

Letters to Mycroft #44: The Best Single Investment by Klarise Yahya

To My Dear Nephew, Mycroft:

Dromedary asked, "Aunt Mitochondria, if a person was only to make one investment in her life, what should it be?"

There are always exceptions, dear, that confuse the issue. For example, if a person bought a bunch of ATCO, a highly speculative stock, at a favorable price and it multiplies in value, that might very probably be the best investment of his life.

Or if a person went past the edge of town, discovered where the new elementary schools are expected to be built, and bought the land around one of the schools the unimproved land that will one day be housing tracts you can be pretty confident it might be the best investment he could make.

Perhaps a person buys a small drive-through hamburger restaurant. He offers only fresh foods - no frozen patties, here and hires eager young counter workers fluent in English. Over time, he clones the store in many locations. Finally, he has fifty or sixty very successful burger restaurants. Well, that original purchase, out of which all the others sprang, was probably the best investment of his life.

Now, all that being said, most folks don't do any of these things. Even if one buys ATCO, there is a very real possibility you will sell at a loss. If you bought the land around a forecast school site, it might be that the school may never be built. Or, you could buy a hamburger restaurant in a great location, and find that In-n-Out builds one right next to you. All of these are highly risky endeavors, and if unfortunate things happen, you modify your aspirations. So, you see, there are many possible best investments if they work out. The issue is not whether an investment might make money. No sensible person puts money at risk and expects to lose. We all become enthusiastic and think we're going to make a profit. But, in my experience, most investments don't meet original expectations.

The real issue we must address before placing money is this: How would a knowledgeable third party appraise the investment?

"Where do you find these experts, Auntie? And how much does it cost for them to give you their opinion?" Dromedary interrupted.

I don't pay for their opinions, dear. It is a free service provided by lenders. You see, a bank can't keep its lights on if it does only a single loan. A bank makes hundreds or thousands or tens of thousands of loans over its corporate lifetime. All these loans go into a database accessible to the marketplace.

"You mean I could just plug into the bank's computers?"

That's not what I mean. The particulars of each loan are proprietary information that the bank is not going to release without just cause. But you don't really care about the details of each and every loan anyway. What you want to know is, with all their institutional knowledge, how would a lender view your proposed purchase.

The results of accumulated corporate experience, on almost any investment, are available to anyone. They call it the loan-to-value ratio.

For example, when you borrow on your stock portfolio its called margin. Basically, you use your portfolio as collateral to borrow from your stock broker. Not every stock is acceptable for a margin loan, and those that are are limited to 50% LTV. Now think about that, because there is a lesson there about how risky the brokers think the stock market is.

I don't even know if ATCO is marginable. If the broker will not lend you money on the security of ATCO, at any loan-to-value ratio, doesn't that tell you

something about how the brokerage community assesses the riskiness of that particular stock?

You can borrow institutional money on raw land, but it, too, is generally limited to 50% LTV. Loans to buy a business are perceived as so risky that the government (SBA) has to step in to guarantee that the banks won't incur a loss. And even the SBA almost always requires cross-collateralization so if the business goes under they can foreclose on your house and get some of their money back.

With that background, let me ask some rhetorical questions. Is there any investment that has such modest risk characteristics that institutional lenders will give you, under the proper circumstances, almost all the purchase price? And doesn't that indicate that this particular investment is seen as awfully secure? What might that investment be?

The answer is small owner-occupied rental properties. With government assisted financing (FNMA, for one example), you can sometimes get 100% LTV. Even without government help, the marketplace can provide 90% combined LTV.

Dromedary objected, "But what can someone do with a single four-plex?"

Good question. I'm just going to make up some numbers here, so bear with me. It's important that you get the concept. You can change the numbers later to fit your situation.

Assume you buy a four unit building at 10 times gross income. Each unit rents for \$1,000 a month, so the building generates \$48,000 a year. You pay \$480,000 for this investment, with nothing down.

You get a 6% loan for 30 years, so your monthly payments are \$2,877. Your taxes, insurance, and maintenance are another \$1,200 a month. Basically, if you pay yourself full rent for the unit you live in, the building will break even. The market permits rent increases of 7% a year.

Now, Dromedary, here are the keys: You pay full rent on the unit you occupy and you pay an additional \$1,173 a month towards the principal. Basically, you are occupying one unit and making double rent payments to yourself. Do you know how the numbers work? You will have the fourplex paid off in 15 years. It will be paid off even faster if you (additionally) apply the full amount of the annual rent increases towards paying off the loan.

So, why would you want to pay off the loan on this little fourplex? Because when you do, you can officially retire. You see, most folks spend at least 25% of their income on rent or mortgage payments. So there you are, living rent free in one unit and living off the \$8,000 you're getting in rents.

"\$8,000?? Where did the eight grand come from?"

Originally, the rent was \$1,000 a month per unit. After 15 years of seven percent annual increases, that monthly rent per unit has become \$2,750. The three rented units are generating \$8,250 a month.

You asked what would be the best single investment a normal person could make. It would be a four-unit building, with a 30 year fixed rate mortgage. Then, she should pay it off as quickly as she could. Did that answer your question? 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.