

The Advanced Teachings of Mrs. Langerhorn: 09

By Klarise Yahya, Commercial Loan Broker

Note to the Reader ... They are not the notes of our conversations that were earlier published under the title "Mitochondria Learns to Invest". 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. I hope you gain as much from her advanced teachings as I did. Earlier articles are available on-line, if desired (google: Klarise Yahya).

Is This a Good Time to Buy Income Properties?

The short answer is "Yes", but the matter is really a little more complicated than that. You probably should understand why it's (almost) always the right time to buy income properties.

Income properties are really just "bond" substitutes. Most investment advisors urge a portfolio consisting partially of stocks (equities) and partially of bonds. The function of the bonds, they say, is to provide a livable cash flow so their client won't feel the need to sell stocks in case they have to, at what may be the worst possible time, to meet living expenses.

The problem with bonds is that their payouts don't increase. If you buy a 25 year bond giving you \$3,509 semi-annually, that's what you'll be receiving until the bond matures. In the meantime, you have to pay taxes on the interest income. Additionally, your purchasing power will be eroded by inflation. If investment advisors disclosed this, and actually put numbers to it, (*"It's a \$100,000 bond, Fred, paying 6% annually. That's \$500 a month! Of course, you're in the 40% combined federal and state tax bracket, so you'll only be able spend \$300. Oops, I forgot! Inflation is running 3%, so if you actually spend that \$300 your purchasing power will erode. You will, in effect, be spending your principal. Too bad. Well, Fred, I gotta run! Thanks for your business!")*) Don't you think they might sell fewer bonds?

The underlying concept of acquiring a stable source of regular cash flows is certainly sound, especially for retired folks. The bond solution, however, isn't very agreeable, at least in my mind. But let's put a pencil to it and see what develops.

Assume you bought a \$55,000 bond in 1982, maturing in 25 years and paying 12.76% interest. Twenty-five years ago, bonds were actually paying this sort of yield. It was one of the best times to buy bonds we've ever had. Under these hypothetical conditions, and not adjusting for taxes or inflation, your gain would be the following:

1. Your investment would have been \$55,000 at 12.76% interest. Your cash-on-cash return would have been \$7,018 annually, or \$175,450 over the twenty-five years.
2. When your bond matures you get your \$55,000 back.
3. Total return is \$175,450 plus the \$55,000 you got back. Over 25 years, your bond made a hair over \$230,000.

Now, instead of buying the bond at such a remarkable yield, imagine that you bought a 10 unit building in 1982 for \$225,000. Rents for these large, two-bedroom units were

\$450 / month per unit. You were grateful to receive, back then, a 16% mortgage of just over \$170,000, payable at \$2,310 per month for 25 years. You put \$55,000 down. Hypothetically, assume you went to sleep for the next 25 years, waking up in 2007. Furthermore, assume you (*well, you were asleep, so it had to be your management company*) properly maintained the building and raised the rents a token 3% (net) each year. Last week, when you woke up, the first thing out of your mouth was “Sell the building! I know it’s 25 years older, but try, *really try* to get the same 4 GIM I paid for it!” How would your investment have performed?

To best illustrate our point, we’ll ignore costs of purchase, tax consequences, and costs of sale. Those things would just clutter up our illustration. And, before answering that question, let’s underscore that you bought the apartments at probably the worst time since the Depression. It’s important to remember this, because we are purposefully comparing extremes (best time for bonds, worst time for income properties) just to illuminate the differences between apartments and bonds

Well, you could have expected \$468 in initial monthly cash flow, which comes out to about 9.8% cash-on-cash, annualized. While that may sound like a lot right now, you’ll recall that bonds were offered at 12.76%, so getting 10% on your down payment wasn’t such a great thing.

Additionally, your cash flow would be increasing at 3% per year for 25 years, and when you sold the building the GSI would be up to \$113,000 and you would be asking a multiple of the increased annual income.

1. You’ve made \$5,616 a year, increasing 3% per year, for 25 years. That comes to about \$211,000.
2. Gross Scheduled Income in year of sale would be \$113,468. At 4 GIM the sales price would be approximately \$450,000.
3. Total gain is \$211,000 plus \$450,000, or approximately \$660,000 on a \$55,000 investment over the same 25 years.

To review, we’ve hypothetically compared the purchase of a 25 year bond at historically high yields with the purchase of a 10 unit apartment building at a very bad time. We’ve assumed GIM at sale was the same as at purchase. Additionally, we’ve ignored costs of purchase, tax consequences, effects of inflation (damaging to bonds, beneficial to income properties), and costs of sale. After 25 years, the total gain from the bond is \$230,000. The total gain from the apartment building is \$660,000. Considering these ending numbers, can we conclude that, generally, we should replace the “bond” portion of our portfolio with income properties? And can we conclude that it probably doesn’t make much difference what the market is like when we buy? So the answer to our original questions is, yes, pretty much anytime is a good time to buy an income property.

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**.