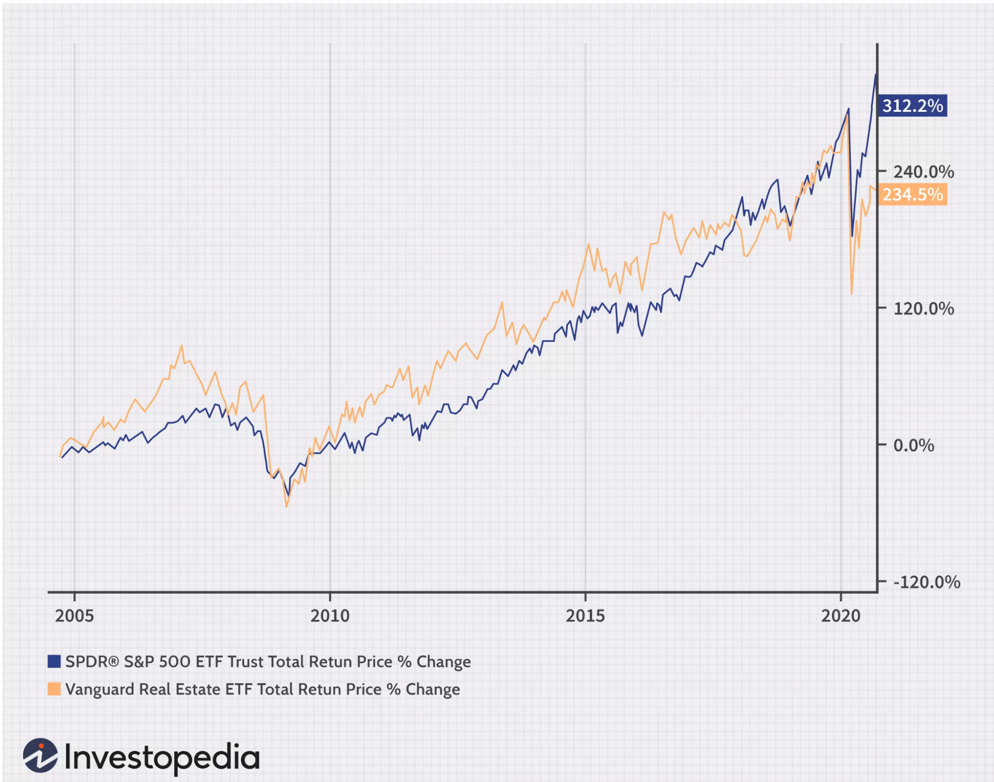
Authors: Zaman Naseer, Hailey Schendel, Jake Canfield, Megan McInerney, and Andrew Cade

A Detailed Analysis of Real Estate as an Investment, and Alternatives

Do you ever find yourself wanting to invest in real estate for stable cash flow, the attractiveness of being a tangible asset, or the opportunity to maximize equity and eventually cash out on your capital appreciation? If you answered yes to any of these opportunities, it is possible you are a victim to mainstream investment pitches. While characterized as a luxurious and lucrative gold mine, the reality of real estate is brimming with hidden pitfalls that outweigh its possible success - pitfalls many individuals are not ready to handle. Real estate is not a realistic venture to improve your financial health. In fact, 95% of real estate rental investors fail because they are either not properly prepared for the commitment or they simply cannot recover from the inevitable costs; the other 5% have dedicated their lives to the cause.

Similar to most "as seen on TV" products, investing in tangible real estate may not pan out as successfully as it may seem from the outside. Before you buy, first determine whether or not you can afford it. Even if you can rent it out or deduct part of the costs of ownership from your taxes, a second home is primarily a luxury, not an investment. You should buy one to add value to your life instead of to your net worth. At BWFA, we believe there are far better investments by taking advantage of the vast possibilities in the stock market. The real estate market has specific characteristics which impose several consequences such as illiquidity, high maintenance fees, property taxes, low rates of return and realized gains, many opportunity costs, and a lack of control over your investment for your future.



It is conclusive that investing in real estate may have the outcome of illiquidity. First and foremost, the most jarring aspect of tangible real estate is the fact that it is highly illiquid. To buy and sell property is a very taxing process on both your wallet and your time. If one were to need cash immediately, it is not as simple as withdrawing money from a bank account or selling holdings in the stock market. Selling a house would require a real estate agent, a hefty chunk of your equity in closing costs, and time. Additionally, due to the volatility of the real estate market, one may have to wait years before a time presents itself that a home sale could break-even. This means that you may end up having to pay tens of thousands of dollars out of pocket in the attempt to free yourself of a second home if you are not able to wait several years before sale.

When a homeowner becomes tied up in a financial investment such as real estate, where cashing in on returns is a lengthy, costly, and a very involved process, other opportunities must be passed by to responsibly manage the existing investment. One cannot use the existing asset, a home, to purchase other investments, and one can not reduce the amount of capital invested in real estate to partially free up assets. For example, if an individual were to find out about a fantastic new business opportunity on the stock market, she could not invest or gain from that opportunity with the equity tied up in her home. She would sacrifice many of the resources invested in her home by rushing to market or making a quick sale. By the time the optimal market for selling the home was identified, an ideal price agreed upon, and a contract settled, she will have foregone many of the gains to be made with more liquid investments. In contrast, stocks, and other more flexible investments allow more flexibility and opportunity to change, grow, and leave when it is opportune by simply trading in or selling investments, without the financial obligation of hiring a team of contractors for repairs, a team of professionals to advise you on how to retain enough from your sale to cover the mortgage, or a realtor to manage the sale.

To illustrate how much an investment home costs in opportunities compared to a traditional investment account, if an individual were to buy a $200,000 investment home with a 20% down payment and take out a 30 year loan, they would have a $757.00 mortgage payment per month. However, if the same investor were to take the same $40,000.00 down payment and invest it into a managed investment account with the same $757.00 monthly contributions, and leave their investment for the same predicted 30 years with average performance (7% annual returns, with an average of 1.02% of the account balance retained quarterly as a management fee), they would have approximately $529,000, or 264% more than the initial value of their home. This also saves the individual approximately 40-50 hours per year in labor to maintain their home and eliminates the need for a paid crew of legal, sales, management, and maintenance staff required for an investment home. Most importantly, if the same individual wanted to pursue a new opportunity, liquidate their assets, or make any other major change to their investment account, they would not have to go through months of repairs, hired sales, and legal pain, and they would be subject only to minimal transactional costs to buy in or sell out of any stock and taxes to cash out.

Furthermore, to supplement monthly income immediately, the same individual could put $200,000.00 into the same managed investment account rather than purchasing an additional $200,000.00 property. You could withdraw $500.00, five times more than the average monthly return of a rental property, every month for thirty years and still make a profit on your overall investment with a predicted ending account balance of $205,000.00. These predictions were calculated based on national averages per Investopedia and the Bankrate.

In addition, there is little opportunity to diversify one's investment in a second property. As one of the defining principles of any good investment portfolio, diversity is critical for ensuring security and stability in an investment profile. While you may leverage the equity in one home to buy another, however, this is far from the diversified security of holding many investments in entirely different markets, where gains can be easily realized and new opportunities can be immediately explored while retaining much of your assets in more secure, long-term growth options. By comparison, a property takes a large chunk of funds and traps them in a market where all of the investment is vulnerable to fluctuations in the market.

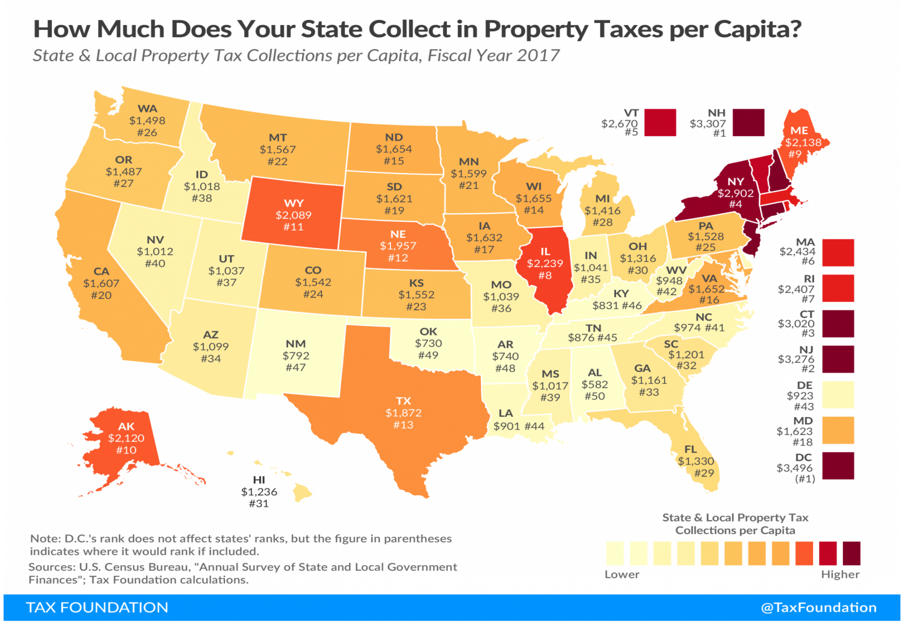
One may counter this thought with the broadly understood knowledge that prices for homes have increased predictably since the 1970's, and that revenue from rental properties can run up into the tens of thousands each month. Generally, one may perceive this as an homeowners dream, as your investment will almost certainly be worth more over time and incoming cash will be substantial. Unfortunately, and more often than not, these earnings are eaten up faster in transactional costs than they can come in. In the following pages, we will discuss a plethora of factors which must be considered when determining what financial gain you are able to actually retain.

The cost of maintaining this home is a huge factor for consideration when evaluating your investment. For example, if someone were to buy a home and hold their investment for thirty years, the selling price of that home will be much greater today than what it was purchased for thirty years ago in 1991. If an individual were to buy a home in Maryland in 1991 and maintain that home for thirty years, the recurring taxes and maintenance alone according to Freddie Mac recommendations would indicate that they could expect to pay 120% of the worth of their home in maintenance alone, giving a seller little room for transaction costs, taxes, or unexpected repairs needed upon sale. In addition to that cost of maintenance, the cost of annual property taxes are a recurring drain on any potential gain from that asset, and the opportunity cost of foregoing better investments for that thirty year period are more than considerable.

Another significant aspect to note is the cost of repairing and staging a home. Throughout your span of owning this investment there will need to be yearly repairs. When investing in real estate most people overlook the prices of these repairs; however, after years of repairs the costs add up resulting in even more expenses. On average, one can typically expect to spend 1-2% of the worth of their home on repairs each year. Some common repairs or wear and tear problems include: landscaping, electrical issues, plumbing, and broken or damaged fixtures. As the years go on, other repairs begin needing attention like: flooring, roofing, water damage, and repairing baseboards. Before placing your home on the market there are most likely dozens of repairs needed to the house

If these repairs are not taken care of oftentimes buyers tend to overlook your property, or seek to buy only after a drastic reduction in value of the home. The longer a house is on the market the less desirable it becomes to the market, because people begin to question what issues the house has. Before putting your home on the market, you need to make the house look presentable. This includes fixing all the cracks and holes in the walls and driveways, making sure all of the utilities are running smoothly, painting, etc. After years of damage to this property, the time and costs of its repairs will add up and take even more of the possible revenue away from this investment.

Also, when thinking about investing in real estate an individual should keep in mind attorney fees, property taxes, transfer and title fees, homeowners association fees, and other courier fees. Even after investing a large portion of your assets in simply maintaining your investment, there are yet more fees to cash out of it, and more fees if you succeed in making money. These additional costs incurred when selling a home drag on the gain generated from your sale, often creating negative returns. On average, sellers pay between five and six percent of the closing cost of the home in realtor fees alone. This means that to sell a $300,000 home, the simple cost of having a realtor to show the houses could be between $15,000 and $18,000. In addition to this, sellers often assume financial responsibility for many of the buyer's fees, contributing yet more to the ever-growing drains on your investment.



To illustrate transactional costs and the difficulty of retaining earnings in tangible investment properties, the above graphic is a representation of the cost in taxes on capital gains, by state, if any are made from the sale of an investment property. These do not include federal gains taxes, which can cost between 10-37% of the gains from your sale depending on your tax bracket.

To view the reality of where additional revenue from renting a second property will go, the graphic below illustrates a breakdown of your monthly earnings and costs based on average rental income and costs for a three bedroom house. These calculations show that investing in real estate will not give you the grand payout you are hoping for as passive income. We have assumed a generous rent amount to be charged but in reality, a $3000 rent for a three bedroom can be very difficult to achieve. In addition to a generous rent, we have assumed a fairly low mortgage rate from a range of averages.

Average Cost of a Home in the US: **$500,000**	$500,000
Average 30-year Fixed-Mortgage rate: **2.8%**	
Average Property Tax: **1.1% of avg home value**	
Monthly mortgage payment: **$2,062.00**	($2,062.00)
Monthly Property Tax payment: ($500,000*1.1%)= $5,500/12 months= **$458.33**	($458.33)
Assumed Rent for this house: **$3000/month** (aggressive)	$3,000
Presumed monthly maintenance costs using 1.5X rule= 1.5*$3,000= $4,500/ 12 months= **$375.00**	($375.00)
TOTAL Monthly Expense= **$2,895.33**	
NET profit / month= **$104.67**	$104.67
Annualized Return= 7.2% Annualized Profit= *0.25%*	
Average Return of REITs in 2020= *10.5%*	

Lastly, one must consider the value of time spent in managing an investment property. This may become quite costly for those who are liable for managing repairs, maintenance, inspections, rental contracts, and renters, in addition to their normal working lives. Homeowners spend an average of 40-50 hours per year maintaining and managing each additional property, which can be a heavy and costly burden as time goes on, especially given travel and time away from one's present commitments. Legal litigation, risk managers, and property managers required to keep renters in check and protection can reduce the amount received from an additional property by significantly more than one may expect, meaning that any landlord should run a budget plan before setting their rent rate, and can only hope that the needed amount remains competitive throughout fluctuations in their local market.

To summarize, real estate mandates the investment of a large portion of resources towards an illiquid, unstable, and costly asset. Given the price of maintenance, transaction fees in selling, opportunity costs in holding, along with the cost of uncertainty in an unstable market, an investor can never guarantee financial gain from holding real estate-- however, a dedicated investor can manage their risk and increase the chance of strong returns with the management and expertise of the following strategies.

STRATEGIES:

<u>REITs</u>

As an alternative to investing in real estate directly, one can invest in bonds correlated to the real estate market. For an individual that is adamant about participating in the housing market, Real Estate Investment Trusts (REITs) may be a more profitable investment opportunity. REITs put the responsibility of real estate success into a professional's hands as you reap the benefits. There are several different types of REITs that one may invest in based on the type of property that the agency owns. Private real estate REITs can be volatile and change in earnings and sensitivities based on what it is linked to. One can also invest in hotel real estate, however these types of investments are vulnerable to shifts in the economy, as vacations and hotel use are one of the first industries to be impacted during a recession. Commercial real estate REITs are relatively stable, predictable investments and have little variation in rent rates, therefore little variation in revenue and dividends. If an individual is looking to stay in the real estate market with a more liquid and diverse portfolio while mitigating personal risk, speak with a financial professional about catering a real-estate backed investment portfolio with REITs, mortgage-backed securities, or other investment opportunities tied to the real estate market.

Trusts

When preparing your family to take over an estate, placing real estate into a trust can give you control over how you would like assets to be appropriately managed, and can lend your family a clear sense of direction. There are two types of trusts, revocable and irrevocable. In a revocable trust, ownership of real estate is retained by the grantor, allowing for receivable income and control over the property. In an irrevocable trust, the grantor is no longer the owner of the property, though potentially still allowed to use the property as determined in the rights of the trust. The property is then placed into a non-taxable estate and managed by a named trustee. Trusts should be discussed with a tax professional and legal representation before moving forward.

1031 Exchange Investments

To minimize the loss in purchasing and selling properties, there are several tax and interest strategies that are available. Tax advantages may help to retain the capital genuinely earned by officially recognizing what has been spent, and this is maximized when reviewed or completed by a tax professional.

Under Section 1031 of the United States Internal Revenue Code, investors can defer taxes on financial gains if the proceeds from the sale of one investment or business property are used to buy another like-kind investment, meaning that the gains from the sale of an investment property are used to buy another investment property, or the gains from a commercial property are used to buy another commercial property. 1031 Exchanges are subject to specific rules and regulations, such as that they require an intermediary to place the gains from the sale of the home into an escrow throughout the exchange. To ensure that conditions for this tax advantage are met, maximized, and recorded accurately, individuals should consult a tax professional.

This exchange offers a competitive advantage in tax rates by retaining the gains made from the sale of one investment. Without this, an individual could lose between 10-35% reduction of capital from their investment simply in moving from one location to another. While you will still be taxed on income kept from the original sale, the tax deferment 1031 allows a seller to transition seamlessly from one investment property to another. This is not a fast or uninvolved process, as the buyer will require expert advice and time to find the right investment, however, as of 2020 the tax deferment is allowed on non-simultaneous investments and can be deferred for a period of time pending the qualification of a specific set of zones and opportunities.

Leaving Real Estate with Minimal Penalties

One must also keep in mind the difficulty of leaving an investment property without financial loss. There are few effective workarounds in existence that can save you money when selling a house, and each involve a series of steps which are best known by a tax or investing expert. Trusts are a valuable resource for managing physical assets such as investment homes, and can be controlled and customized to an individual's specific circumstances in many regards. If it is desired to leave an actively managed, illiquid real estate investment, hiring a professional and inquiring about how to allocate your assets to a trust could save you over 30% of your investment and potentially even reinvest your assets to foster recurring, passive income for many years to come.

HELOCs

For those who want to expand or diversify their properties, whether it be a rental home or a vacation home, there are ways to finance it while leveraging your existing property through a Home Equity Line of Credit (HELOC). Instead of taking out another mortgage at a fixed rate, you have the power to leverage your house against the loan it will provide you for your second property. HELOCs offer greater flexibility with “borrowing” than a traditional mortgage would. With a HELOC, you borrow only as much as you need up to a maximum amount that is predetermined. HELOCs do not have to be a way to finance monthly payments on your second home, but could also be used for renovations and other unexpected maintenance costs. Creating an ideal borrowing strategy allows for smarter financing without negatively impacting your personal financial situation.

CONCLUSION:

Buying a home is much like buying a new dog. It can be fun, but it is a lot of work and it will cost you money. Financial drawbacks such as illiquidity, high maintenance fees, property taxes, low rates of return and realized gains, opportunity costs, and a lack of control over your investments make investing in property an unstable and impractical reality. Normally, an individual looks to enter a market where their money can do the work for them. Even with hired help, entering the real estate market is not a passive investment and will require as much time and energy in maintaining the property as would a second job. Investors should do their due diligence to investigate these underlying consequences before entering the market of uncertainty and be prepared to hire professional help regarding taxes, retaining earnings, diversifying investments, heirs and estates, and legally protecting their investments. The strategies to exit out of property investments are best left to the professional, as tax laws and work around investments may save you tens of thousands in loss when trying to free yourself from this market, but are difficult to know and impossible to execute without professional help. When searching for the right type of investment, it is important to foster a situation where your money grows as freely from expense and additional required labor as possible.

Sources Cited

18, Andy Rachleff. "Why Rental Properties Are Not Good Investments." *Wealthfront Blog*, 23 Oct. 2020, blog.wealthfront.com/why-rental-properties-are-not-good-investments/.

24, Brandon Cornett | March. "What Will the U.S. Real Estate Market Look Like In 2022?" *HBI News*, 24 Mar. 2021, www.homebuyinginstitute.com/news/what-the-market-looks-like-in-2022/#:~:text=What%20the%20Real%20Estate%20Market%20Could%20Be%20Like,big%20one%20for%20the%20nation%E2%80%99s%20real%20estate%20market.

Associates, // by Nissen and, and Nissen and Associates. "IRS Extends the Opportunity to Defer Capital Gains." *Nissen and Associates*, 14 Sept. 2020, bellinghamtax.com/irs-extends-the-opportunity-to-defer-capital-gains/#:~:text=If%20you%20invest%20that%20%24250%2C000%20gain%20in%20a,QOF%20within%20180%20days%20of%20the%20sale%20date.

Backman, Maurie. "Property Taxes Too High? Here's How to Fight Back." *Millionacres*, Millionacres, 28 July 2020, www.millionacres.com/taxes/articles/property-taxes-too-high-heres-how-fight-back/#:~:text=According%20to%20ATTOM%20Data%20Solutions%2C%20property%20taxes%20on,Here%20are%20a%20few%20important%20steps%20to%20take.

Boykin, Ryan. "The Advantages of Real Estate vs. Stocks." *Investopedia*, Investopedia, 29 June 2021, www.investopedia.com/investing/reasons-invest-real-estate-vs-stock-market/.

Chen, James. "Investment Horizon Definition." *Investopedia*, Investopedia, 19 May 2021, www.investopedia.com/terms/i/investment_horizon.asp.

Chen, James. "What Is the Federal Housing Finance Agency (FHFA)?" *Investopedia*, Investopedia, 24 June 2021, www.investopedia.com/terms/f/fhfa.asp.

Daly, Lyle. "2021 Capital Gains Tax Rates: Everything You Need to Know." *The Motley Fool*, The Motley Fool, 7 Apr. 2021, www.fool.com/research/capital-gains-tax-rates/#:~:text=Federal%20long-term%20capital%20gains%20tax%20rates%20%20,%20Over%20%24250%2C800%20%20%20Over%20%24473%2C750%20.

"Existing-Home Sales." *Www.nar.realtor*, 10 June 2021, www.nar.realtor/research-and-statistics/housing-statistics/existing-home-sales.

Fuscaldo, Donna. "How to Deal with Monthly Maintenance Fees When Buying Real Estate." *Investopedia*, Investopedia, 21 May 2021, www.investopedia.com/articles/investing/091515/real-estate-investing-monthly-maintenance-fees.asp.

Ganti, Akhilesh. "Dow Jones Industrial Average (DJIA) Definition." *Investopedia*, Investopedia, 7 July 2021, www.investopedia.com/terms/d/djia.asp.

Garber, Julie. "Here Are Some Helpful Tips on How to Fund Real Estate Into a Trust." *The Balance*, 13 Sept. 2020, www.thebalance.com/how-to-fund-real-estate-into-a-trust-3505275.

Henderson, Andrew. "Why Buying a House Is a Bad Investment." *Nomad Capitalist*, 25 Jan. 2021, nomadcapitalist.com/2016/10/14/buying-a-house-bad-investment/.

"Housing Market Indicators Monthly Update." *Huduser.gov*, U.S. Department of Housing and Urban Development, May 2021, www.huduser.gov/portal/sites/default/files/pdf/Housing-Market-Indicators-Report-May-2021.pdf.

Merryman, US Census Bureau Ray. "US Census Bureau Construction Spending Survey." *Census.gov*, 11 Aug. 2010, www.census.gov/construction/c30/c30index.html.

Millsap, Adam A. "Treating Housing As Investment Is A Bad Idea For Homeowners And Hurts The Economy." *Forbes*, Forbes Magazine, 8 Jan. 2021, www.forbes.com/sites/adammillsap/2020/02/28/treating-housing-as-investment-is-a-bad-idea-for-homeowners-and-hurts-the-economy/?sh=91e469759ce4.

"MSG Management Study Guide." *7 Reasons Why Real Estate Is the Worst Investment*, www.managementstudyguide.com/7-reasons-why-real-estate-is-the-worst-investment.html.

"MSG Management Study Guide." *The Problem with REITs*, www.managementstudyguide.com/problem-with-reits.htm.

"Professional Resources." *S&P Dow Jones Indices*, 2021, www.spglobal.com/spdji/en/.

"Real Estate Investing Strategies." *Connected Investors Blog*, 12 Feb. 2018, connectedinvestors.com/blog/best-real-estate-investing-strategies/?wickedsource=google&wickedid=492547685987&wv=3.1&utm_medium=ppc&utm_network=g&utm_campaign=12118200924&gclid=CjwKCAjwiLGGBhAqEiwAgq3q_mZI03lsPLzNzshLe3UCgKjpLMKly5KDjwoceoDXffJdZdzfOMcLMRoCCwkQAvD_BwE.

Ross, Sean. "Has Real Estate or the Stock Market Performed Better Historically?" *Investopedia*, Investopedia, 19 May 2021, www.investopedia.com/ask/answers/052015/which-has-performed-better-historically-stock-market-or-real-estate.asp.

Santarelli, Marco, and Jules Rollheiser. "Housing Market Predictions 2021 & 2022: Crash or Boom?" *Norada Real Estate Investments*, 13 July 2021, www.noradarealestate.com/blog/housing-market-predictions/.

"USHMC - National Housing Market Indicators: HUD USER." *USHMC - National Housing Market Indicators | HUD USER*, www.huduser.gov/portal/ushmc/hmi-update.html.

Wieland, David. "You Can 1031 Exchange Into A REIT, Here's How." *1031 Exchanges - DST, TIC, NNN*, Realized, June 2020, www.realized1031.com/blog/rolling-from-property-to-reit.