

**Letters to Mycroft #39:
Investment 701
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To My Dear Nephew, Mycroft,

On March 2nd, 1866, the Excelsior Needle Company started making sewing machine needles in Wolcottville, Connecticut. Dromedary knew that Uncle Gustov collected important anniversaries like this, and tended to celebrate them with a little Jack Daniels. It was a good time to ask him questions, because after the first glass or two he got kind of talkative.

"*Uncle Gustov*", Dromedary asked as she delicately sipped her raspberry tea, "*How much of my money should be in income property, and how much in stocks, and how much in bonds?*"

"Well, lass, the four *necessaries* (sometimes Uncle Gustov tended to make up words) of any good portfolio are (a) growth, (b) income, (c) capital preservation, and (d) liquidity.

"I don't know of any way to get all four in a single investment, except perhaps in a good mutual fund. Some of them might make your investment grow while giving you a little income. They are clearly liquid, meaning that you can buy and sell interests with very low friction costs. And by having shares in many companies, the capital preservation component is addressed, if not fully answered.

"But there are problems with most mutual funds. There's phantom income, for example. You see, if the fund bought a particular stock real low in February and sold it at a huge gain the following November, they owe taxes on the increased value. Naturally, they pass the tax liability through to their fund holders.

"Now, assume you buy into the fund in December, just before the end-of-year statements are mailed out. You know who has to pay the taxes on the gains? You do! Even though you *never got the money* ... you get to pay the taxes.

"*Uncle Gustov!*", Dromedary interjected, "*that hardly seems fair!*"

"Well, you are the owner of record. You know that when you buy a business, you assume liability for the debts of the business. Similarly, when you buy into a mutual fund you assume liability for accrued taxes. It's the Pregnancy Principle at work ... *the last one to touch it, that's whose fault it is!*

"People who buy mutual funds are not really investors. They are just common "savers" who scramble up the risk / reward ladder. Real investors learn to analyze the flow of money. They make their own decisions and live with the consequences.

"Going back to your question about the four necessities, you have to decide where your comfort level lies. But remember that nobody can be expert in all investments, so you will probably pick one or two kinds and stick with them. Whatever kinds of investments you select, **the portfolio as a whole** really should provide for growth, give you some cash flow, keep your principle relatively safe, and be liquid in case you need money for some reason.

"Apartments can give you the first three necessities. All things being equal, as rents increase, the value of the building goes up. As rents go up, obviously your income increases. And the data shows that well located apartment buildings tend to at least preserve your capital, even if you get a sucker that never goes up.

"I like to look on apartments kind of like non-liquid bonds, but better because the "principal" grows. You see, if you buy a bond, you normally get semi-annual interest payments for the term of the instrument, then you get your principal back.

"Say you buy 100 bonds. Bonds are normally sold in \$1,000 increments, so you would be investing a total of \$100,000. Presume the bonds pay 5% interest. Every six months (bonds normally pay semi-annually) you get a check for \$2,500. Out of that, you have to pay taxes. Hypothetically, say you're in the 35% bracket. You have \$1,625 left. But then you have to account for inflation. If inflation is 3%, then your net spendable is \$1,600. That's \$267 per month on a \$100,000 investment.

"In a simplified manner, that's how a bond works. Now, instead of buying 10-year Treasuries, let's say you put that same \$100,000 down on a small apartment building.

"The purchase price is \$400,000 and you put 25% down. There are tax advantages when you own apartments, and inflation tends to work in your favor because it pushes rents and values up. So we can probably ignore any adverse tax or inflation consequences.

"You get a loan of \$300,000 at 6% interest, with payments of \$1,799 monthly. Automatically, you know that your initial cash flow has to be at least \$4,317 a year.

"How do you know that, Uncle Gustov?" Dromedary puzzled.

"Easy. It used to be that banks would lend money on apartments without caring whether the borrower had any cash flow. But when the economy changed, the banks got a lot of apartment keys dropped on their desks. Pretty quickly, they learned that their foreclosure rates went down a lot when the borrower had a positive cash flow every month. So they just stopped making loans unless the borrower could achieve a net cash spendable every month.

"The banks did that by using a Debt Coverage Ratio and applying it to the building's Net Operating Income. Remember, the NOI is what's left after paying all expenses, but before making the mortgage payment.

"The banks just started dividing NOI by a DCR of, generally, 1.20, meaning that the loan payment is represented by the "1" and the borrower's initial cash flow is the point 20. So you want to know how much is the starting cash flow on a maximum apartment loan at 1.20 DCR? Just take 20% of the payment. I'm surprised you didn't learn that in school!

"If the DCR was 1.30, then the starting cash flow would be forecast at 30% of the monthly loan payment. If the DCR was 1.50, then your initial cash flow would be estimated at 50% of the monthly payment. You get the idea. *A key point here is that the higher the DCR, the riskier the bank thinks the loan is.*

"Anyway, in this example the monthly cash flow comes to \$4,317 a year, or 4.3% on your down payment. Doesn't that compare pretty well with the taxable \$5,000 you got with the bond? And remember, with the bond, your "cash flow" is fixed. With an apartment building, we expect the cash flow to increase every year. So there is the *cash flow* requirement of our portfolio.

"When bonds mature, they will be redeemed at par. Meaning that when bonds with a face value of \$100,000 are cashed in you'll get \$100,000.

"But if you buy an apartment building like we discussed earlier, and keep it for 10 years, your mortgage balance should be down to about \$250,000. You've paid off fifty grand right there. And, assuming the building appreciates at 5% per year, the new building value will be about \$650,000. So instead of just getting your money back (as with a bond), your down payment will have grown to \$400,000 (new value of \$650,000 minus mortgage balance of \$250,000). So there you have the *growth* portion of your portfolio.

"What about capital preservation? Well when you buy an apartment building with 25% down, you are essentially self-insuring the first 25% of the buildings value against loss. But the bank is self-insuring the other 75%.

"Think about it like this: You want to buy an apartment building, and a complete stranger offers to put 75 cents of his own money in the pot for every quarter you put in. The stranger's experience with similar loans makes him confident that the building will not drop more than 25% in value, regardless of poor management, regardless of whatever happens in the economy, regardless of new competition being built right next door.

"What alternative investment, Dromedary, can you think of that gives you that kind of *capital preservation* confidence?

"The biggest problem with owning apartments is that they are not liquid. Say you own a 20 unit building worth, say \$3,000,000. All of a sudden you need \$75,000. Can you quickly sell one half of a unit to get the money? Of course not. Even if you found a way to sell half a unit, it would take time.

"So the biggest *portfolio* problem with owning apartments is a lack of liquidity. You have to have easily accessible money somewhere.

"But of the four necessities any well constructed portfolio should have, apartment buildings provide three of 'em. *And that's a good thing.*

"So what portion of your portfolio should be in income property or stocks or bonds? I've never found much of value in bonds, so I don't put any money there. All my money goes into income property or stocks. And generally, I like to keep my assets about 75% in apartments and 25% in stocks. That ratio seems to let me sleep best at night."

Cordially,
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**.