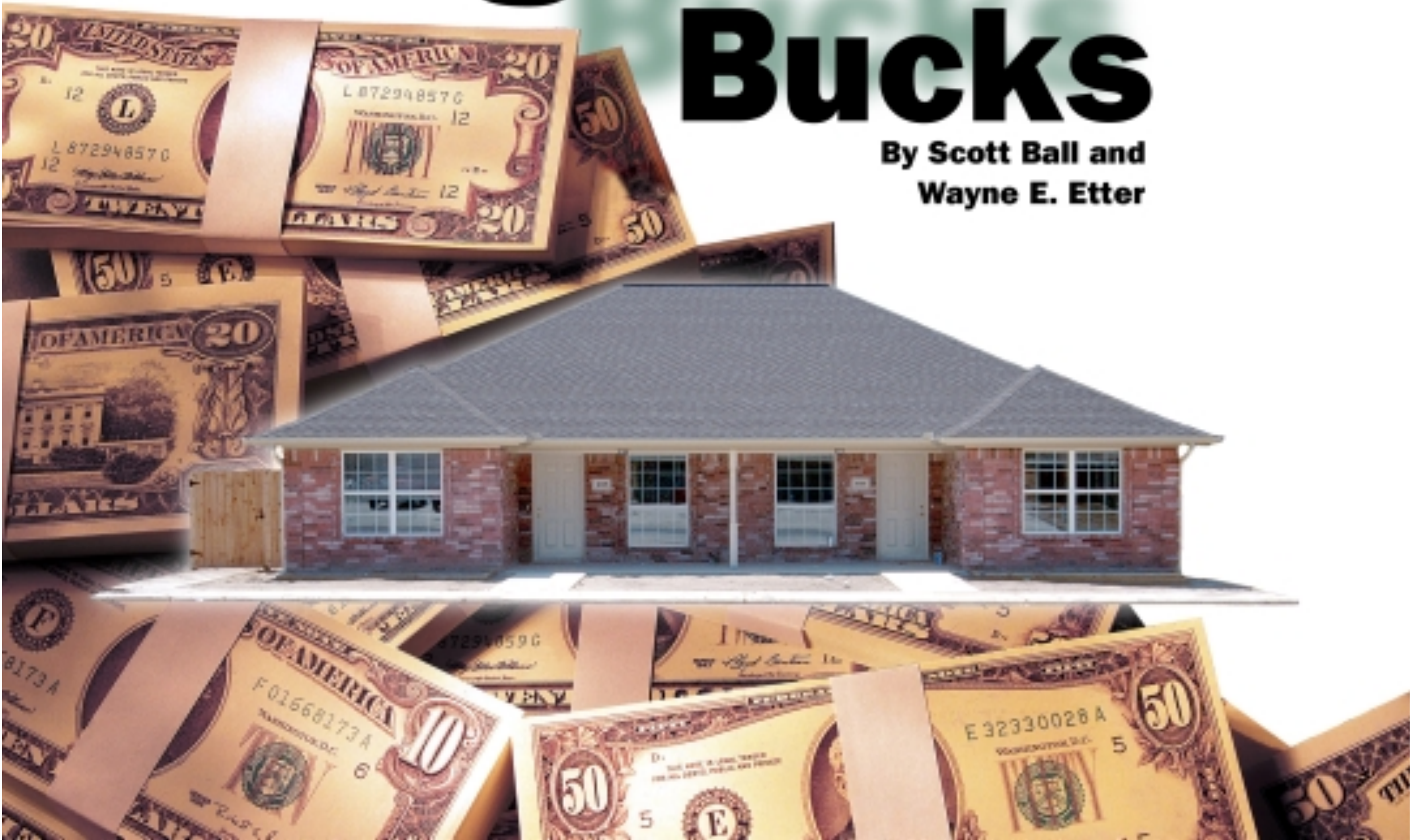
A Reprint from *Tierra Grande*, the Real Estate Center Journal

Beginner's Bucks

By Scott Ball and Wayne E. Etter



Although most people are more familiar with houses than they are with common stocks, investing in a rental house or a duplex warrants considerably more investigation than does a stock purchase. The extra effort is required because the characteristics of the two investments are quite different.

Common stocks and other securities are portfolio investments — securities the investor can review, study and analyze at convenient times. Considerable information is available, and a beginning investor can find low-cost guidance by reviewing the opinions of many experienced investment advisors. Factors that affect the stock's market price will be analyzed thoroughly by professional analysts, and the investor can come to a reasonably informed opinion.

Investors in portfolio assets often set goals in terms of the dollar amount of their regular investment contributions, their target rate of return, the level of acceptable risk and portfolio diversification. Usually the time required to manage the portfolio is not a major consideration for beginning investors.

A house or a duplex, on the other hand, is a unique physical asset. While many houses and duplexes are similar, none are exactly the same. In addition to a property's size, amenities and age, its location relative to employment centers, colleges and universities, schools, shopping, medical facilities and transportation are important determinants of a residential income property's value. The decision to buy an income property must be based on careful study.

Before considering the purchase of a particular property, the beginning investor needs to spend considerable time studying the local economy and real estate market, the advantages and

Table 1. Investment Returns, Year Ending July 29, 1999

Investment	Percent Return One Year	Three Years	Five Years
S&P 500 (with dividends)	18.95	29.52	26.70
Equity mutual funds			
Capital appreciation	18.89	21.59	20.59
Growth and income	12.22	21.72	20.08
Income	10.36	19.69	18.29
Bond mutual funds			
General bond	1.34	6.96	7.75
U.S. Treasury	–0.42	6.55	7.21
High-yield bonds	–1.48	8.22	9.12

Source: *Wall Street Journal*

disadvantages of owning rental property in particular neighborhoods and the neighborhood's supply and demand conditions.

Because considerable transaction costs are involved in acquiring a rental property, and because real estate is a relatively illiquid asset, a mistake in selecting property cannot be easily undone. Once a house or a duplex is acquired, selling it might take a long time and result in financial loss. The beginning investor must bear in mind that a rental property is a physical asset and can demand an owner's attention at any time, convenient or not.

Expected Rate of Return on Equity

Typically, an investor's *expected rate of return on equity* is based on a set of best-guess assumptions. How much does the property cost? How much can be borrowed? How much rent can be charged? How much will be paid out in operating expenses? How much will the property appreciate? With this information, the investor calculates the expected rate of return.

In many instances, the use of best-guess assumptions leads to an expected return on investment that is larger than might be expected to be earned on bonds, common stocks or mutual funds (see Table 1).

Does real estate's larger expected return on investment mean that it is a better investment? Perhaps, but the beginning real estate investor must remember that there is a relationship between risk and return — investors demand a larger return when they accept a larger risk. Sometimes, larger risks result in losses instead of larger returns. When large returns are averaged with losses, real estate's total return is reduced.

The investor should establish a required rate of return, meaning the minimum acceptable rate of return on the equity investment. The required rate of return should reflect risk—the larger the risk, the larger the required rate of return. For example:

Required rate of return (percent) Minimum	Maximum	Risk
4	4	Risk-free rate of return
8	10	Time required for resale
0	10	Increased expenses resulting from property's age
5	10	Location and access to schools, shopping, transportation
5	10	Reduced rent resulting from vacancy and collection losses
22	**44**	**Total risk**

What seems like a large expected rate of return relative to other investments might, in fact, be too small for the risk associated with a particular property.

Strategy for Beginning Investors

A strategy for a beginning real estate investor is to acquire property that will be owner-occupied or occupied by his or her child (or children) or parents. This strategy provides significant benefits because many lenders use the same terms to finance properties that are to be occupied by the investor's children or parents as they use for owner-occupied properties. These terms are more favorable than investor financing terms (see Table 2).

The smaller down payment and interest rate increase an investor's return on equity through the benefits of *financial leverage,* which is the use of debt to increase an investor's expected return on equity investment. For example, assume that an investor is planning to acquire a $100,000, five-year-old duplex in good condition. The investor plans to live in one unit and rent out the other unit for $625 per month. The property's total monthly operating expenses (property taxes, property insurance and maintenance) are estimated to be $325 and its rental income and resale value are expected to increase 1 percent annually.

Table 2. Financing Terms

	Owner-occupied property	Investment property
Down payment	3–5 percent	10–30 percent
Interest rate	Single-family rate	Single-family rate plus 1–2 percent
Term	15–30 years	15–30 years, five-year balloon

Source: Real Estate Center at Texas A&M University

Because the investor is living in one unit, owner-occupied financing terms should be available for the purchase of the duplex. Only the rented unit's share of property tax, insurance and maintenance are treated as operating expenses and only one-half of the loan payment is considered in this before-tax cash flow. Depreciation and interest are not considered in this before-tax analysis.

As shown in Table 3, the investment has a 117.5 percent before-tax internal rate of return on equity, using owner-occupied financing terms. If, however, the duplex is purchased with investor financing terms, the before-tax internal rate of return on equity is only 18 percent. This difference results in part from the smaller equity investment required for the owner-occupied property — $1,500 versus $20,000 — and the larger mortgage loan — $48,500 versus $40,000. However, because the mortgage loan for the owner-occupied property has a lower interest rate and a longer amortization period, servicing the larger mortgage loan requires $450 less per year than the smaller mortgage. With the reduction in the required equity investment **and** slightly higher before-tax cash flow, return on equity is increased.

Investing in properties that are to be leased to immediate family members may provide a larger return on equity than investing in properties to be leased to non-family members. In fact, the investor financing terms produce a before-tax return that might be too small given the risk of real estate investment and the availability of other investment opportunities.

Further, the investor using owner-occupied terms has the financing terms (including the interest rate) locked in for as much as 30 years, instead of five. The five-year balloon increases the investor's risk because the future financing terms may be much less favorable than present financing terms. An increase in the interest rate at the time of refinancing would

increase the investor's monthly mortgage payment and reduce return on equity.

Today, most mortgages made to finance owner-occupied property are packaged as collateral for mortgage-backed bonds that are sold to secondary mortgage market investors. Because Fannie Mae guidelines prohibit a borrower from obtaining secondary market financing for more than five mortgages (four mortgages in addition to the mortgage on his or her principal residence), the investor must turn to local lenders after acquiring five mortgages. Obtaining local mortgage financing allows the investor to develop a financial relationship with local lenders, but the financing terms will be less favorable and, all other things being equal, the rate of return on equity will be smaller.

***OWNERS CAN** increase profits by managing and maintaining a property themselves, but the time and effort required may make this "sweat equity" costly.*

Table 3. Benefits of Owner-Occupied vs. Investor Financing Terms

	Owner-occupied Financing	Investor Financing
PURCHASE AND RESALE OF ENTIRE DUPLEX		
Property purchase price	$100,000	$100,000
Down payment (equity)	–3,000	–20,000
Mortgage loan	$ 97,000	$80,000
Mortgage loan terms	7%, 30 years	9%, 20 years, 5-year balloon
Monthly mortgage payment	$645	$720
Resale Price	$105,100	$105,100
PURCHASE OF DUPLEX, WITH OWNER OCCUPYING ONE UNIT AND LEASING THE OTHER		
Property purchase price	$50,000	$50,000
Downpayment (equity)	–1,500	–10,000
Mortgage loan	$48,500	$40,000
Monthly mortgage payment	$323	$360
Monthly before-tax cash flow, year 1		
Monthly rent	$625	$625
Expenses	–163	–163
Net operating income	462	462
Mortgage payment	–323	–360
Before-tax cash flow	$ 139	$102
Annual before-tax cash flow		
Year 1	$1,678	$1,231
Year 2	1,733	1,287
Year 3	1,790	1,343
Year 4	1,846	1,399
Year 5	1,903	1,457
Estimated before-tax cash flow from resale, year 5		
Estimated resale price	$52,550	$52,550
Resale expense (7%)	–3,679	–3,679
Unpaid mortgage balance	–45,654	–35,483
Before-tax cash flow from resale	$3,217	$13,388
ESTIMATED BEFORE-TAX INTERNAL RATE OF RETURN ON EQUITY	**117.5 percent**	**18.0 percent**

Selecting the Property

With this family financial benefit available, the beginning investor can acquire a duplex or a fourplex, personally occupy one unit and lease the other units to unrelated tenants. Or an investor can buy a duplex or a fourplex, lease one or more units to his or her child, children or parents and lease the remaining units to unrelated tenants. The investor's third choice is to buy a single-family house to be occupied by family members other than the owner.

The choice among these property types is dependent on the investor's demand analysis of the local real estate rental market. Simply put, the investor should choose properties that will be in demand when the family members who are the initial tenants no longer want or need to lease the space, rather than properties that meet the current needs of specific family members.

Making this choice requires that the investor decide what type of property and what location will best suit the needs of target tenants. Will the target tenants be individuals, couples, college students or young persons who are just entering the workforce or families? What will be their income level? Will they need access to public transportation? Will they want to walk to

shopping centers, schools, college campuses and employment centers?

Management Considerations

Rental properties must be advertised, leased and maintained. Finding the time and money required to manage property is a key consideration for the beginning real estate investor. Property management companies typically charge a fee equal from 5 to 8 percent of a property's gross income to manage a small residential property. In addition to the management fee, the property owner pays the actual maintenance and rehabilitation costs of the property.

To maintain a consistent cash flow from the rental property, successful investors pre-qualify their tenants. During the application process, the prospective tenant provides critical personal and financial information. With the prospective tenant's Social Security and driver's license numbers, accompanied by written permission to verify the applicant's past rental history, current, accurate information can be obtained from past records and credit reporting agencies.

Obtaining credit history information from a reporting service can be costly. Smaller investors may not have the financial resources to use reporting services, or they may consider such services an unnecessary expense. Access to this information also is available by subscribing to the services of a real estate locator company, which typically provides this service as a part of their fee.

Smaller investors should belong to the Texas Apartment Association (TAA) and use their lease contracts. TAA's lease contract is rendered void if used by a non-TAA member. Using TAA's contract and gathering up-to-date information about prospective tenants from a reporting service should reduce the investor's bad debt-collection loss ratio.

If the investor-owner has the time and skills to perform these management duties, management fees and labor costs associated with maintenance and rehabilitation can be saved. Of course, the investor-owner will spend nights and weekends advertising and leasing the property and performing the needed maintenance and rehabilitation chores.

Although doing these things will increase the investor's cash flow from the properties, the time spent has an opportunity cost — what other activities will the investor-owner have to give up? Because the other activities might be profit or leisure opportunities, saving money in this way may be costly in the long run.

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Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $30 per year, including 12 issues of *Trends*.

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