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Real Estate Brokerage/Retirement Planning

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Investment Newsletter – February 2006

Accessing Home Equity for Retirement

This month's newsletter is written as advice to a certain segment of the population but there are implications for all real estate investors. This is because the large Baby Boomer generation's looming retirement will cause large shifts in capital out of certain assets and into others. Such shifts cannot help but affect investment returns in the assets where capital is flowing in or out.

The term Baby Boomers refers to the generation born between 1943 and 1960. I want to describe a typical scenario for the oldest of this generation and provide my advice for arranging their affairs for retirement. Specifically, I will consider someone who is at or near retirement with a large amount of equity in their personal residence. Furthermore suppose that:

- You are not tied to location by job or other obligations
- Your children are gone and your house is bigger than needed
- You need to replace wage income

In looking at the choices to be made, I will consider potential psychological and social factors that may constrain actions. In particular, many people have developed an aversion to renting and some may consider it unacceptable regardless of its financial benefits. Because of nearby family and friends or because of a natural desire to avoid big change, some people will put limits on where they can relocate themselves in retirement.

The Big Price Gains are Past for Bay Area Housing

Many people feel that their house is an excellent investment. Looking backward they are right. Returns on houses have been very high over the last few years. However, as many learned when the stock bubble burst in 2000, past returns do not guarantee future returns. In fact, given the psychology of markets, they tend to overshoot. Psychological momentum causes prices to be bid up longer than is justified by underlying economic factors so that periods of extraordinary returns are often followed by losses or low returns. Therefore, it is important to understand what has driven prices and returns in the past, and whether these conditions will persist going forward.

I will illustrate with Bay Area house prices but much of this analysis will apply in other parts of the U.S. House prices in the Bay Area have risen far out of proportion to incomes so that currently only 12%[1] of households could afford to purchase the median priced home with a 20% down payment. Statewide only 14% can afford the median priced home. Prices have risen to this level because the supply of houses for sale has been small relative to incremental demand in the market. I.e. more capital is coming into the market than is being taken out. People with very high incomes (or large amounts of capital) relative to the general population are buying up the limited supply. Dropping interest rates and easier loan terms (100% financing, interest only, negative amortizing loans) have vastly increased the amount buyers can borrow and thus the amount of bank capital flowing into the market. The rapid increase in prices has also fed upon itself psychologically: there are indications that much of the demand has been from speculators rather than end users – especially in San Francisco.

At this point the increase in capital flows from banks is over. Long term interest rates are moving up and the Federal Reserve has raised short term rates such that they no longer can be used to qualify a borrower for a larger adjustable rate loan. In addition, the bank regulators are becoming concerned about easy loan terms and have signaled that they may force the banks to tighten up standards. Without larger mortgages, buyers must bring more cash to bid up prices – and they don't have it.

The media has picked up on this reduction in demand. This has spooked the speculators and so dampened this source of demand further. There are non-financial buyers in the market but even they are concerned.

Now let's look at supply. With demand clearly past its peak there is good reason to expect increasing numbers of sellers to try to get out of the market before prices decline significantly. Speculators and recent buyers who had to use adjustable rate loans to afford their houses may be forced (by higher loan payments) to sell - particularly if they were counting on appreciation to bail them out of the higher payments. Over the long run, many in the coming wave of retirees will do the math and figure out they will be much better off by selling. They will pull their capital out of the overpriced (and therefore risky) Bay Area, and buy a bigger house in a lower cost location such as Phoenix or Palm Springs. They can then invest the vast bulk of their capital in assets that produce income and enjoy a higher standard of living. As more and more Boomers retire to take advantage of this location "arbitrage", they will take larger and larger amounts of

[1] According to the California Association of Realtors as of December 2005.

capital out of the Bay Area housing market – and increase the supply of houses for sale. This phenomenon will not be limited to the Bay Area. The same thing will happen everywhere that prices have run far ahead of the fundamentals.

Returns Going Forward

In the short run, house prices will probably drop as more capital comes out of the market than is going in. In ten years I expect house prices in the Bay Area to be roughly where they are today. But let's use the optimistic assumption that prices increase 2.5% annually over the period. A typical homeowner nearing retirement in the Bay Area has $400,000 equity in a $700,000 house. After retirement it will probably not be possible to refinance the mortgage to a higher amount. Thus equity will build up and further depress returns. If we include the net rental value of the house in our calculation[2], and assume a combined marginal tax rate of 33%, the average after-tax return over 10 years would be 6.5%. Let's compare that with what you could earn with other possible investments.

The Opportunity Costs: Alternative Investments

First let's look at houses in lower cost retirement locations as investments. If you buy a house in New Mexico, for example, you can probably rent it out for breakeven cash flow with 20% down. Even if it only appreciates at the same rate as the Bay Area house (2.5%) the additional leverage boosts your return to more than 10%. Given the likely flows of retirement capital into places like this, annual appreciation of 5% is more likely. This would boost the average annual returns to more than 16%.

If you want to earn cash flow from a real estate investment, you can buy a triple net leased commercial property. With this type of investment you have no management responsibility – just collect your check every month. You could expect to earn 11% on such an investment – 4% in the form of cash in the first year with cash flow increasing over time as rents escalate.

Even the stock market would probably yield after-tax returns four to five percentage points higher than what you would earn on equity in a Bay Area house (if you follow the correct investment strategy). I expect people investing in my separately managed accounts to outperform by at least 10% a year compared to the returns they will earn on their personal residence in the Bay Area.

These differences in returns will matter! The message is that you will be better off if you can take your gains and move your capital elsewhere. What if you cannot bear to do this, but you still need to replace wages when you retire?

Reverse Mortgages

In concept, reverse mortgages look like a good idea. You pull equity out of your house without having to make any loan payments during your lifetime unless

[2] I'm assuming annual rent minus non-mortgage expenses are 3% of asset value to start and grow at 3%.

you sell the house. Unfortunately, you must have a very special situation for these products to make financial sense. The main problem is that the interest on the loan is not tax deductible during the life of the loan because it is not paid in cash. Thus the tax benefit of mortgage borrowing is postponed indefinitely. Another problem is that maximum loan amount for someone just entering retirement is 50% of their house value (or $362,790 for the best loan terms, whichever is less). In California many people will have higher existing loans and therefore they cannot even do a reverse mortgage. The other negative point is that all these loans are adjustable rate loans and therefore they expose borrowers' wealth to interest rate risk. Assuming a marginal tax rate of 33%, I estimate that use of a reverse mortgage compared to a conventional mortgage would reduce after-tax returns on capital by almost 2%. You're better off borrowing as much as possible right before you retire and investing the proceeds well. By doing this you can get the benefits of the reverse mortgage without the downside. On the other hand if you are over 70, in a very low tax bracket, have a small existing mortgage, and don't want to sell, then a reverse mortgage *might* make sense.

Conventional Mortgages

For people just entering retirement who don't want to sell but are comfortable taking more risk, it makes financial sense to maximize your loan size before you retire (refinance while you can still qualify) and invest the proceeds in income generating assets that can help pay the mortgage. This will pay off big if inflation and/or interest rates increase through time as I expect they will. In this case the income may significantly exceed the mortgage costs. This strategy also provides cash for emergency spending if needed – even after you no longer qualify to borrow.

Flexibility Drives Relocation Decision

A major factor in determining the extent that you can tap your home equity for retirement is how flexible you are about where you will live. If you absolutely must own your existing house, you will probably only be able to pull out a small fraction of your home equity to live on in retirement. Let's assume you are willing to sell your house to both lock in your gains and to access as much equity as possible for retirement. Some of you will want to remain within driving distance of your current location, others will want to be within a short flight, and some will have total freedom to live anywhere in the world. We'll look at all these possibilities.

One choice is to just sell a large house in order to buy a smaller house or condo nearby. This will help some, but the big gains come from pulling all equity out of a high priced market (at least until prices fall to a sustainable level) and renting or moving away. Let's consider the options if you must stay in the area.

Generally people raise the following objections to renting: they don't get a tax deduction, the rental is short term so they cannot fix it up the way they want it, and they might have to move. Tax deductions are only valuable to the extent you pay a high rate of tax. Therefore mortgage interest deductions become much less valuable when you retire. Also, most homeowners in high cost places like the Bay Area do not realize that rent is so much less than the cash costs of owning a house that even full tax benefits do not make up for the difference. Owning rather than renting is only better *financially* if appreciation of the house is enough to make up for the higher cash costs. If my analysis is correct, renting while the market goes down will be the smart thing to do financially. The other objections to renting can be overcome by negotiating a long-term lease or renting in a city with rent control (which gives you de-facto ownership without the capital requirements in a multi-unit building). You might even be able to lease back your own house long-term from an investor who buys it.

Suppose you have the flexibility to buy into a low cost retirement community early before prices run up. There are compelling reasons for large numbers of retirees to migrate from high cost coastal cities to Florida, the Southwest, and California desert areas. As their capital shifts to these areas, prices will be driven upward. If you know where you want to be, you should be buying as soon as possible. There are decent values in rural California (e.g. Clear Lake), Arizona, New Mexico, Nevada, and Florida. Hawaii is also likely to see capital inflows both from the mainland U.S., and from Japan. Current high prices in Hawaii, however, make it somewhat risky to buy houses and condos there. Because I expect new technology to significantly reduce building costs there, I recommend buying land rather than an existing dwelling.

For those of you who are very flexible and don't mind flying, retiring outside the U.S. may be very appealing. Houses and the cost of living in places like Mexico, Costa Rica, or Thailand are a fraction of U.S. costs. Even retirees of relatively modest means can afford beachfront homes in such low cost locations. Also, real estate in these places is likely to appreciate very significantly as retirees, and their capital, arrive in increasing numbers. While you'll pay more to fly to the U.S. to visit your friends and family, the cost savings and the increased investment returns will be many times greater than your increased travel costs.

Investing the Money

How you invest the capital you pull out of your home depends on your total capital, your age, and your tolerance for risk. I will describe the choices here but the process of choosing how to allocate funds among these is beyond the scope of this newsletter.

The three categories of investment we will consider are:

- Publicly traded securities – stocks and bonds
- Real Estate
- Alternative investments – private securities.

In the realm of stocks and bonds there is a wide range of risk levels and an even wider range of potential money managers that can manage your investments for you. Bonds are promises to pay certain cash flows in the future. Their risk depends on who is making the promise and how far in the future the principal will be repaid. The safest of these are U.S. government obligations but these only yield about 4.5% currently. Riskier (below investment grade) corporate and foreign government bonds can yield reasonable returns in the 6 to 8% range. These returns are taxed at ordinary tax rates. Assuming a 25% tax rate, the after-tax returns would range from 4.5% to 6% on the riskier bonds. Even if the issuers keep their promises, these securities have price risk over their term. Since I expect U.S. dollar interest rates to trend upward from here, I recommend that you invest mainly in floating rate bonds. By this I mean bonds whose interest payments increase along with the general level of interest rates.

Preferred stocks are similar to bonds in that they pay dividends that are fixed promises to pay. These securities rank behind bonds in safety of principal. Also issuers have the right to suspend the dividend payment if the company faces financial difficulties. Therefore, the preferred stocks of a particular company will generally have a higher yield than a similar bond of the same issuer. Preferred stock dividends sometimes, but not always, qualify for the lower 15% federal tax rate. The tax rate depends on whether the company paying the dividend pays federal taxes. For example, bank preferred stocks will qualify for the lower tax rate, but preferred stocks issued by Real Estate Investment Trusts (REITs) will not qualify. Preferred stocks also vary according to whether dividend promises are fixed or floating. In the current interest rate environment, I recommend buying preferred stocks whose dividends will rise along with short term interest rates. Assuming a federal tax rate of 25%, you can expect to earn 4.25% to 6% on preferred stocks on an after-tax[3] basis for the lowest risks securities. Note that the low end of this is roughly equivalent to the after-tax cost of a mortgage.

For those willing to take on more risk but still looking for income, there are equity income investments: high dividend yield stocks and trusts. Generally the best of these are REITs and energy trusts – particularly Canadian energy trusts. You can earn 10-11% pre-tax in mortgage REITs and a bit more than that with Canadian energy trusts. The Canadian trusts are taxed at the 15% rate while REIT

[3] Considering federal tax only, not state taxes.

dividends are taxed at ordinary tax rates. While these dividends could be cut, it's more likely they'll actually increase over time.

Finally, we come to something everyone is familiar with: investing in stocks for capital gains. This can be a good strategy even for investors who need income as long as you recognize that capital gains are income too. Capital gains are taxed at the 15% rate so this strategy has the potential for very high after-tax returns. Because of the random fluctuations in pricing that provide opportunities in the stock market, you will need a long term investment horizon to take advantage of the higher returns here. The key is finding an investment manager who can consistently earn good returns without taking significant downside risk. A good manager, focused on market beating returns, should be able to earn returns of 10% or higher over the long run. There are hedge fund managers who have earned more than 30% annually over long periods. Unless you have thorough training in finance and can devote at least 8 hours a week to investment management, I highly recommend that you do not try to pick your own stocks. Rather, focus on picking the right manager.

Moving on to real estate, there are two types of property I recommend. Most people should invest in at least one of these types. The first is triple net leased property which I mentioned earlier. These properties are similar to bonds but with some built in inflation protection. These properties are generally purchased in order to generate a steady monthly income to live on. Buying with a mortgage on the property will reduce these cash flows but boost overall returns and lead to faster percentage growth in income. Thus you should project out your cash flow needs before deciding how much leverage to use.

The second category of real estate that you should look at buying is resort real estate. Condos and houses in vacation/retirement areas should perform very well going forward so long as you are careful not to overpay relative to current rental income. As the baby boom generation retires, they will have more time to spend traveling to resort areas and properties in such places should earn very good returns over the long run. These investments require significant analysis - I would recommend you seek expert advice before buying.

In the category of alternative investments, the most appropriate investments are syndicated real estate deals and hard money loans. By syndicated, I mean a real estate investment sponsored and managed by someone who raises money from investors and splits returns with them based on some formula. These can be good deals for all concerned. The investor has the potential for high returns without direct management responsibility. The sponsor can apply his skills to add value to more capital and therefore earn more for himself. These deals will usually be residential rehabilitation or development but there are endless possibilities. Such deals require extensive study to understand all the terms and the risks. A sponsor you can trust is the most important aspect for these investments.

Hard money lending means that you act like a bank and lend money secured by real estate. There are many real estate brokers who can help you make such loans. Typically you will lend to an entrepreneur who has a value added strategy that requires more capital than he has. This lending will not earn as high a return as on a syndicated deal but the risk will be much lower so long as you structure the deal correctly. Typically hard money lenders earn 9 - 15% pre-tax depending on the risks of the loan.

Conclusion

If you have substantial equity in your home that you wish to use to fund retirement spending, the current market environment dictates that you take action sooner rather than later to access that equity. Financially, the best choice is to sell and reinvest the funds elsewhere. Berkeley Investment Advisors can help. If selling is not an option, then it's best to maximize your mortgage now and lock in the rate long term. Then use the money to invest in income producing investments. This should boost your income over the long run and provide liquidity for emergency spending. The decisions made now can have a big impact on your standard of living in retirement – inaction is a decision that can cost you money! Whatever you do, get expert advice – it will be worth it.

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