

# How Real Estate Stacks Up Against Other Investments

## A Brief Analysis of the US Capital Investment Markets, May 2005

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### Stocks

The stock market is the most popular form of individual investment. While individual stock investing entails more knowledge, research and involvement, most investors now utilize mutual funds, where an investor needs nothing more than the cash and fund sector, with all other details handled by the brokerage house. However, stocks have one of the highest levels of investment risk, and the market is subject to severe short term price fluctuations. Stocks are influenced by several external factors, including interest rates, inflation, cost of capital, employment, regulation, terrorism, and consumer sentiment. In recent years, there has been an outbreak of fraud and insider trading. Corporate governance is criticized for not representing the best interests of the shareholders. And there is always the risk that you can lose 100% of your capital. Until recently, this risk was only a major concern for small and unestablished companies, but fraud and bankruptcy have greatly damaged shareholders of such firms as Adelphia, Bruno's, Bank of America, Enron, Fannie Mae, Freddie Mac, Halliburton, Healthsouth, Tyco, US Airways, Worldcom, and Xerox. America's third largest company, GM, just announced it lost \$1.1 billion dollars in three months. Insiders whisper that undiscovered fraud is rampant. While there will certainly be winners in stocks, is this really the market you want to play?



### Bonds

Bonds deliver a lower, more stable return, with less risk and lower price fluctuations. However, two strong arguments against bond investing exist today. First, bonds are a form of debt investing. By purchasing bonds, you are lending money to a borrower at a fixed rate. One of the biggest enemies of bonds is inflation. As David Dremen of Forbes magazine writes, "Inflation will ... destroy any bond portfolio." While official government numbers suggest rising inflation in 2005, the big news is that the CPI may be underestimating actual inflation. In fact, the Federal Reserve bank itself suggests that rent inflation is underestimated by as much as 1%. Furthermore, the rising trade deficit, budget deficit, ongoing military expenses, reduced tax revenues and increased government spending all point to a rise in inflation, as America must borrow from overseas lenders—and with a weak dollar! Second, bond prices are driven primarily by interest rates. An inverse relationship exists between bond prices and interest rates. With current rates near historical lows, interest rates have nowhere to go but up, meaning lower bond prices. Certainly, now is not the time to be buying bonds, especially long-term bonds.



### Commodities

Commodities are currently in a bull market, and are traditionally a strong hedge against inflation, making them a good prospect at first glance. The key here, as with stocks, is picking the right commodities. Unlike the stock market, an accurate and complete commodities index fund simply doesn't exist, and there is no easy way for individual investors to invest in this sector without making risky individual investment decisions. While the current weak dollar suggests that the rising commodities price trend will continue, there are problems inherent in the commodities market. For one, commodities often undergo violent price fluctuations. For example, while oil prices are widely expected to rise over the next few years,

they may move sideways or even drop for months at a time. If your commodities contract expires before the prices jump up, you have no gain, and potentially a loss. Commodities investing often involves purchasing risky futures and options, and requires a high degree of investor knowledge and risk capital. Furthermore, you have the external factors such as worldwide demand, market substitution, new technologies, and the future of the US dollar as the reserve currency. This is not a market for the novice.



### **Banks/Credit Unions**

While insured and guaranteed against a loss by the government, inflation has recently delivered most accounts a negative real rate of return. This is a place for emergency funds and short term liquid capital, not your nest egg.



### **Real Estate**

Real Estate offers a tax-advantaged, inflation hedging investment in a real, tangible, income producing asset. Unlike other asset types, real estate rarely earns negative annual returns. Risks exist, but insured property will never incur a complete loss of value. Real estate is a great hedge against inflation: David Lereah, chief economist at the National Association of Realtors states, "In the past, investors bought gold as a hedge against inflation... now they buy real estate". It achieves high returns with reasonable risk, as The Appraisal Institute states: "Real properties...pay relatively high dividends, compared to other asset forms... The result has been a reduction in the risk premium" Investment participation is fully determined by the investor. While some owners prefer to operate and manage their own properties, others pay a management company and only know when to expect their check in the mail. Special tax laws allow write-offs for depreciation and expenses, shielding of income from FICA taxes, and deferment of capital gain taxes. Additionally, real estate is a broad asset class, allowing investors to select the investment size and sector that meets his/her needs, from apartments, to hi-rises, to office buildings to self-storage. Real estate deserves a place in every investor's portfolio.

#### Advantages:

- Tangibility—unlike corporate securities or futures, real estate is a real, physical asset
- Leverage—Banks are eager to lend on many investment-producing properties for as little as 20% down
- Control over investment—unlike the a corporate stockholder, you have control over how your asset is managed and run
- Inflation hedge—Real estate is well known as a protection against rising prices
- Strong returns, Low risk—Real estate is less risky than stocks, with comparable returns

#### Disadvantages:

- Illiquid asset
- Imperfect market / dissimilar product
- High Transaction costs

At Baker & Associates, we believe real estate investment is a vital component of capital appreciation and investor return. Call or visit our website at [www.bakervaluation.com](http://www.bakervaluation.com) to find out how we can make real estate work for you.