

Eyes Wide Open

Understanding Why Real Estate Is a Solid Investment

ADVANTAGES OF INVESTING IN REAL ESTATE

All investments include risk, and real estate is no exception. Be wary of anyone who tries to tell you something different. Like all kinds of investments, buying and selling property also has its advantages and disadvantages. It is not for everyone.

That said, real estate is often considered to be a lower-risk investment than investing in the stock market. Moreover, real estate investment can have more advantages, depending on your investing style and your willingness to do some legwork. Let's run through the pros and cons of investing in real estate.

LEARNING NEVER STOPS

Do you need to think about why you invest in real estate if you're already doing it? Yes. Reviewing what we "think" we know helps investors identify areas where they've gone astray. Occasional reviews will help you re-focus your investments.

Appreciation

Why does real estate appreciate over the long term? Because people will always need places to live and places to conduct their businesses. Moreover, real estate has a finite quality few other investments can emulate. In the words of Mark Twain, the great American humourist, "Buy land. They're not making it anymore!"

Investing in real estate, especially over the long term, usually results in a steady appreciation of property value. Historically speaking, property values have also outpaced the rate of inflation each year. As a general rule, real estate appreciates when inflation rises because the cost of building properties rises over time. Everything from the cost of land to the price of bricks and the bricklayer's wages trends upwards.

Real estate values also rise with regular upkeep or the kind of renovations that add value to a property. This is why many real estate investors deliberately seek out rundown properties as they may be able to manufacture immediate appreciation (although this can also get people into trouble where the appreciation is less than expected). Here, their business goal is to fix up these properties in a cost-effective way and thereby increase the value and hopefully boost their return on the investment when it's time to sell. The property "flip" is so common across North America and Europe today that it has spawned a special genre of television programming. It is also worth noting that some investors deplore the word "flip" because they think it undermines the serious work that goes into identifying, buying (when the price is right!) and renovating these properties. This is, after all, one segment of the real estate investment market where the appeal of "easy money" most frequently leads market newcomers towards nasty economic outcomes. Indeed, such investments may prove very costly when appreciation is less than expected and an investor is working with borrowed money.

Leverage and Minimal Starting Capital

In real estate investment, leverage is the ability to borrow money towards your investment. When it comes to investments, this is huge, since real estate investing allows you to use leverage to increase your return.

Buying property typically requires minimal starting capital of roughly 5% to 10% of the property value, and the ability to borrow the rest. The exact minimum payment will depend on a number of circumstances, such as the lender, the nature of the property and your own credit profile. There are a variety of methods to acquire properties with little or no money down, some more risky than others, but all with issues that need to be addressed. (Note: Under new mortgage rules that came into effect April 2010, changes to qualifying standards mean borrowers must be able to handle a five-year, fixed-rate mortgage (but the borrower can opt for a shorter term and lower rate.) As well, refinancing homes are limited to 90% of the value of a property, down from 95%, and a minimum down payment of 20% is required for government-backed insurance on properties not lived in by their owners. That's up from 5%.)

Generally Lower Risk

Real estate is generally viewed as lower risk when compared to other traditional investments, such as stocks and various equity funds. That is because the housing market is often less volatile, even during an economic downturn. Since people will always need places to live, there will always be a market for housing. During the last global recession in 2008–09, the Canadian housing market dipped about 10% across the country on average. Ten percent is significant but pales in comparison to the 40% drop in the S&P/TSX Composite Index.

Over the past several decades, the stock and equity fund markets have swung dramatically, even when the economy was doing well. In the meantime, the housing market has continued its steady, long-term appreciation. This was particularly noticeable after the drop in the late 1980s and early '90s.

Success in real estate investment is linked to several interconnected factors. These can include the length of time you carry a real estate investment and the conditions under which you buy and sell. Those conditions may be impacted by market cycle, location and the condition of the property. (A property located in walking proximity to a new commuter transportation line may be worth more than a property a few blocks away. The latter property may, however, appreciate in value if it features more upgrades.)

There will always be real stories of people who lost money in real estate. New and seasoned investors need to take a case study kind of approach to these situations to ascertain what really happened. Were the investors short-term speculators who were unprepared for the risks involved with deals whereby the potential for higher profits includes a potential risk for greater losses? Did they buy a property where the cost of “unexpected” upgrades pre-empted cash flow?

Cyclical, rare and unusual circumstances can also inflict damage to an investment. For example, anyone who purchased property in Calgary or Edmonton at the peak of the market in 2006 undoubtedly expected continued strength in a housing market buoyed by a booming economy. If those same investors were forced to sell when the market retrenched in late 2008 and early 2009, they likely lost money. Investors may also have lost money if they bought a leaky condo in British Columbia in the 1980s and '90s, since costs for repairs to the defective units wiped out longer-term gains. Similarly, investors in small manufacturing towns in places such as southwestern Ontario, or in forestry towns in British Columbia, may have seen their properties depreciate after the recent recession, which wiped out thousands of jobs in those communities, causing real estate values in those areas to drop.

These are bleak examples of what can go wrong in the real estate investment business. They are also the exception compared to the majority of

long-term real estate investments in Canada. Many property owners have done very well over the years. They've watched the value of their investments rise, despite economic downturns.

The most important thing investors need to remember on this point is that the real estate market is cyclical and, over time, it has demonstrated that it involves less risk than the stock market, especially for long-term property investors. But this doesn't mean there are guaranteed profits in real estate by any means.

Building Equity

Equity is the difference between fair market value and the unpaid mortgage balance on a property. Real estate investors (and homeowners, for that matter) build up equity the longer they own a property, assuming the property is not refinanced with additional debt. Making regular mortgage payments means you pay down the principal, thereby reducing your mortgage debt. The lower your mortgage, the higher your equity in the property. You can build equity even more quickly when renting out the property by putting that monthly income towards your mortgage principal.

Better still, equity is leverage! The more equity you have in your property, the more room you have to borrow against the investment, if necessary or desirable.

Income

One of the biggest bonuses of a property investment is the income you will receive from tenants. Whether the property is residential, commercial or industrial, the monthly rent payments can be used to pay the bills and the mortgage. Because it's considered income, that money can also be used for other purposes, as you see fit. Just remember that income is what is left over after expenses. That includes taxes, utilities (if they aren't paid by the renters), insurance and regular and unexpected repairs. In the early days of an investment, it can also include closing costs.

Investors who need the "income" side of their investments to be positive look for cash-flow properties. These are investments that cover the monthly expenses of property ownership.

Tax-Planning Opportunities

Real estate investors also realize many tax advantages. These advantages will be discussed in greater detail throughout the book. For now, just consider the various write-offs (tax deductions) investors can make against their property investments. For instance, property investment expenses, including insurance, can be deducted against income, as can property depreciation.

Rental income can also increase your RRSP contributions, because, if personally owned, it is considered by the Canada Revenue Agency to be “earned income.” When you sell the property, often you pay taxes on only 50% of your profits.

There is also capital cost allowance, which will be discussed in detail. Capital cost allowance is a tax deduction you can claim for loss in value of the capital assets due to wear and tear or obsolescence, for example. You use the capital cost allowance to deduct a calculated portion of the asset cost as an income tax deduction over a period of years as the property depreciates. Since real estate often appreciates in value, you can receive a deduction for an *appreciating* asset. The amount you deduct depends on when the property was purchased and what class it belongs to, as defined by the Canada Revenue Agency.

No Experience Required (at First)!

One reason so many people are interested in real estate investing is because it's one of the few ways you can make good money without having to spend years, and thousands of dollars, in school. You can also invest while keeping your day job.

To become a real estate investor, all you need is a little up-front money (yours or someone else's) and the motivation and desire to learn the necessary skills. (You are reading this book, which means you are already on the right path!) Although no experience is required to get started, we want to stress that you will want to educate yourself and, over time, build up a variety of skills. We will also tell you that, while there's no need (or the ability) to be an expert at everything, you will always need to be an expert at putting together the team you need to cover the skills you don't have.

YOU CAN BUY EXPERIENCE

Experience is not a pre-requisite of real estate investment. You will want to educate yourself and, over time, build up knowledge and skills to optimize your investment returns. In the beginning, however, you can hire individuals to form a team that delivers the skills you don't yet have. And the members of that team can change. With experience, many investors actually hire out even more functions, since this frees them to focus on aspects of the business that need their attention.

Freedom

Once you've learned the right skills, as a real estate investor you will have more free time than, for example, a day trader who makes his living off the

minute-by-minute moves of the stock market. Real estate investors can also choose how much time they want to spend keeping their books or managing and repairing their properties. In strong and weak real estate markets, investors often hire professionals to help them run their businesses instead of trying to do all the work themselves.

THE FLIP SIDE: WHY LONG-TERM COMMITMENT MATTERS

The advantages of real estate investing present a pretty compelling picture. Those pros aside, we want investors to recognize that real estate investment is not about chasing quick profits. Why can real estate investors talk up the advantages of appreciation, equity accumulation and cash flow? Because they understand the connection between real estate investment and a long-term commitment.

As you read through this next section, think about your willingness to work with issues such as commitment, liquidity and government red tape. We've said it before and we'll say it again: successful real estate investing does not require a great deal of money or a predetermined set of skills. It also owes very little to luck! The profits associated with appreciation and cash flow are real, but there is no substitute for an investor's due diligence.

... INVESTORS NEED TO INVEST WITH A TIMEFRAME IN MIND

It is easy to toss around words like "short-term" and "long-term" investment without really thinking about what those words mean in the context of an investor's lifespan. We want you to approach this discussion thoughtfully. Looking at your financial future, you need to decide what constitutes a long- or short-term investment in your portfolio. Generically speaking, short-term investments could run for less than two years, less than five, or even less than eight years. Others might view anything over five years as long term.

The reality of real estate investing is that some investors excel at holding properties for relatively brief periods of time. That is, they renovate and re-sell, or strategically re-sell (perhaps with knowledge of an impending development boosting appreciation in a particular neighbourhood) within one to five years of property ownership. Other investors might want to hold a property for a minimum of five years and view that as a "long-term" investment.

Going into an investment with a timeframe in mind can be a good way for an investor to calculate risk. Knowing you will hold an appreciating property for 10 years, for example, can help an investor keep negative cash-flow months in perspective.

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Then again, a timeframe should never be set in stone. Your timeframe guides your exit strategy, but market-awareness remains critical. There may be good reasons to sell a long-term property well before you'd planned to sell and good reasons to hang on to a property for much longer than you'd originally intended.

In real estate, as in life, there are no absolutes. Seasoned investors manage the uncertainty with the best market data they can find.

Here are some things to think about in terms of long-term commitment. First, real estate is typically not about the quick buck. To make money in real estate, you usually need to stick with it, which often means an investment of time that runs five to 10 years. Of course there are exceptions, but most real estate investors are in it for the long haul. That may be seen as a disadvantage for those seeking a quick return on their investment.

You also need to commit time and money to the tasks of making the investment work. That includes managing the property, dealing with tenants (including unplanned vacancies), bookkeeping and covering unexpected costs such as a leaky roof or a broken stove. The good news is that advanced planning, which includes reading this book, helps investors manage their time and money wisely. You can, for example, hire someone to run the property and keep the books. You do not, in essence, need to have “answers” for every issue that comes your way—but you do need to be determined to look for those answers when they're needed.

Less Liquidity

Liquidity speaks directly to one's ability to sell an asset quickly. And let's be clear: real estate properties have some liquidity. Unlike a stock, however, it's not possible to click a button or simply call your broker and sell a piece of investment property the same day. Selling your property takes time and money, which makes a real estate investment much less liquid than investing in the stock market.

Here again, the issues regarding liquidity can often be dealt with via planning and with the help of outside experts. Ideally, investors never sell properties because they “need” the money quickly. Instead, dispositions are planned in advance as part of an investment exit strategy, then timed to take advantage of specific market changes.

You Need Money Up Front

Above, we noted the appeal of an investment that often only requires putting 5% or 10% down. That can, of course, also be a disadvantage if you don't have much equity to work with, or if the property you want to buy is expensive. Pulling together even a small down payment can be especially complicated when buying a multi-family unit, or even a single unit in an expensive city such as Toronto or Vancouver. That said, you still have to spend money to make money—and experienced real estate investors probably appreciate the reality of that expression more than most investors!

MONEY IS NOT AN OBSTACLE

Real estate investment is possible without using any of your own money, even if you're new to the industry. That's because you can "manage" an investment that was purchased with money you raised from family and friends, for example. The structuring, operation and disposition of investments that use other people's money can be tricky. This book shows you how to do this in a legal and tax-efficient manner.

Lower Risk, Not No Risk!

The first part of this chapter covered the idea that its relatively low risk is one of the advantages of a real estate investment. But *low risk* does not mean *no risk*. A disadvantage to real estate investment is that, when the housing market falls, some investors may have to sell property to pay their debts. That said, patient investors who are prepared for bad times may be rewarded. The key is advance planning. Here, discipline is critical. Disciplined investors will use cash flow to increase their equity in a property (by reducing the mortgage balance), build contingency funds to carry them through periods of low vacancy or build a war chest for future opportunities.

Government Red Tape

One risk that sometimes takes new real estate investors by surprise involves changes to government laws and regulations that could have an impact on the investment property. The key is to do your homework on any potential issues that may arise and be aware of any new changes that could crop up. These include municipal zoning restrictions and changes, provincial standards and tax implications at all three levels of government.

Because governments tend to act slowly, any new laws and regulations are usually announced well in advance of being implemented. Investors who pay attention to government deliberations are better able to weather the changes when they occur.

This book draws attention to some of the areas where tax rules are confusing and where new rules are pending. We also invite you to register your copy of the book at www.reilaw.ca and www.georgedube.com so you can access news and updates.

ASK FIRST

Remember that old rule of thumb about how those who “assume” make an ass out of you and me? When it comes to making assumptions about the law, ignorance and willful disregard of the rules are the same thing—and both will cost you. Never assume you can do things, like add a rented suite to an existing property or buy a luxury vehicle “for business use,” without first checking the rules. You may have to rip out that suite at your own cost, and you may not be able to deduct as much as you think for that car. These rules are not new, so you ignore them at your peril.

Improbable Expectations Compromise Freedom

Far too many people invest in properties with the expectation of constant and immediate cash flow. That’s an unfortunate starting point since, from our observations, the majority of investors have negative cash flow for the first five or so years of ownership unless they carefully plan their property purchases or place a sizable deposit on the property (with the opportunity/financing costs of a large deposit ignored, which is an extremely questionable strategy).

Our point is that improbable expectations of profit, when not met, create financial stresses and emotional burdens that force some unfortunate investors to spend an increasing amount of time on their properties and the work surrounding property ownership. Their lives begin to revolve around the properties and the work they need to do to maintain those properties in order to squeak by. These investors experience property ownership as something that compromises their freedom!

We contend that successful property investment requires an extensive set of learned skills. It is not easy, but it gets easier with practice and education. That’s right: financial and educational preparation can largely mitigate these issues and, over time, will help investors towards the freedom they desire.

... YOU NEED TO WORK SMARTER, NOT HARDER

Real estate investments make sense, but far too many people approach this industry with the expectation of immediate and constant cash flow. That's a problem, since investors' money-losing experiences—often the result of ignorance and lack of planning—can feed into negative talk about a potentially lucrative and rewarding business that inexperienced investors simply don't understand.

So, let's be honest about what it takes to be successful in this business. First and foremost:

Knowledge + Hard Work = Investment Success

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