

Letters to Mycroft #51: Dedicated Purchases

By Klarise Yahya

To My Dear Nephew Mycroft,

As you know, my book *The Teachings of Mrs. Acosta*, is almost finished. It is short. In just over 100 pages Mrs. Acosta, in a step-by-step manner, takes a young woman from being deeply in debt to independent wealth.

Now we're looking for a good literary agent. If you can recommend one, please ask him to contact me.

One of the things discussed in *The Teachings of Mrs. Acosta* is a dedicated purchase.

Conventional Investment Wisdom (CIW) says that if you know you will have a large bill to pay several years down the road, you should buy bonds now (less risky than stocks, they say, and yielding more than you get on plain savings accounts) and reinvest the interest. In this way you expect to have the money to pay the obligation when due.

For example, assume you know that college expenses in an affordable school currently total \$35,000 a year. You anticipate costs will increase at 5% per year, so when your newly born granddaughter turns 18, her college will cost an estimated \$84,000 annually, or \$336,000 over the full four years.

You are better off than your adult children and want to make sure the little girl's education is covered. How are you going to do it?

You could, of course, purchase a few bonds each year. Over time, you hope that their accumulated value at maturity will be sufficient to properly fund her education. But because we don't know what your situation will be like each year of the next 18, this is an unsure approach.

For greatest certainty, CIW states that you will immediately buy \$197,000 of zero-coupon bonds paying a current (hypothetical) 3%. Because they are zero-coupon, your interest will compound at the agreed rate and at the end of 18 years you will have the necessary \$336,000.

This is a dedicated purchase. But there is a much, much better approach.

Could you buy a little condominium right now and sell it in 18 years for enough to fully fund your granddaughter's education? If you projected that the condo would appreciate at 5% per year, a condominium that would be worth \$336,000 eighteen years from now could be bought for only \$140,000 today. This might require \$35,000 or less down.

Let's say you put 25% down on a \$140,000 rental condo. You finance the balance with a 15 year mortgage. You will almost certainly have a negative cash flow for the first several years (reducing each year, as your rents increase), but then it will turn positive and the remaining portion of the holding period will generate increasingly positive cash flows. And when she's old enough, the money for college will be there. The entire process will have cost you much less than the "bond" alternative.

You can have other dedicated purchases, as well. Assume you bought your home fifteen years ago. You had no real money back then, so you purchased it with a high loan-to-value 30 year mortgage. You got into your home with almost nothing down. Your home appreciated handsomely over the next last several years. You refinanced and bought a cute little fourplex near the hospital. Recently, you refinanced both your house and the fourplex and purchased a 10 unit building close to the university.

You are mortgaged to the hilt. But you have your home, a fourplex, and a ten-unit. What are you going to do now?

Let's protect your home first. You have to live somewhere, so make your home a dedicated purchase. The goal is to pay off dedicated purchases. You determine to increase your monthly payments slightly so you can retire the mortgage in 15 years. Think about that for a moment. You originally got a 30 year mortgage with almost nothing down. You've used the house to buy two income properties, and your home will still be paid off thirty years from the date of purchase. All with none of your own money invested. Not bad, huh?

You very much like your fourplex. It's well located, architecturally appealing, and easy to manage. Some buildings are just Golden Children, and this is one of them. You decide that you

will pay off the fourplex, so you begin to dedicate any positive cash flow it generates to reducing its mortgage. From math done previously in this series of articles, you expect that if you apply all the cash flow a building generates (given normal increases in rent and expenses) it will pay itself off in about 12 years. The fourplex will be a pleasing addition to your retirement income.

The ten-unit is nice, but it's really just a simple commodity building. There is nothing special about it. You still dedicate all of its positive cash flow towards paying down its mortgage, but you realize that what you really want to do is to develop enough equity in it that you can trade up.

What you have done is to divide your portfolio into three levels. Your home is in one stratum: you have to live somewhere and you don't want to continue making mortgage payments after retirement. It is a dedicated purchase. Your fourplex is in another layer: you will pay it off and use its cash flow to augment your retirement. Retirement buildings are dedicated purchases, too. The last band, containing only your 10-unit, is inventory.

Let's stop for a moment and review our situation. If you make no additional purchases, you will be able to retire in 12 years with your home mortgage nearly paid off, and both the fourplex and the 10-unit free and clear.

Assuming your net operating income (gross income minus all expenses except for mortgage) is \$700 per unit. You will have 14 units paid off. If you only keep your rents adjusted for inflation, your properties will generate \$9,800 per month (in constant dollars) to augment your retirement. Not bad, huh?

Your inventory constitutes of the building(s) you buy-sell-trade with the hope of improving your situation. Over the next couple of years, you renovate your 10 unit building. You surface-coat the driveway and parking areas. You landscape the yard in an affordable manner. You paint the exterior yellow with white trim. As the units become vacant, you do the normal paint and carpeting but you also change the bathroom and kitchen floors to ceramic tile. You get rid of that yucky plastic shower enclosure and replace it with tile. And you make the kitchen counters granite. We call this PCCD (paint-carpet-clean-drape). As you renovate each unit, you raise the new rents to the maximum the area will support.

Eventually, all your units are renovated. It's time to move up. As you up-trade your 10 unit, you probably will want to use some of the equity to buy another (retirement) fourplex. In that way, you'll have 22 units total (two "keeper" fourplexes and a 14 unit commodity building).

Why accumulate a number of fourplexes as "Golden Children"? It's just a safety precaution. It may be that you will have an urgent need for cash after you retire. It is a lot easier to sell one fourplex than it is to sell four units of a 50 unit building.

Cordially,

Aunt Klarise

Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more anywhere in the U.S.A., Klarise Yahya can help. Find out how much you can borrow! For a complimentary mortgage analysis, please call her at (818) 500-9966.