The Advanced Teachings of Mrs. Langerhorn: 06

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Note to the Reader … These are the papers Mrs. Langerhorn left me after she passed away. They are her advanced teachings and they, naturally, overlap and reinforce her earlier principles. They are not the notes of our conversations that were earlier published under the title "Mitochondria Learns to Invest".
I hope you gain as much from her advanced teachings as I did.

Why Not Bonds?

Most financial advisors – perhaps not all, but certainly most – divide portfolios under their management into at least two portions. One portion is devoted to stocks (they call them "equities") and another portion assigned to bonds. The percentages differ between advisors and among clients, but a commonly repeated axiom is that you should have your age in bonds (if your are 45, then 45% of your investable assets should be in bonds; if you are 72, then 72%) and the remainder in equities. The reasoning appears to be that bonds are viewed as safer than stocks, and, as you get older more of your money should be in "safe" investments because there just isn't time to make it again if it is lost. This is a very basic form of diversification, and certainly seems reasonable.

Parenthetically, most advisors further diversify by buying bonds with different maturities issued from different borrowers. And they diversify the equity portion of the portfolio between large capitalization companies, medium, and small cap. Often, they diversify further into domestic stocks and foreign stocks and emerging markets. At some point it just seems like you can diversify right down to a market return. At that point, why not just buy a handful of stock and bond index funds and be done with it?

Remember that investments provide a stream of income. That is, in fact, their definition. If something does not provide a stream of income, it is not an investment. There are only three things that are investments: income properties, stocks, and bonds. The incomes of well chosen rental properties and stocks tend to trend upwards over time, but bonds don't; thus, I don't buy bonds. I want my cash flows to grow. Bonds are useful places to temporarily store wealth, not to enhance it. But you should know why I think bonds are probably not suitable for me and perhaps not for you.

Bonds are fixed income investments. That means that you are supposed to get your interest checks like clockwork, every time they are due, but the amounts go neither up nor down. They are "fixed", and some people find security in this.

But wait. If the company goes bankrupt, what happens to your checks? What happens to your principal? The checks stop and even the principal may be at risk. If you buy a bond, whether corporate (can go broke) or foreign government (can default), you usually have no upside. The very best that can happen is that you get your interest and principal

at the agreed times. In exchange for this you accept the possibility that you can lose your entire investment.

The market is a lot like a poor poker player. If you know how to read the “tells”, you can learn a lot. For example, assume that the 10 year Treasury note is offered at 6%. Now, that is considered to be a “risk-less” investment because, when your interest is due or at maturity, the U.S. Government will, if it must, just print more money to pay you off. This lack of default risk is the only “risk-less” characteristic of U.S. Treasury securities. Other than that, they share the same market risks as any other fixed income investment.

Hypothetically, let’s assume you buy a U.S. Treasury bond paying 6%. Well, that six percent doesn’t stay in your purse very long. First of all, it’s subject to federal tax. If you are in the 33% bracket, 2% goes to the taxman. You are down to 4%. If inflation is 3%, you have to reinvest that amount each year or the purchasing power of your principal will decline. Deduct for taxes and inflation, and that 6% bond gives you 1% of spendable income.

Can’t we just buy a bond with a higher interest rate? Well, we have to ask ourselves this: if the risk-less Treasury bond is paying 6%, exactly why would that corporate bond paying 8%? The obvious answer is that the 8% includes a 2% of risk premium. The market is saying that if a person bought a basket of various 8% corporate bonds, enough would default that the overall “basket” return would be 6%, the same as Treasury issues. Simply put, higher interest rates are offered to offset greater risk.

If it’s true (and I don’t know that it is, this is just where my mind goes whenever I weaken in my dotage and start to think how nice it would be to have bonds and not have to deal with tenants) that the “risk-less” return is whatever the similar duration Treasury is yielding, then why buy any bond except a U.S. Treasury issue? And are there any other risks to the “risk-less” bond?

Right now, we’ll discuss only one risk (there are others) that affects all streams of income, including U.S. Government issues, both positively and negatively. That is market risk. It is how a change in market interest rates impacts a fixed stream of income. If, for example, we buy a $100,000 perpetual stream of income yielding 6% annually, we will pay $1,666,667 ($100,000 divided by .06). If market rates change, say they go to 10%, then our $100,000 a year is only worth $1,000,000 ($100,000 divided by .10). We would lose over $666,000 of principal if we had to sell. Alternatively, if market rates dropped to 2%, our $100,000 annual stream of income would be worth $5,000,000 ($100,000 divided by .02). Notice that rising market interest rates reduce the principal value of a fixed stream of income, while lowering rates increase the value. This is consistent with our capitalization formula, isn’t it (Income divided by Yield equals Value)?

We, as individuals, have no material control over the direction or rate of interest rate change. But if we buy a stream of income and the interest rate declines, our principal goes up and we look really, really smart. This is what happened to those folks that bought apartment buildings in September, 1981 (high mortgage interest rates) and sold in May, 2003 (low mortgage rates). The value of apartment buildings (and pretty much all streams of income) multiplied during those 22 years, mostly due to the lowering of mortgage rates.

That was a long time – 22 years – between the high and the low of this last interest rate cycle. After reaching their lows, it is reasonable to expect rates to trend upwards, perhaps over many years. Almost nobody can wait until rates reach another high and

begin to again decline before they begin investing. It would not leave sufficient remaining time for their investments to mature. Most of us have to just take the interest rate environment however it is, and make the best of it. The way to do this is to accept that, in a period of rising interest rates, the value of income property will not appreciate as much as it did during the 22 years of declining rates.

In my mind, I have adjusted to the possibility that my income properties may appreciate very little or even not at all. That's not necessarily a bad thing. In most of the country (generally, that portion of the country beyond 50 miles from the coast) property appreciation has never been really high. This is can not be a surprise to you. How many times has one of your friends announced that he has sold his six units in Santa Monica and is in escrow for 48 units in Wisconsin? The reason this disparity exists is that the value of coastal property ("They're not making any more!") is predicated on the price of land while the value of suburban property ("Shucks, Fred, that guy is asking too much for his lot. Let's just go a little way down the road and build there!") is driven by construction costs.

So, in an era of low appreciation, why buy income properties? *Because they are bond substitutes.* Remember how, after adjusting for (01) risk, (02) state and federal taxes, and (03) inflation, bonds just kind of break even? Well, income properties are the way out of that conundrum. Even without appreciation, income properties can generate a splendid return even after adjusting for risk, taxes, and inflation. Consider that the cash flow does not have to be adjusted for inflation, as inflation is offset by higher rents. Consider the tax advantages of rental properties. And reflect on the fact that lenders will provide 75% of the funds necessary to purchase the property, indicating that, in their overall institutional experience, income properties are remarkably low risk.

If we get a (hypothetical) 6% cash flow from an income property, we can usually reasonably expect that stream of income to be adjusted for inflation, to be favorably taxed, and to be very nearly as safe as a good quality bond. What more do we need from a bond substitute?

Well, how about growth in principal? Every time you use part of the rental income to pay the mortgage, an increasing amount goes to pay off the balance. This results in equity build-up, a kind of forced savings.

Without being too technical, if we put 25% down and borrow 75% for 30 years, it is pretty clear that when the building is paid off our equity will have grown from 25% to 100%. Our profit will be 300% Yes, I now that our money will have quadrupled, but one of those druples is just getting our own money back. Just getting your own money back is not "profit". We will have profited only threefold.

Our bond substitute, then, is the superior choice not only due to low risk, but also because (01) the cash flow can increase with inflation; (02) the cash flow is taxed at favorable rates, and (03) our equity increases even if the building never appreciates a dime. We'll talk more, later.

- **The "real" return (net of risk, taxes, and inflation) of bonds approaches zero**
- **Bonds do not grow wealth, but they can be useful for maintaining wealth**
- **A change in market interest rates can have a large impact on the value of your bonds if you have to sell them.**

- **Most of us have to invest regardless of the trend of market interest rates**
- **Well chosen income properties can beat the pants off bonds.**

Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more – it's probably happened, but not to me or anybody I know – 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.***