flow
- Accumulation of equity
- Protection against inflation
- Preservation of capital

a. Income flow

One component of the total return earned by an investment is the value of any cash flows that asset is expected to produce over time. For instance, in the case of stock ownership, income is obtained through the distribution of dividend payments. In the case of a small income property, income is obtained through rent paid by tenants.

When evaluating the overall *value* of an asset, an investor will consider both the expected price appreciation and the *present value* of expected future cash flows. That is, estimating the current worth of an asset based specifically on the amount of cash the investor expects to receive in the future by virtue of owning that asset.

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b. Accumulation of equity

The overarching goal of investment activity is to build your wealth by accumulating equity over time. Several factors impact how well and how quickly a given investment helps move you toward this goal:

- **Appreciation:** One fundamental way to earn money on an investment is to purchase an asset then sell it at a later date for more than you paid for it. *Appreciation* refers simply to the increase in the price of an asset over time. Appreciation is one component of total return on an investment. For instance, a piece of artwork purchased for $1,000 in 2000 and sold for $1,500 in 2002 has appreciated $500 (50%) over two years.
- **Leverage:** The ability to *leverage* refers to an investor's ability to control an asset of greater value than the cash invested, generally by using borrowed money. Shrewdly using leverage is a powerful way to magnify returns.
- **Creating value:** An investor may be able to increase the value of his investment by altering the asset in a strategic manner. Such improvements might increase the price others are willing to pay for an asset, or increase the income that asset produces.
- **Tax advantages:** Certain types of investments and investment techniques allow an investor to take advantage of opportunities to avoid undue taxes. The less tax you pay, the higher your return will be on a given investment.

c. Protection against inflation

One of the single biggest threats to long-term investments is *inflation* (the general increase in the overall level of prices over an extended period of time). Historically, inflation can be counted on to reduce the value of your money by about 3.2% per year. When considering the value of different investment options, you must account for the impact inflation—often experienced at variable and unpredictable rates—will have on expected future returns.

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d. Preservation of capital

Volatility refers to the tendency for an asset price to fluctuate sharply within a given time period. Assets that experience rapid rises and falls in price over short time periods may be difficult investment choices for individuals with a low risk tolerance or for those who are looking at a shorter investment time horizon. The relative volatility of an investment impacts the risk that the price of the asset will actually fall below your purchase price. For instance, had you invested in a Nasdaq index fund around the time of the market's peak in March 2000, you could have lost a significant proportion of your original investment as prices declined dramatically and (effectively) permanently.

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III. How Does Real Estate Stack Up?

Let’s take a look at how an investor can evaluate different types of investment opportunities according to the components of a “good” investment that we just described.

a. Income flow

The worth of an investment is measured in part by the amount of annual income it can be expected to generate—now and in the future. Many investors have the explicit goal of creating a healthy annual income during their retirement years.

Let’s first look at the income flows generated by stock ownership. What do we know about the dividend yields of stocks (the annual income that stocks can be expected to provide)? In June of 2006, average annual dividend yield for the S&P 500 was at 1.8%. The average dividend yield of the Dow Jones Industrial Average was 2.3%. The owner of a small income property, by contrast, can expect to earn an annual net operating income of between 6 and 12 percent. With careful property selection and management, rents can provide a generous and steady annual cash flow.

With such low dividend yields, how are stocks going to provide you with an inflation-adjusted annual income for a long retirement? To draw a significant retirement income, you would need to invest a tremendous amount of capital. One million dollars invested in stocks might pay you $20,000 per year; that same amount invested in a small apartment building could pay you $60,000 or more each year.

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b. Accumulation of equity

Appreciation

When we look at the past to inform our future decisions, we often give more weight to the events of the more recent past. Our collective memory, therefore, tends to emphasize a period of incredible price appreciation in the stock market. The years between 1981 and 2001 saw tremendous price growth (the Dow-Jones Industrial Average grew by nearly 14% annually) in the stock market. During such periods, shrewd investors are able to take advantage of rapid price appreciation while focusing on preserving their capital (consider the "dot com" boom). Over the very long haul, however, we see that there are periods in which stock prices appreciate much more slowly, or even fall. From 1906 to 1981 the DJIA experienced only about 2.75% compound annual growth.

So how does real estate price appreciation compare to the observed appreciation in the stock market? Because of the private and unique aspects of the ownership of small income properties, it's far more difficult to generalize about price appreciation. However, one piece of data that we can examine for comparison over time is the median price of a single-family home in the United States. While not a perfect measure, it can give us an idea of overall trends in the broad U.S. market.

If we compare home price appreciation over time to stock market appreciation, we see that in some periods (1960 to 1982, 2000 to present), single-family home prices have appreciated faster than stocks; while in others (1982 to 1999), stocks have appreciated faster than home prices. Overall, and over the very long term, the growth in price is fairly similar.

However, appreciation alone does not tell the whole story. Although overall long term growth in price is comparable, investors in income properties can accumulate equity much more quickly and predictably than investors in stocks. To understand why, let's look at the effects of leverage.

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Leverage

Leverage is a powerful reason for investing in small income properties. If an investor uses 100% cash to acquire a house worth $100,000, and the house increases in value by $5,000 in one year, the investor makes a return of 5% (assuming no other costs). However, if the investor obtains 90% financing, only $10,000 cash is required at the closing table, and a bank or other lender loans the remaining $90,000 to acquire the property.

Assuming the same $5,000 increase in value, the investor's cash contribution of $10,000 yields an increase in equity of $5,000 in one year–a 50% return. Readily available financing at favorable terms helps the real estate investor buy, and earn, significantly more than he or she otherwise would.

These favorable lending terms make it possible for small investors to grow acorns into oak trees over time. Imagine this fairly conservative scenario: Joe Smith purchases a small apartment building in his hometown. He puts 20% down and finances the remaining 80% of the purchase price with a 30-year mortgage. Joe's rental revenue is just enough to cover his mortgage payments and operating expenses. He isn't bringing home any additional income from owning the property. Isn't Joe merely breaking even?

Far from it. Joe has purchased a predictable accumulation of equity. Even in the unlikely scenario that the property doesn't appreciate, and rents do not go up in the future, equity is built up with each mortgage payment—with no additional money coming out of Joe's pocket. As Joe's equity grows, he can consider borrowing against it and using those funds as a down payment on another income-producing property. In this way, Joe—and other savvy real estate investors—can "pyramid" equity into more wealth.

Leveraging cannot be applied so effectively when investing in other types of assets, such as buying stocks on margin. At around 1.8% to 2.3%, the dividend yield from stocks is generally not sufficient to cover interest payments on the debt (typically around 6-10%). This means an investor will have to pay money out of pocket to cover finance charges. Further, if a stock price falls enough, even temporarily, the lender may demand that you provide additional capital. If you fail to provide the additional capital, you will be considered in default and the broker may sell your shares. A mortgage lender, by contrast, cannot require that you provide additional capital if the market goes into a temporary downturn.

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Creating value

It's not possible for the typical small investor in stocks or bonds to exert any substantial control over the performance of the purchased asset. The savvy owner of a small income property, on the other hand, can take advantage of opportunities to create value by making strategic improvements or employing a shrewd market strategy.

Tax advantages

A real estate investor is able to take advantage of a number of tax avoidance techniques and strategies. If a small investor sells stock to purchase more, he or she will lose part of the investment through taxation. A real estate investor, on the other hand, is frequently able to reinvest the proceeds of a sale to take advantage of the 1031 (or "like kind") exchange and avoid capital gains taxes.

c. Protection against inflation

No investor should underestimate the investment-eroding power of ever-climbing prices. Even moderate rates of inflation can significantly diminish the buying power of your future income.

Because stock market investments offer such low dividend yields, an investor must count on price appreciation that consistently outpaces inflation rates. But has that been historically true? If we look at the performance of the stock market during America's greatest inflationary period (1965 to 1982), it's clear that stock prices failed to keep pace with inflation.

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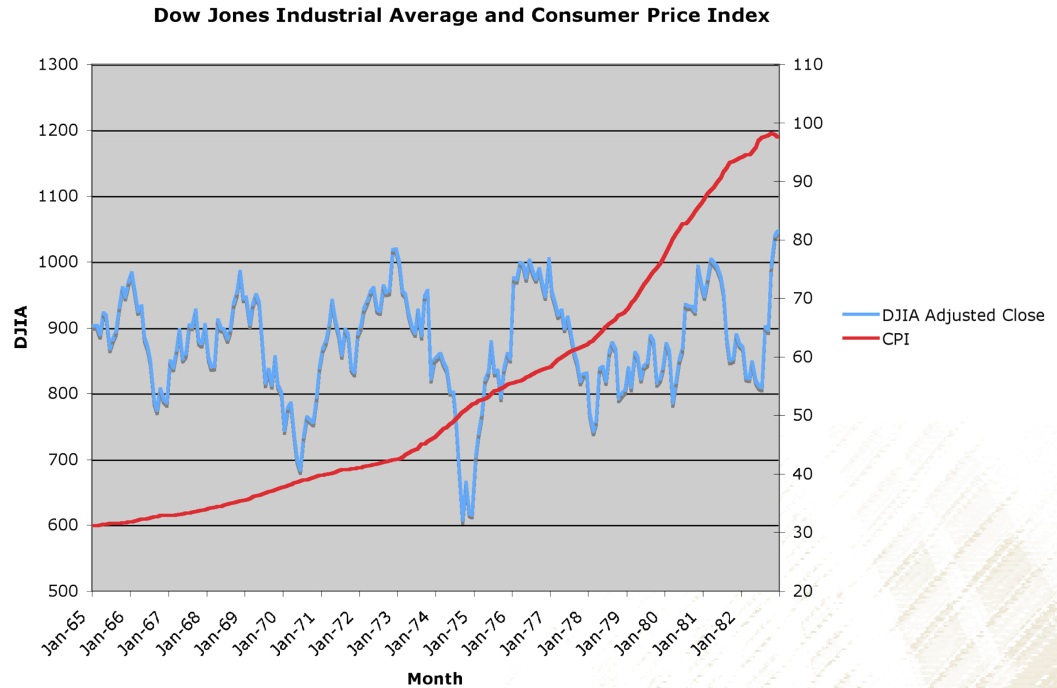

Unlike stocks, real estate can offer dependable increases in both price and income—even during inflationary periods. While no national index can capture these trends perfectly, it's clear from experience that home prices rarely sink like stocks and that rents persistently rise. In fact, a reasonable estimate of an annual rate of rent increase is 4 to 6 percent—the rate of inflation plus the annual increase in national productivity. Typically, property prices only fall temporarily during periods of serious recession or unemployment, during times of local overbuilding, or after periods of increased speculation.

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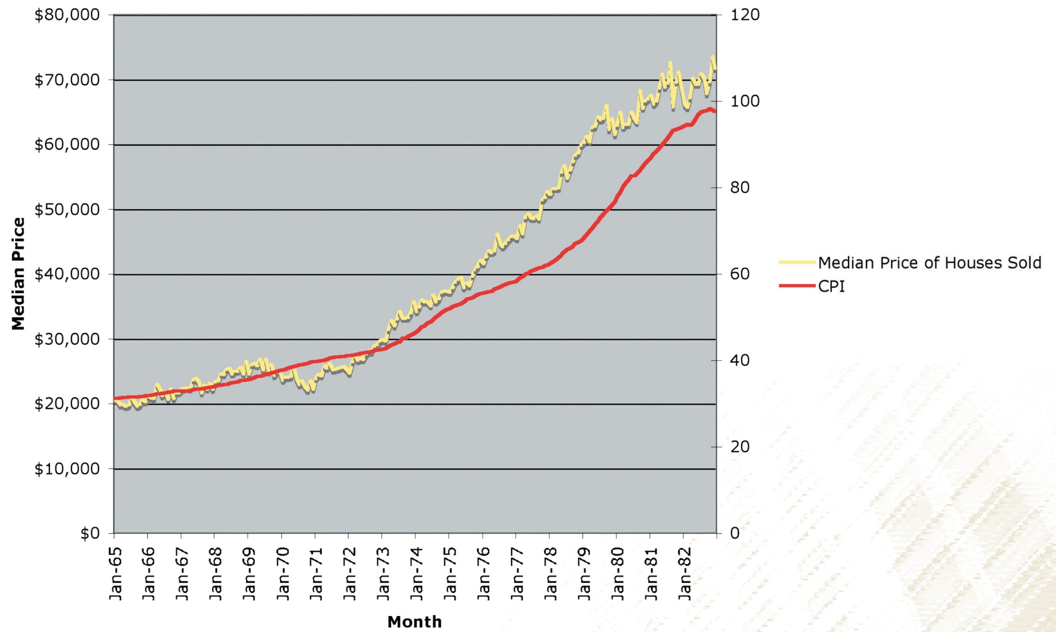

Not only do properties maintain their value during periods of rapidly rising prices, they also maintain value during times when prices rise more slowly. When the inflation rate is high, value is maintained because costs increase and the supply of new property is restricted. When rates of inflation are low, values still rise as lower interest rates increase affordability.

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d. Preservation of capital

As we've seen in recent years, it's possible for stock prices to soar beyond the biggest optimist's predictions. It's also possible (and probable) that prices will suffer unimaginable downturns. Stock prices are comparatively volatile, with lots of dramatic up- and downturns.

The prices of small income properties, on the other hand, show a more gradual, steady rise through time. While real estate prices are certainly subject to cycles, it historically takes some very special circumstances (such as large-scale recession or unemployment) to make residential prices and rents fall significantly. In addition, while some of the value of real estate investments is found in price appreciation, much of the worth of the investment is tied to the annual cash flows (rents) it can generate.

Recall that a key component of successful investing is making sure that an investment *preserves your capital.* Imagine a stock market investor who has the unfortunate timing of investing a good amount in a Nasdaq index fund in early 2000. Prices are rising almost as fast as analyst's "dot com" earnings estimates. The market is reaching previously unimagined heights and our investor has already started shopping for a retirement home. Then, suddenly, our investor is hit with staggering losses. Over the next two and a half years, the value of his portfolio sinks by 40 percent—and his portfolio is now worth less than he paid for it. This plunge in stock prices is possible because the prices are not tied closely to the income-producing power of the asset.

Unlike companies that can "go broke," well-selected properties and locations are rarely subject to permanent declines in prices. As we saw earlier, housing prices are much less volatile than stock prices and, as such, are better able to help you preserve capital.

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IV. Conclusion

While no single class of investment is *always* a better choice than another, it's easy to see how investment in small income properties can help you build your wealth and meet your retirement goals. Real estate investment offers steady appreciation *and* delivers a strong, inflation-adjusted annual income. In addition, leverage and tax advantages are powerful investment tools.

A small investor who takes the time to build his knowledge and skills is much more likely to make good, fact-based buying and selling decisions about investment properties than he is about stocks. No small investor is going to beat Wall Street insiders or be able to buy stocks below market value. The knowledge and influence required is simply not accessible to the small investor.

In real estate investing, on the other hand, a small investor can conduct thorough research and analysis of individual properties. An investor can learn about a market by walking the neighborhood and talking to property owners. He or she can head down to city hall and look up sales and tax information and use that knowledge to help acquire properties at bargain prices. The small real estate investor is even able to negotiate price with sellers—something inconceivable in stock market investing!

As more and more individual investors recognize the wealth building potential of investing in small income properties, earning high returns will become more and more challenging. To succeed, an investor must be more educated and more entrepreneurial than his competitors. Knowledge is the key to your achievement in real estate investments.

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No matter which channel you use to grow the value of your real estate investments, you must be able to:

- Use leverage wisely
- Strategically analyze local markets
- Negotiate shrewdly
- Make targeted improvements that increase property value
- Manage properties strategically

Courses in the Real Estate curriculum at Trump University provide training in these and other skills necessary to get the highest returns from income-producing properties. In our comprehensive Investor Training program, students learn and apply investment techniques in a realistic practice environment, shortening the time it would take to accumulate experience in the real world. Log onto www.trumpuniversity.com. for more information.

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About the Author

Gary W. Eldred, Ph.D., is the head of Trump University's real estate faculty. He has worked as an investor, consultant, professor, and author in the field of real estate for more than 25 years. He frequently speaks at major investment conferences and has been interviewed/consulted by journalists at CNN, BBC, Fortune, The Wall Street Journal, The New York Times, and many others. Dr. Eldred, has authored 21 books, including *Investing in Real Estate* and the series, "Make Money in Real Estate." He has also written or co-written three college textbooks and many academic articles and research papers. Dr. Eldred began acquiring properties at age 21, and today his properties include residential rentals as well as ownership interests in office buildings, shopping centers, and apartment communities. As a real estate consultant, Dr. Eldred has served Fortune 500 companies such as Wells Fargo, Georgia Pacific, and Century 21, as well as entrepreneurial investors and property developers. He has held faculty positions in the graduate business programs of Stanford, University of Illinois, and University of Virginia. He has also taught urban land economics and real estate investing at the University of British Columbia, and the American University of Sharjah in Dubai.

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