The Advanced Teachings of Mrs. Langerhorn: 34
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Note to the Reader … These are not the notes of our conversations that were published earlier 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 as such they overlap and reinforce her earlier principles. I hope you gain from them as much as I did. The earlier lessons are incorporated in the book "Stairway to Wealth" available at LuLu.com

BULLET POINTS, PART III

Dear Mitochondria,
Portfolio Management: The economy rises and falls on interest rates. If you think of the economy as an ocean, the surface waves reflect daily changes in the cost of borrowed money. That's all most people see. So if a wave crests that day, buyers hesitate. If they see a trough, boldness returns.

But whales look beneath the surface. It's not that nuanced investors totally ignore daily interest rate fluctuations. Clearly, if you can pay a little lower interest rate, that's a good thing for the borrower … it's just not the *central* thing. The most important thing is the *direction* of interest rates. And the *direction* is public knowledge.

The government tells us which way interest rates are going, and it usually tells us well in advance. The Federal Open Market Committee (FOMC) is the group that makes key decisions about interest rates and the growth of the money supply. They meet every couple of months and their expectations about the future direction of interest rates are published in business newspapers and reported in televised business programs.

Even if you're late to the party, you'll likely still have time to make your changes. Although the interest rate cycle might take rates up or down 10 or 15 or more points over two or three decades, rates are typically adjusted incrementally, in small (25 basis points or ¼ percent) steps. Does the FOMC do these things because they love your brown eyes? No, they do it because it serves their purpose of facilitating a smoothly cycling economy. Surprise changes in interest rates, especially if they are significant (50 basis points or ½ percent or more) disrupt the markets.

To get an overview of how long the recent interest rate cycle has been, consider that the Prime rate was 1.75% in December, 1947. It rose and fell in fits and starts until peaking in December, 1980, at 21.5%. The uptrend portion of the cycle took 33 years.

Shortly after peaking in late 1980, the Prime rate began a long decline until it reached 3.25% in December, 2008. This downtrend portion consumed 28 years.

Caution, Will Robinson! This most recent cycle may not be typical. Future cycles may be

shorter or longer. Even this cycle was not without it's mini-cycles. For example, In Jan 1975 the Prime rate reached an interim high of 10% before briefly dropping to 6.75% in May, 1977. Thereupon it began it's climb to 21.5%. Fits and starts, remember?

When the FOMC announces weeks in advance that their bias is towards increasing rates 25 basis points the next time they meet, the market (and the economy) has time to adjust. It's good for them and good for us. A change in market interest rates is generally a leading contrary indicator of the direction of the larger economy. When rates increase, the economy normally slows, and when rates decline the economy normally accellerates.

But wait! We've already got the loan we wanted. Why should we care what happens to interest rates (at least until we want another loan)?

It's because interest rates affect the price of investments. For example, many sophisticated investors consider short term Treasury bills as very nearly the perfect provisional place to park prodigal pesos. After all, the biggest risk factor in Treasuries, or so I've been taught, is interest rate risk and having low duration effectively minimizes that. Thus, T-bills are often the default investment.

- *Duration*: the percentage of your principal you'd lose (or gain) with each 1% change in interest rates. It's a good word to know, but it has only minimal impact with T-bills because – rather than selling at a discount – you'd more than likely just wait until the bill matures, always in less than one year.

Given that "risk-less" T-bills are an obvious default option, why would banks lend at less than the T-Bill rate? And why would anybody buy a risky apartment building if it's cap rate is less than the T-bill? To motivate a buyer to buy, or a lender to lend in all but the most unusual circumstances cap rates have to exceed T-bill rates. The take-away here is that as the government adjusts interest rates, cap rates also change and that causes the value of your investments, both current and potential, to change. Sometimes it's up; sometimes it's down. Over time, the investor can benefit enormously by incorporating prospective interest rate changes into portfolio management.

Here are the Expectations:

- If interest rates (cap rates) trend down, the apartment building you bought will be worth more money.

- If interest rates (cap rates) trend up, the building you bought will be worth less money.

None of this should be a surprise to you if you've been following this series of letters. You know that the value of an investment is the capitalized value of it's net income. The arithmetic is: annual Net Operating Income (NOI) divided by Cap Rate (in decimals) equals Price.

Example: Annual NOI of $90,000 divided by a Capitalization Rate of 8% (0.08) indicates a price of $1,125,000. If the cap rate was 10%, the price would be $900,000. If it were 6%, the price would be $1,500,000. As cap rates go up, price goes down. As cap rates go down, price goes up. *You can get very rich buying at a 10% cap and selling at a 6% cap (more later).*

Ok. So how might a cyclical change in market interest rates affect our apartment investment decisions?

If the trend is towards higher interest rates, it's reasonable to expect values to trend down. Thus, you would not buy a new building because you'd expect to buy the same building (or an equivalent) for less money towards the top of the interest rate cycle. The interest rate would be higher, but we would expect the price to be lower. The whales see this as an opportunity, as the price was fixed at purchase but they can always refinance – sometimes multiple times – as rates trend down. They would then have the best of all worlds, a low purchase price and a low interest rate.

If you expect higher interest rates, what do you do with our existing buildings? You probably should refinance right now to get new loans with the longest fixed rate periods available. If the building's net income is enough to support a fully amortized 15 year fixed rate loan, that may be the way to go.

Example: Assume a $1,000,000 appraised value and a 75% LTV, fully amortized over 180 equal payments. *Further assume the rental market is bad for the next 15 years and your net rental increases don't even offset the decline in value caused by ever-increasing interest rates* (these won't directly affect you, you're "fixed", but they affect the value of your building because they limit the maximum loan the new buyer can get).

So you've paid $1,000,000 for this building that your broker told you would be the best investment you'd ever make and at the end of the 15 years it's only worth $750,000. Terrible, huh? Well, in addition to whatever cash flows and tax advantages you've taken, your $250,000 has turned into $750,000. Your $250,000 down payment has been increasing at 7.6% per year for a decade and a half even though your building has lost value. There are probably people who would eat a worm for that kind of return. What's the takeaway? Under conditions of ever-increasing interest rates, it might be best to pay off your building(s) as quickly as you can.

At the very peak of the interest rate cycle, just when the FOMC starts to make noises about reducing rates and you perceive that the long term trend is about to turn back down, maybe you should think about refinancing whatever properties you have and buying some more. After all, the cycle has turned and the buildings you bought at a high cap rate will be worth more money as interest rates decline. Pull money out of your earlier purchases and buy more and more properties as rates continue to fall. Repeat until the cycle again turns and it's time to stop buying and start paying off.

Example: Assume your $750,000 building was paid off last week and this morning you read that interest rates have peaked at their current atrocious level and the FOMC expects to reduce interest rates ¼ point next month. You immediately refinance your lil' ol' building for the most you can possibly get at the current 18% interest. You net about $225,000. That $225,000 buys a $500,000 building.

A couple of years later you see that the step-down pre-pay has dropped to acceptable levels and you refinance *both* of your buildings at the then-current 16% rates. You get another $100,000. You buy a $300,000 buildng.

Two or three more years pass, rates are 12% and your pre-pay is again acceptable. You refinance all three buildings, pull out $400,000 and buy a fourth building.

Twenty or so years slip past and by aggressively following the buy – refi – repeat process you've run your first little $250,000 investment in an 8 unit building into in a portfolio of fifteen buildings containing 450 units and a a net worth of $9,000,000.

This morning you read that the FOMC expects to increase interest rates ¼ point next month. Oh-oh. Time to refinance to get new loans on all your buildings with the longest fixed rate periods available. If their net income is enough to support a fully amortized 15 year fixed rate loan, that's propably the way to go. Interest rates being at the cyclical low, it's probably the top of the real estate cycle and your buildings are near their peak value. Maybe you'd consider selling some buildings and using the proceeds to pay down the loans, at least to the level that they'll support 15 year fully amortized mortgages, on your best buildings.

The takeaway is this: *You have become very rich by buying at high cap rates and selling at low cap rates.* Repeat as desired.
Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more, Klarise Yahya can help. Find out how much you can borrow! For a complimentary mortgage analysis, please call her at (818) 500-9966.