

Myth Busting: Buy and Hold Forever (Cash Flow)

By: Jim Adams

The Hypothesis

When I turned my first home into a rental in 2000, I was of the same opinion as many other real estate investors, which was that “Buy & Hold Forever” is the best strategy. The monthly income was going to be a big part of my retirement. I’m a spreadsheet guy, so I’d estimated what the income and expenses would be over the next thirty years and it was exciting to see the pop when the mortgage was fully paid and the rent became “pure profit.” Fortunately, the financial needs of my kids growing up forced me to consider whether the “Buy & Hold Forever” mantra was really the best strategy, or just another myth.

Life gets in the way of the best laid plans (fortunately!)

Early in 2005, my youngest daughter was finishing high school and preparing for college. She was considering a nursing program at a local trade school. My challenge was paying for it so, I applied for a Home Equity Line of Credit (HELOC) against my rental property which provided the cash for tuition. The increased interest deduction was nice, but the payment impacted the cash flow (gross income less all expenses). In turn, I decided to look at how the write offs, expenses and rent increases impacted to the overall income. Have you read my previous articles or watched the Discovery Channel’s MythBusters? If so, you already know the steps we’re about to take. First, we restate the Hypothesis, “Buy and Hold forever is the best strategy in real estate investing.” Next, we conduct a numbers based Analysis (I love the numbers part) and finally we draw a Conclusion that supports or debunks the hypothesis.

Here’s what we need for the Analysis

Each property is different and has unique characteristics, but can still be measured by a standard set of metrics. The Key Assumptions in the model are that; **A**) loans are fully amortized **B**) investors are taking the deductions allowed by law, **C**) for ease of calculations, deductible annual expenses are a constant percentage of income (although personal experience says expenses rise over time), **D**) the depreciation schedule is a straight line method and **E**) the rental increases are a standard average year over year. Both **C** and **E** use property specific historic averages which may or may not reflect future trends.

To simplify, there are two primary components of cash flow; income and expenses. What isn’t so obvious is that income takes two forms, actual and phantom. Actual income is the rent tenants pay each month and Phantom income is the depreciation deduction and its impact on year end taxes. Most expenses and depreciation are deductible against income so it’s worth looking into how these factors might support or contradict the B&HF myth.

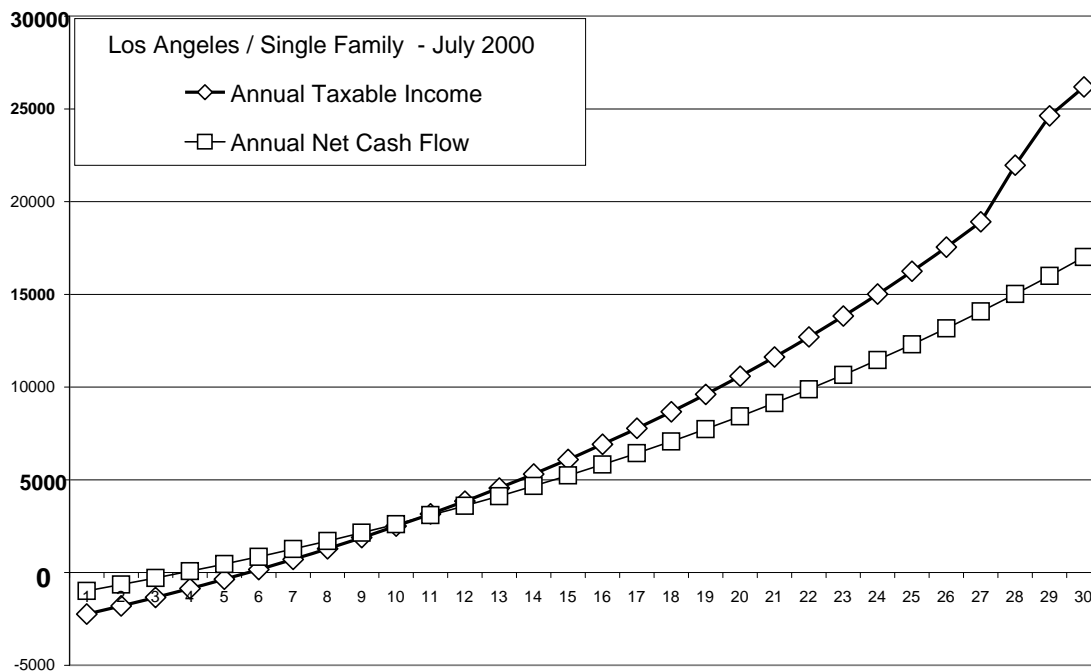
Our Analysis – Buy and hold, but for How Long?

The first thing was to build a spreadsheet with the key metrics. I used a number of standard Excel® formulas to extrapolate thirty years of monthly data which was then

rolled into annual periods. The final step was to chart the Net Cash Flow and Taxable Income (See Figure 1 for each property.) Of course investors want the best of both worlds – high Cash Flow and low or negative Taxable Income. An interesting observation became fairly obvious as a number of properties were charted.

Property 1

The chart in Figure 1 is from the single family home. I bought in 1989 and lived in prior to conversion into a rental in 2000. There was a slightly negative net cash flow at first but due to the rapid appreciation in that period, I was willing to live with it. Also, I believed it wouldn't be long before the annual income would exceed the expenses. I knew the difference would eventually be taxable income. I was ready for that, but here's what shocked me. In year 11, the Taxable Income would actually exceed the Net Cash Flow. I wondered "How can that be?" The answer came from the loan payment schedule. As a standard 30 year loan is paid down, more of the payment becomes principle, meaning less is interest. So, less of the payment is deductible. In year 28, it becomes even more dramatic when the depreciation deduction expires!

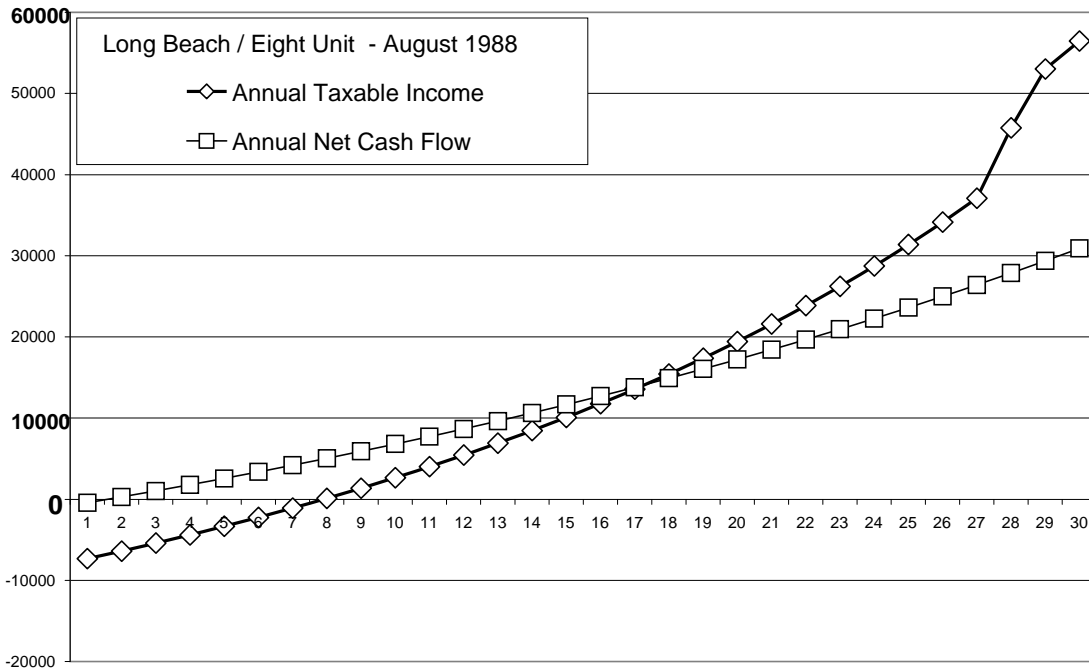


Property 1, Figure 1

So I sold this property at the beginning of 2006 for a nice profit. The decision to sell was based on overall Return On Investment (ROI) and triggered by market timing factors. My research indicated I could get better monthly cash flow with less risk of a market downturn.

Property 2

Since each property is unique, here's a small apartment complex. The two things to look for are where the Annual Taxable Income (the diamonds) cross above the "zero" line and then again when it crosses the Annual Net Cash Flow line (the squares).

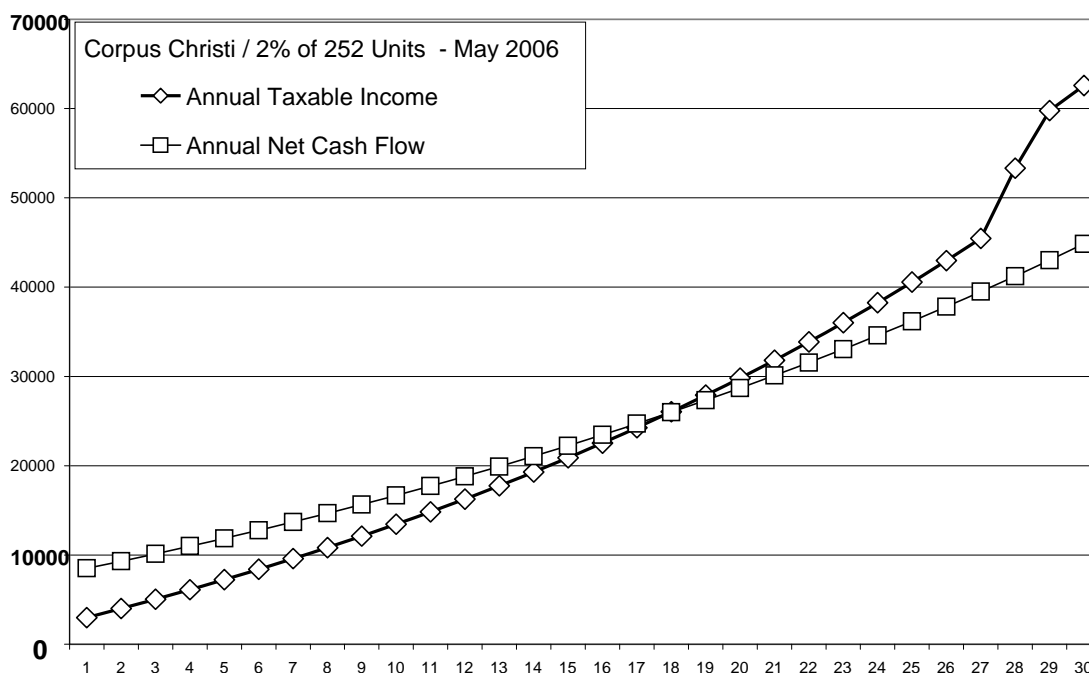


Property 2, Figure 1

In this case, Property 2 was a good buy. It started with fairly flat Cash Flow, but has provided steady growth year over year. It's now year 20 and the Taxable Income has recently begun to exceed the Cash Flow. This property has reached the end of what I call (based on the evaluations I've done) the "Optimum Hold Period".

Property 3

Just to be sure, here's a third. This case is different in that it reflects *a fraction* of an apartment complex, also known as; Group Investing, Fractional Ownership or Co-Ownership. Title is often taken as Tenants In Common (TIC) or through a Trust. When structured properly, the income and tax benefits still flow through to the investor's Schedule E. The investor may, or may not be involved in management depending on structure.



Property 3, Figure 1

Property 3 is nice from a cash flow perspective. It starts with a sizable positive Net Cash Flow which, like the others, is larger than the Taxable Income. But, like the others, the Net Cash Flow will eventually be overcome by Taxable Income, likely resulting in taxes due. In the mean time, because of the way this TIC is structured, the investor enjoys the income and tax benefits, but a professional management company deals with the headaches of managing rental property.

The Conclusion

I think we can label Buy and Hold Forever a “Plausible” hypothesis. Holding appears to be a good strategy, but our data shows there is a point at which it *may* make sense to sell. I won’t classify this as a “Busted Myth” because each investor should evaluate a number of things specific to the property and their personal needs. First, the investor should determine if the investment meets their core objectives. Next, they must consider where they are in their overall investment lifecycle. For example, are they in a growth period, where rapid appreciation is the target? Are they in a stable period where they want less risk and are comfortable with moderate growth? Or are they close to, or in, retirement? At retirement the objectives typically shift to stable income, capital preservation and reduction of management duties. The “Optimum Hold Period” may actually be “forever”. That is, the property and the objectives both change over time and move in sync, while continuing to meet the investor’s needs. But, this won’t be obvious unless there is a regular evaluation of a number of factors, not just what’s presented here.

We’ve done the review, what are the options?

Doing nothing is always an option. The interest deduction will continue to decline, driving the taxable income higher. Unfortunately, as buildings age, expenses usually

grow. In this case, the annual increases in rent may be consumed by expenses and the loss of deductions. Unfortunately, this is the default option for many investors.

Another option is to refinance and purchase additional properties. This enables diversification into other property types or geographic areas, mitigating risk. It also creates additional interest write offs. This sounds good but the investor should be sure the initial property still supports itself on a standalone basis. This option is simply an arbitrage play of the new mortgage payment versus the income from the new property.

The third option is to sell, execute a 1031 exchange and purchase a newer property. This should reduce the maintenance expenses and improve the depreciation schedule as well. By stepping up to a bigger, better quality property the investor can often improve the monthly cash flow.

“What should I do?”

Investors should evaluate each property on a regular basis. It’s easy to lump them all into a pile and calculate the returns, but as with stocks, you’ll sometimes find dogs hidden in the pile. Overall returns can often be improved by analyzing the line items, discarding the laggards and rebalancing on a regular basis.

To determine a property’s Optimum Hold Period, work with your CPA or financial advisor. The necessary data can be found on your Schedule E. If your Cash Flow is, or will soon be, less than your Taxable Income, consider taking action. Remember, every investment likely has an Optimum Hold Period, evaluate and manage each one like the golden years of retirement depend on it!

Reference:

Data for the properties represented are “best effort” estimates reflecting averages over a period of years as of Fall, 2007.

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Jim Adams is a Senior Consultant with Midpoint Financial Services, a securities brokerage firm specializing in real estate based investment opportunities. Mr. Adams is an experienced business executive with over 20 years in various industries as well as an active real estate investor. Jim currently holds series 22 & 63 licenses with Financial Industry Regulatory Authority (FINRA). For more information, please contact Jim at Jim@MidpointFinancial.com or by calling 800-409-1031. More information can also be found on the web at www.MidpointFinancial.com.