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Why the Real Estate Market Beats the Stock Market

You can make money from either stocks or real estate, but that doesn't make deciding where to invest any easier. All investments are cyclical, but there's a reason sophisticated investors own property.

Everyone knows someone who has made a good investment in property – someone who got in at the right time and bought low and sold high. However, the same can be said for stocks and bonds. It's not unusual for those in the financial services industry to have reports with "documented results" or testimonials from investors who have reaped significant gains through strategic planning and fortuitous market-timing.

> **Have questions? Need help?**
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> Call Dan today at 602.332.3499 when you need help deciding where and how to invest in real estate. I'm happy to answer any questions you might have.

Still, there's an inherently large amount of risk associated with investing in the stock market and as smart investors will tell you, real estate, by contrast, provides a controllable, predictable source of wealth generation that affords a certain comfort. That's because the stock market is a fickle thing – an unpredictable, intangible asset that has little, if any, tax benefits. Real estate, on the other hand, is far less volatile, has superior tax benefits, significant cash flow and a high degree of leverage. The comfort that comes from these attributes gives those investors whose comfort level lies somewhere between low and no risk an ideal investment vehicle.

COMFORT FACTOR #1: *Tax benefits*

There are many tax benefits associated with investing in real estate, including:

- Depreciation – applies to a whole variety of investment properties, including rental houses, apartments, condominiums and commercial buildings. Depreciation is essentially a "paper loss" for wear, tear and obsolescence – and a big tax incentive because it generates fax savings with no out-of-pocket costs;
- Materially participating in the management of their property are entitled to many additional tax deductions such as property taxes, mortgage interest, insurance, maintenance and repairs.
- Real estate investors can sell their properties without paying capital gains taxes as long as they *exchange* them for others of like kind, as permitted under section 1031 of the Internal Revenue Code;
- Invest in qualifying properties in special areas and the IRS will allow you to write off 50 percent of the value of the improvements – you invest a dollar and the IRS may essentially gives you back two.

To summarize, sell stock in which you have a gain and you'll be paying taxes – there's just no way around it. But sell appreciated property and if you do it right, you can defer your tax indefinitely.

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COMFORT FACTOR #2: Cash flow

Most stock market investors will pay 100 percent of the share price for a stock (investors who don't mind the risk of margin calls can buy many stocks for 50 percent down), while real estate investors typically need to put down only five to 10 percent with no risk of margin calls.

To illustrate, Investor "A" buys $100,000 worth of stock that appreciates an average of 10 percent annually. At the end of five years, Investor "A" would have stock valued in excess of $160,000 - a gain in excess of 60 percent. Likewise, Investor "B" invests $100,000 in real estate.

With 20 percent down, Investor "B" now controls real estate worth $500,000. Investor "B" maximizes leverage by obtaining an interest-only loan and with the property appreciating at six percent per year, after five years the $500,000 property is now worth $670,000. That $170,000 gain is a result of investing only $100,000 and is therefore a 170 percent return-on-investment (ROI) compared with the stock investor's 60 percent ROI.

In addition to tax benefits, the real estate investor can also rent the property, resulting in monthly cash flow - something even dividend-paying stocks and interest-paying bonds usually can't match. The practical investor recognizes the benefit of investing $100,000 and potentially earning $170,000 over five years in real estate, versus earning only $60,000 in the same time with the same investment in stocks. In reality, the stock market does not go up every single year while real estate often does, so that the above comparisons are even more skewed in favor of real estate.

COMFORT FACTOR #3: *Risk management and control*

For decades, real estate has been the most reliable and dramatic wealth generator for millions of people - and despite the slump experienced in some recently booming areas, many parts of the country continue to experience price appreciation. Real estate markets with steady, solid growth present little risk to mortgage lenders, so it makes sense for them to loan money to investors on attractive terms. Not only does it make sense, but they are actually anxious to loan it to you. And while banks may also loan money for other purposes, they are more willing to loan it to real estate investors because of the safety of the collateral. If for some reason the investor doesn't pay, the bank still has a physical asset that has significant value. Real estate will never go to zero (as many stocks have) because it is in limited supply, has universal demand, and is constructed from materials which are increasing in price, such as lumber, copper and stone.

Additionally, real estate investors have more control over their investment than they would over stocks. Although stock investments have potential for lucrative returns, they are unfortunately afflicted with volatility and suffer unpredictably sharp price fluctuations that often have nothing to do with the quality of the company or the competence of its management.

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COMFORT FACTOR #4: *Leverage & appreciation*

Housing is a universal need and with labor and building materials becoming more costly and populations on the rise, real estate prices have nowhere to go but up in certain markets over the long term. With mortgages on sale at the lowest interest rates in the past 40 years, it makes sense to invest in real estate. By stocking up on these bargain-basement mortgages (that are actually paid back by the tenants' rent), investors can maximize leverage and thereby accelerate wealth generation. Real estate in many areas of the country is appreciating at around six percent per year, plus the added bonus of tax benefits. With a 90 percent loan-to-value (LTV) ratio mortgage, six percent appreciation translates to a return-on-investment (ROI) of 60 percent per annum. That's because when an investor puts 100 percent down (as in stock purchases) he has zero leverage. His return is just six percent when the asset appreciates by six percent. However, putting 10 percent down magnifies the ROI by a factor of 10, creating a lucrative return of 60 percent. To simplify, investing $10,000 in residential real estate with leverage versus a $10,000 investment in the S&P 500, results in residential real estate solidly outperforming the S&P 500 - not counting the tax benefits of real estate.

COMFORT FACTOR #5: *Early mortgage payoff*

Rent a property for greater than the sum of the monthly expenses and you've got positive cash flow. Use the income to enhance your lifestyle, pay off debt, or re-invest in additional properties. This is when Rent-to-Value (RV) Ratio™ becomes critical - a quick, rule of thumb evaluation technique that can instantly determine whether a property makes good investment sense. The ideal RV Ratio is 0.7 percent - anything below 0.5 percent would be considered an unwise investment decision. For example, considering a $200,000 house in Texas that rents for $1400/month (RV equals 0.7 percent). Renting the property for as low as $1000 would still result in an acceptable RV Ratio of 0.5 percent. By comparison, a $500,000 property in Southern California may rent for $1500/month, generating a 0.3 percent RV ratio. By selecting properties that make sense from the start, cash flow can be maximized. Even by using a similar ratio for stocks, the price-to-earnings (PE) ratio, choosing a stock that appears to make sense will not necessarily produce as predictable and reliable an outcome.

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