

Letters to Mycroft When the Market Drops

To My Dear Nephew, Mycroft:

Aunt Mitochondria expected the apartment market to drop. I asked her what made her think so.

Oh, it's because money is liquid, dear. It's always flowing from one investment to another. When new money comes into the market, it goes to where the greatest returns are thought to be.

Imagine placing a long plank over a sawhorse. You have created a teeter-totter, with the sawhorse being the net income you expect from that particular investment. At any given moment in time, the net income is fixed. Oh, it may have changed in the past, and it might certainly change in the future. But right now, at this instant, it is fixed.

Label one end of the teeter-totter **Price**. Label the other end **Yield**. Price and Yield go up and down on both sides of the sawhorse. The sawhorse represents **Net Income**. As long as Net Income stays the same, if Price goes up, Yield must go down.

For example, suppose we have a Net Income of \$100 a year that we buy for \$2,000. What is our Yield? Simply divide \$100 by \$2,000 and we find our Yield is 5%.

Now, imagine that the Price of that \$100 annual income goes to \$5,000. What happens to Yield?

Wait, Auntie. We don't even know what the investment is! And why should it go to \$5,000?

It doesn't make any difference what the investment is. It could be anything that generates a stream of income. It could be apartment buildings, or stocks, or bonds or even egg-laying chickens. All we know is that this hypothetical investment generates a stream of income of \$100 a year, and for some reason the market heats up and the Price of that stream of income skyrockets.

So the question remains. If Price goes up, what happens to Yield. Remember the teeter-totter? Price is on one end and Yield is on the other. If Price goes up, Yield must go down.

In this case, a stream of income of \$100 a year purchased for \$5,000 yields only 2%.

Why would anybody pay \$5,000 for something they could have bought for \$2,000?

Because there are two streams of income provided by almost any investment. The first is annual cash flow. That is represented by the \$100 Net Income.

The second stream of income comes in a lump sum when you sell the investment. The sales price could be what you paid for it, or it could be less or more. If you bought a government bond for \$1,000 that paid 4% interest, you could expect to receive \$40 a year until the bond matures, when the government would give you back your \$1,000. You got back what you paid for it.

If you bought a stock for \$40 that paid you two-percent dividends, you would receive \$0.80. If you sold the stock at the end of a year for \$35, you would suffer a loss.

But, oftentimes, things do go up. Say you pay \$1,000,000 cash for an apartment building that generated \$80,000 a year in Net Income. Your capitalization rate was 8%.

Over the next three years, you manage the building well and your net income rises to \$120,000. At the same 8% capitalization rate, your apartment building would be worth \$1,500,000. You are a happy camper and sell your building for the same 8% cap rate you bought it for. You pocket a cool half-million. Life is good.

But when you try to buy another building, you find that while you weren't looking, cap rates dropped to 6%. Just to replace that \$120,000 stream of income you used to have now runs you \$2,000,000. It'll cost you a half-million more. Life sucks.

What happened, Dromedary, is that folks began to realize that they could make money buying apartment buildings and raising the rents. You bought yours at an 8% cap rate, and so did a lot of other people. But, soon, the competition for promising buildings increased and people started to bid the prices up. They would say, I don't need to make half a million. I would be happy with \$400,000 profit in three years. I'll bid \$1,100,000 for those units! Then the next guy would say, I'll bid \$1,200,000!

Now the first guy says to himself, Wow! Those units shot up \$100,000 just as I stood here! They must be a great investment. I'll bid \$1,300,000!

Pretty soon, two things happen. The first is that the annual Yield on the investment drops because the Net Income hasn't changed even if the bid Price goes up. The second change is that folks begin ignoring the monthly cash flow they could pocket from the building and begin emphasizing the profit upon resale. The market enters its bubble phase.

How do you know a financial bubble when you see one, Auntie I asked.

Oh, everyone knows that! Whenever an investment's annual cash flow is less than that of a risk-free 10 year Treasury, you are witnessing a bubble phenomenon.

Bubbles benefit current owners if they sell or cash-out/refinance in a timely manner. Whether they sell or cash money out of their building, they generate funds that can be used to buy more buildings after prices come down.

So, do you think apartment prices will come down?

Well, interest rates are at a two-generation low. Because money is liquid, it flows, for example, from bonds to stocks and income property and back around again. It flows to any investment that promises greater yield. Historically, interest rates have to increase, whether this year or the next. As interest rates go up, the Net Income from an apartment building will service less and less debt. That makes sense, doesn't it?

If the building supports a smaller mortgage, but prices stayed the same, doesn't it seem reasonable that you would have to put more money down?

If you make a greater down payment, but the Net Income stays the same, doesn't that reduce the Yield on your down payment?

And remember, there aren't as many investors who can make large down payments. So that puts additional pressure on sale prices. Ultimately, dear, interest rates will inevitably go up. When that happens, the prices of income properties will go down.

That sounds so terrible! I only have one little building, and I don't want it to go down! Isn't there anything I can do?

Well, you certainly can't change the market cycle. But you can use price fluctuations to increase your net worth. You could refinance and cash-out as much money as you can right now. Then just put the money somewhere safe, and use it to buy another building when prices are favorable to you. That, Dromedary, is how I benefit from market cycles.

Colloco, Ergo Sum,

Aunt Klarise

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.