

# QUARTERLY COURIER

## Profiting in Real Estate

For those investors who rely on real estate for their livelihood, the time has arrived to pay close attention to changing market conditions.

The scenario is common: you work hard to get into an investment groove, achieve what appears to be a sustainable and profitable investment practice, focus your attention elsewhere, and rather suddenly the market changes. By the time you refocus attention to your investments, serious erosion to your capital base has occurred. Those of you who relied on the stock market at the end of the last century for your livelihood should understand what I am talking about.

Serious losses in real estate are avoidable. A seasoned investor understands that real estate, like all enterprises connected with people, is very dynamic. In real estate this dynamic is often described as cyclical. The notion of a cyclical trend in real estate infers that market conditions are repetitive and exactly the same as during the previous cycle. I believe, although real estate trends are cyclical, the variables involved within the cycles are always different.

Two markets in which we are very active, the City of San Diego and the City of Visalia, demonstrate this fact: San Diego offers more socio-economic diversity than any other market in which we operate and is experiencing a negative change in property values, while at the same time Visalia is home to relatively little socio-economic diversity and is enjoying a positive change in property values. Literature and opinions are widespread inferring that these two markets are experiencing the same general value trend concurrently. Investing money in real estate under this assumption could be a mistake. When considered in the context of making a profit in real estate, all markets are very different in terms of **where** they are located and **when** they are evaluated. Each market and, in fact, each neighborhood in each market should be periodically evaluated, individually.

## Market Valuation

Accurate market valuation requires access to a variety of information that can be obtained through a number of real estate websites via the internet. Information that I use for the purpose of forecasting real estate market trends falls into the categories of national, regional, local, and neighborhood indicators.

### National indicators

#### Interest rates

Changes in the Fed Funds rate, a short-term rate at which banks trade money, does not directly affect rates for long-term loans. However, the rising cost of money eventually affects all rates of interest.

Presently, the average rate for 30-year mortgages, which remained constant for much of the past year, has risen past the 6 percent level. Any significant rise in mortgage interest rates has an immediate impact on the real estate market on all levels.

Historically, rates are still low. According to Freddie Mac, one of two major government sponsored residential mortgage lenders, the average annual rate in the 1990s was 8.12 percent. In the 1980s, the rate averaged 12.70 percent, peaking at 18.45 percent during October 1981. These high rates were the result of runaway inflation.

#### Inflation

Inflation has been defined as a process of continuously rising prices, or the falling value of money. Devaluation of money equates to less buying power.

#### Housing Affordability Index

The National Association of Realtors® tracks data measuring whether or not a typical family could qualify for a mortgage loan on a typical home, referred to as the *Housing Affordability Index*. The following assumptions are used to determine if the median income family can qualify for a mortgage on a median-priced home:

- A typical home is defined as the national median-priced, existing single-family home as calculated by NAR.

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- The typical family is defined as one earning the median family income as reported by the U.S. Bureau of the Census.
- The prevailing mortgage interest rate is the effective rate on loans closed on existing homes from the Federal Housing Finance Board.
- Borrower qualifications assume a down payment of 20% of the home price and a qualifying debt ratio of 25%, meaning the monthly mortgage payment cannot exceed 25% of the median family monthly income.

The resultant index moves up and down relative to 100: this means that an index of 110 represents that the typical family has an income that is *10% greater* than what is needed to qualify for a national median-priced, existing single-family home. Conversely, an index of 90 indicates that the typical family has an income that is *10% less* than what is required to qualify for a national median-priced, existing single-family home.

The Housing Affordability Index for the western region of the United States was at 83.6 in October of 2005.

### **Regional Indicators**

#### ***Migration***

People moving into and out of a particular region, or the change in population, is an important demographic affecting the basic regional supply-demand balance in real estate. Housing availability, affordability, as well as jobs related to real estate, are directly impacted by migration.

Migration is an indicator that generally builds and declines slowly, the impact of which affects regional and local economics for years.

#### ***Economic Growth and Diversity***

Local economic indicators should be viewed with extreme caution if, at the regional level, economic growth is weak and/or economic diversity is limited. Real estate values will rise and fall with economic growth, employment, and the diversity with which money is circulated through the economy.

For example, the economic diversity of San Diego, which includes a strong and deep-rooted government economy, a recent influx of information technology companies, an emergent and powerful biotechnology industry, as well as international trade, is more likely to withstand a wide scale economic downturn than Visalia, which is primarily an agriculture based economy infused with equity investments originated and withdrawn from much larger, more diverse markets. As such, it is likely that the Visalia market is a far more vulnerable economic ecosystem.

### **Local Indicators**

#### ***Land Availability***

Land is the limiting factor in real estate. The availability of land and the ability to subdivide land at pace equal to meet the demand for buildable lots controls growth and affects market values. San Francisco is a good example of how demand and values are affected by the scarcity of land and buildable lots. Buyers will purchase homes solely for land, razing older dwellings to create buildable lots.

#### ***Land/Housing Value Ratio***

As mentioned, land value is the denominator governing real estate values in a particular market. Typically, lenders will use a land to dwelling ratio of about one-third when underwriting mortgage loans. This means that a home selling for \$300,000.00 should include the land site value of around \$100,000.00. If this ratio is skewed, and is not typical for the given market, a "field review" appraisal is performed to validate the rationale for this deviation. Obvious exceptions to this rule would be coastal beach front parcels, which would normally have much higher site value ratios, and remote properties, typically having lower site value ratios.

### **Neighborhood Indicators**

#### ***Inventory***

Inventory levels, when viewed over several months, indicate the supply and demand for a specific market. Higher inventory levels relative to previous months are generally accompanied by lower values and longer market time. Conversely, lower inventory levels are normally the result of an increase in demand, reduced market time, and a rise in value.

#### ***Value Change***

Appreciation in real estate is the best shortcut to wealth of which I am aware. Of course, depreciation can lead one to the poor house just as quickly.

The first order of business when I enter a new market is to analyze the change in market value over, at a minimum, 18 months. My preference is to study the change in value in 3 month increments and plot out the trend in value change.

A rising market might look something like this: showing 6 months of appreciation at one-half percent per month; followed by 6 months at one percent or more per month; maybe 3 months at 2 to 3 percent appreciation; peaking at 3 to 6 percent for 2 to 3 months; followed by a correction period where optimistic prices which overshot the market are readjusted; a period of stabilization wherein supply is absorbed; and ultimately a gradual decline until supply and demand are somewhat balanced.

Understanding and developing a feel for the value in a given market minimizes the risk in real estate investing.

## Financing

Another factor important in real estate investing is how a property is financed. Financing is not only a consideration when buying an investment, but also can be studied for the purpose of determining the direction in which a market is heading.

For example, many home owners have opted for the affordable housing that manufactured homes can provide. For the past 18 months, many lenders – most lenders – have pulled out of the manufactured home lending market. The reason: providers of funding, primarily large insurance companies understand that historically manufactured homes decline in value in a down market at a far greater pace than do conventionally built homes. This rationale also applies to condominiums, rural properties, and undeveloped land.

Probably the most dangerous financing instrument that has emerged since the 125% second mortgage of the mid 1990s is the 2-year or 3-year fixed rate mortgage. These loans are often coupled with a prepayment penalty coinciding with the fixed term of the loan. After the 2 year or 3 year point in the loan, the rate then converts to an adjustable rate mortgage. The rate at that point is calculated by adding a margin to an index. It is usually not a pretty outcome. If you have this type of loan, you should make every effort to refinance out of it NOW. These loans will likely be responsible for a good percentage of future foreclosures. Here is why: upon maturity of the fixed term of the loan, 2 or 3 years, the rate will increase substantially in most cases. It is likely that property values will not continue to increase over this period of time. In fact, it is possible that values will decrease. Should values decrease to a level that adequate equity required to refinance is not available, the owner of property encumbered by this type of loan will have to bring in cash to create adequate equity in order to refinance, or simply ride the loan out. Many of these loans will be “mortgage breakers.”

### **Holding Time**

A most important consideration in the process of selecting a mortgage instrument is the period of time that the property encumbered by the mortgage will be held. Long term debt tied to short term indices (ARM mortgages) is a risky proposition. Under most market conditions, short term debt mortgaged with long term fixed rates amounts to leaving money on the table.

Collecting rebates by paying a significantly higher rate of interest is an effective strategy for generating additional cash if the property is intended to be sold quickly, or “flipped.”

An adjustable rate mortgage featuring a low start rate, or “teaser rate,” is another instrument that can create additional cash when turning properties over quickly. Interest-only mortgages work well for properties that will be held for investment purposes for not much longer than 10 years, as most of the mortgage payment is interest for the first 10 years anyway.

### **Real Estate Investments**

There are many ways to invest in real estate. Typically, investors are seeking returns in terms of equity, income, or a combination of equity and income. Common investment vehicles include property ownership, mortgages, and development. A diverse real estate portfolio will include a balance of these investment vehicles.

#### *Investment Properties*

Property ownership can be in land, single family housing, housing units, and commercial land and structures.

Land is typically a long term, equity investment, inasmuch as land seldom generates income sufficient to maximize the financial leverage available to real estate investors.

Single family housing can be either an equity and/or income investment and is typically the vehicle with which investors begin their careers. Multifamily units possess many of the same benefits of single family housing, but generally require more management and are more expensive to buy into.

#### *Trust Deeds*

A trust deed is the instrument securing the mortgage on a particular piece of property. Trust deeds are strictly collateralized income instruments securing the mortgage on a piece of property. Income from trust deeds is secure, but they normally do not go up in value. Trust deeds are safe and secure, if properly originated. This investment should be made by seasoned real estate investors who understand property valuation.

#### *Development*

If you are a risk-taker, and enjoy excitement that rivals the rush that one might feel at the poker table in a Vegas casino, then real estate development might be a good option for you. By far the riskiest investment, development has tremendous reward potential. Development could consist of a project as simple as acquiring land and construction a house – which is not at all simple, to purchasing and subdividing farm land. Development is an investment activity best left to seasoned experts.

## Timing

Timing is, in my opinion, the single most important consideration in real estate investing. You might own the most desirable parcel in the area, but not be able to sell it for what you paid for it because of timing.

Each property in which you invest should have a plan based on how long the property is to be held. This criterion will determine the appropriate financing for the investment, your market (to whom you would be selling and at what price), as well as your exit and reinvestment strategy. Although location is generally regarded as the most important element in real estate investing, I would argue that timing is far more important.

*Chameleon, Bree Real Estate, Red Hawk Realty and Interstate Funding Group* offers real estate services in San Diego, Riverside, Imperial, Kern, Kings, Fresno and Tulare Counties. Transaction types include land, lots, homes, units, commercial and business opportunities.

We also offer real estate financing, originating all types of mortgage loans nationwide, including land loans, home loans, commercial loans, and private money loans.

Business opportunities and business consulting remain an integral part of the Chameleon business portfolio.

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## REFERRAL FEE COUPON

### **\$250.00**

For the past several years, the vast majority of our business has come to us through client referrals. As such, we would like to demonstrate our appreciation for referral business by offering a substantial fee to clients referring our services to their relatives, friends, and associates.

This offer has no expiration date. However, as the person referring our services to another, you must do one thing in order to be compensated:

***You must send in this coupon with the name of the person that you have referred to us!***

You will be compensated immediately upon the funding of any transaction in which CHAMELEON, or any of its affiliates, received compensation involving the person that you referred.

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