

An Exchange of Opinions: #3 – Newbies vs. Vetranos
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If you've missed some of the prior articles, basic guidelines on successful investing are in my book "Stairway to Wealth" available at LuLu.com

NEWBIES vs. VETANOS

Questions of general interest will be addressed in this column. Due to space limitations, not every question can be discussed in print although I'll try to respond at least once to every phone call (818) 500-9966. This month's question comes from BH (Chino Hills, CA):

Q: I bought your book on basic investing. Some of the examples are out of date but I guess the concepts are timeless so I still learned a little. Anyway, what do you believe is the most important principle of good investing?

Thank you for what I *hope* was a compliment.

Your question is interesting, because in many ways investing is like buying a new dress. Once you have the dress, you need the shoes. Then the purse. Maybe a nice little jacket with those cute $\frac{3}{4}$ sleeves so people can see the bracelet you got because it goes so well with your new shoes. Then the seasons change and you have to start all over again. Being a woman is dreadfully stressful.

But do you see how one thing leads to another? There's never an end to it. However, the fact that there's not an end doesn't mean there is not a beginning. And the beginning for a newbie is different than for a veterano.

Newbie's start with less money, so they're often limited to real estate that's easier to finance. Things like single family homes, condos, or perhaps two to four unit buildings. All of these are financed as though they were SFRs, so negative cash flows are permitted. That means that you could buy a four unit apartment building and still have to feed it each month. In this example, you will have purchased an alligator, and nothing good happens at the zoo.

Let's say a newbie buys a fourplex with a negative cash flow of \$900 monthly. That's not unusual. But then somebody moves out. No problem, it's only a 25% vacancy factor. Thankfully, we're not talking about a rental house where one move-out would mean a 100% vacancy factor. But now we no longer get that \$1,200 a month and our negative has grown to \$2,100. And then you have to renovate the vacant unit. The negative and the renovation costs can be a big hit, especially when your hours are cut or your wife is laid off. And you know these things happen.

So the newbie put 25% down on the fourplex and now it costs him money he really doesn't have just to climb back to where his negative is only \$11,000 a year. Vacancies are rising and values are holding stable. At some point the phrase "good money after bad" starts resonating. So, for a newbie, the most important thing is not to buy an alligator. Veterano's don't have that problem. First, they'll have more money and will be buying larger projects (five units or more). Once you get to that level the banks step in to "assist" you in structuring the deal. Borrow money from them? Ok, but you have to put more money down. Then they'll lend you no more than can be repaid by 80% of the net operating income (reflecting a 1.25 Debt Coverage Ratio). And you'll have to have cash reserves equal to 10% of the loan before they lend you a dime. Jump through these hoops

and it's much less likely that you'll run into the cash flow problems our newbie experienced.

So the veterano has a different problem. His issue is not to avoid an alligator. Under current conditions, it would be really unusual for a bank to knowingly fund a negative cash flow apartment building. The veterano's challenge is to forecast the future, and that's always difficult because the indicators are confusing. You open the paper and see on page one - "Fed to Keep Interest Rates Low". You read the article and it seems convincing. Then you turn to the Money and Investing section and, somewhere in the back pages there's a short entry about the annual federal debt, the cumulative deficit, and increasing taxes.

The newbie, if he gets the Wall Street Journal at all, would see the first page article and think all is well with the world. He's watching the waves, the ocean's surface noise. The veterano recognizes noise as what it is and snorts his dismissal. The veterano searches for the deepwater currents ... like things that might influence interest rates.

Interest rates determine the value of all investments that you can borrow against. If you have to borrow money to buy a stream of income, that stream of income is worth a lot less at 15% carrying charge than it would be at 2%. There's only so much debt that any given investment will support.

The best time to buy apartment buildings is when interest rates are at their peak and the government is struggling mightily to bring them down. The period just after President Reagan took office comes to mind. Folks bought apartments then, even at really high interest rates. They understood that high interest rates mean low prices. Then they simply refinanced and bought more buildings every time interest rates dropped a couple of points. By the time rates bottomed out, some 20 years later, they found themselves shockingly rich. We've gone over the math in earlier Letters. The results continue to astonish me.

But now we're coming to the end of multigenerational low interest rates and we're facing a long term uptrend. And the beginning of a long term uptrend in rates is about the worst time to buy income property. At times like these our challenge is just to survive until rates top off – and to be liquid enough at that time to start buying.

Ok. So to review ... a newbie would read the front page of the day's WSJ, conclude that interest rates will continue at the present low levels for the indefinite future, and invest enthusiastically. The veterano reads the back pages of the Money & Investing section and concludes we're in the beginning of a long term uptrend in rates. That white light at the end of the tunnel is a train.

When discussing principles of good investing, BH, there's a difference depending on where you are on your career path. Newbies should be careful of alligators. Veteranos should plumb the currents.

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 or email at KlariseYahya@SBCGlobal.net.