

The Advanced Teachings of Mrs. Langerhorn: 23
Surf the Tide
By Klarise Yahya, Commercial Loan Broker

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

Dear Mitochondria,

When I was a young investor-in-training I would look in the paper and see what the interest rates were and think they will always be thus. Consequently, when interest rates bounced up a quarter point, I would feel extorted. If rates went the other way, if they dropped a quarter point, I would think it the bargain of the century. I was wrong both times.

In 1963 mortgage rates were beneath 6% and I thought they would never go higher, yet in 1981 my husband and I were grateful to secure two small loans, and each of them hovered around the 18% interest rate level. I want to emphasize that we were really, really grateful for the loans. Rates had been trending up for almost 20 years and I saw no end in sight. I thought they would go up forever, but I was again wrong. In 2003 I refinanced most the properties I had then – my husband, having passed, was not longer active in the business – at under 6%.

Please reflect on the period: twenty years from the low to the next high and a little over 20 years to the following low. Does that mean that the interest rate cycle always takes forty years from peak to peak? I don't know that we have enough data to support that observation, but we can certainly conclude that interest rates fluctuate – sometimes widely – and that my youthful conviction that interest rates were essentially stable was clearly misplaced. If we agree on this, the issue becomes how best to surf the interest rate cycle. There is only one way.

While there are underlying tides in the interest rate ocean, they are, like the long term cycle, largely invisible to most of us. Most folks see only the surface waves. Waves are short term phenomenon that do not necessarily foreshadow the underlying direction of rates. Upticks and downticks are a market response to short term supply / demand expectations, and sometimes they can run counter to the long term trend. In volatile times, interest rates can change even during the day. These changes are totally without any practical interest. If, for example, we sign loan documents for a \$1,000,000 loan amortized over thirty years, with the first 10 years fixed at 6.50% our monthly payment will be \$6,321. If the best loan we could get carried 6.75% interest, our monthly payment would be \$6,496. Since the only difference in these hypothetical loans is a quarter point

on the interest rate, we can compute that the lower rate would save us \$21,000 in interest over the 10 year period. For most purposes, I am convinced that in the grand scheme of things a difference of \$21,000 on a million dollar loan over ten years is without significance. Insignificant things are waves, and waves don't make us money. Tides do.

Remember the four decade long interest rate cycle we talked about a moment ago? When interest rates are going down, the best thing to do is to make as much money as you can. Wait. That's not as empty-headed as it sounds. When rates are declining, any existing stream of income will be worth more money.

For example, a building having a \$10,000 stream of net income is "worth" \$100,000 at a 10% cap rate, but if cap rates go down to 7% that same \$10,000 becomes worth \$142,000. At 5% interest, it's worth \$200,000. As cap rates go down, value goes up. That's the rule. So even if the net income of your building never changed from 1981 to 2003, the value of it's stream of income would have soared. Originally, in 1981 at 18% cap rate, a \$10,000 stream of net income would have been worth \$55,500 (\$10,000 divided by 0.18), yet in 2003 that same \$10,000 would have been worth \$167,000 (\$10,000 divided by 0.06). In this hypothetical example, rent increases over 22 years pretty much offset offset increases in expenses, so there was no increase in net income, yet the value of your building tripled.

If you had reasonable annual net income increases, say 4%, then in 2003 your net income would have risen to \$23,000 and the value of your property \$383,000. You paid \$55,500 for it, and now it's worth \$383,000. That's almost a seven-bagger. Life is good.

During this extended period ("tide") of lowering interest rates, you more than likely would have refinanced your building several times and used the cash-out proceeds to buy more property. Depending how aggressively you pursued this approach (*Buy, Improve the net income while you're waiting for rates to drop. Refinance. Buy another. Repeat*), there is no telling what you could have wound up with by 2003. Maybe the seven western states.

But the Tide turned and interest rates stopped dropping. They haven't yet climbed very far – they've mostly kind of gone sideways over the last couple of years simply because the Fed has thrown unbelievable amounts of money into the system – but most folks would probably agree that interest rates have begun their long term uptrend.

Can you still buy? Yes, but the guidelines are different now. In the first part of the cycle, you bought for capital gains. Now that interest rates have begun a long term uptrend, you buy only if you can improve your poker hand. Will the purchase increase the total net income generated by your property portfolio? Are you trading a commodity building for a franchise building? Are you going from an icky rent-controlled building to a non-rent controlled?

If the purchase does not improve your portfolio in meaningful ways, don't do it. Instead, put as much income as you can towards paying off your buildings. If your loan is out of the prepayment penalty period, every month make the largest principal reduction that you can. If you're still in the prepayment penalty years, save as much as possible so you can make a significant principal reduction payment as soon as it's appropriate. The goal is to pay off all the mortgages on your income properties.

If your loan balance reduces and it turns out that we're wrong and interest rates drop lower, you can refinance at a lower rate and expect to get a larger cash-out and buy more buildings. If rates (and inflation) go up, you'll be very grateful that one or more of your buildings are mortgage free. Having significantly higher cash flow is rather nice. Then, when the interest cycle reverses, you will have the choice of refinancing your buildings and pulling out a ton of money to buy even more buildings (don't wait too long, as ever-decreasing interest rates will push up the prices of any buildings you will want to buy), or you can just sit there on the porch admiring your portfolio of paid-off buildings. Sip a Jack Daniels and gloat smugly.

In my mind, the best way to approach paying off your buildings is to use all available cash flow to first *pay off the building with the lowest loan balance*. Then use the new, higher cash flow to pay off the next lowest loan balance, etc. In this way you will have the greatest number of paid off buildings in the quickest time.

*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**.*