Planning for Younger Clients: Where Does Real Estate Fit?

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Backdrop

As a financial planner working on an hourly basis, I see many clients who are young people – often employees of companies that have hired me to do planning and education for team members. It is striking that these clients almost universally share as a top goal the desire to accumulate savings for a down payment for that first home. A few have had interest in rental real estate or the desire to invest in that area. These are no doubt excellent ideas for most of them.

Home ownership has been one of the basic elements of the fabric of American society. A society of citizens who own the real estate they live on is one that is fully invested in its community. Moreover, the tax deductions and growth in equity in the property add significantly to most families' wealth.

However, the need to begin to establish good saving habits for longer-term security in their retirement accounts is huge too. It seems irresponsible to advise a 25 year old to postpone contributions to a 401(k) account until the first home purchase has been accomplished. Even a cursory look at the impact of compounding of returns over 40 years of contributions to a 401(k) tells us that missing the first five years of saving would have an immensely damaging impact.

By the same token, to ignore the desire to buy a first house overlooks another opportunity to build wealth. More importantly, the client usually sees this as a more pressing and immediate need. Giving advice that downplays their more immediate dream risks their not doing anything at all.

With the sub-prime crisis' effects leaching into increasingly broader segments of the economy, including in its latest manifestation, the downfall of Bear Stearns, our perspective on real estate is deserving of fresh scrutiny.

The result for the financial planner and the client is a juggling act, trying to reach an acceptable compromise in which they are somehow addressing both the home ownership and the longer term savings needs.

All of this led me to a revisiting of two fundamental financial planning issues: (1) Where does real estate 'fit' in an investment plan and (2) what is the most effective technique to formulate a savings plan that somehow accommodates conflicting goals for saving?

Real Estate in Asset Allocation

What do investment pros say about real estate as an investment?

In *The Wall Street Journal Complete Money and Investing Guide,*[1] author Dave Kansas breaks investing in real estate into four categories: our homes, second homes, income properties, and real estate investment trusts (REITs).

Kansas highlights the familiar advantages of deductible mortgage interest, possible deductibility of certain improvements, and the exemption from capital gains tax of the first $250,000 of profit from the sale of a home ($500,000 for couples).

Buying a second home, which often doubles as a vacation home, can provide more exposure to real estate for many people. The tax benefits vary with how the property is used. If it is purely for personal use or rented for less than 14 days per year, the interest is deductible, just like on the first mortgage. If it is rented for more than 14 days, it will be treated as an investment property, with interest and maintenance split proportionately based on the days rented. The expenses for the investment portion are deducted while the personal portion is not.

Income property is more complex. Challenges keeping it fully rented and maintained can make it difficult to value and can erode projected returns. However, if the initial valuation, vacancy rates, and maintenance can all be managed, the returns can be substantial. Kansas' word to the wise is that you know what you are doing when it comes to the selection, valuation, and ongoing management of the property – or be able to afford to hire someone who does.

The most practical way to just 'invest' in real estate beyond home ownership is through real estate investment trusts (REITs). REITs trade like stocks and pay good dividends (they are required to pay 90% of profits as dividends, but they are taxed as ordinary income). Moreover, they can provide for capital appreciation. In 2004, according to Lipper, REIT mutual funds were the best performing sector in the U.S., returning 32%.

Interestingly, Kansas starts this chapter with a note that economists were then (in 2005) locked in a hot debate about whether real estate had become a 'bubble' noting that "…few economists expect that housing prices will collapse, but the heady growth of the first five years of the new century will be hard to maintain." In 2007, according to Morningstar, Vanguard's REIT index fund returned -16.46%!

In his 1997 book, *Wealth Management,* financial planner and author Harold Evensky notes on real estate: "Anxious to include real estate in our portfolios and impressed by the research, we elected to include REITs…we allocate 5% to REITs in all our portfolios."[2]

At another point, on page 246, there is an interesting passage about the standard deviation in real estate returns, hinting at their potential to be riskier than many assume. "The nature of the appraisal process results in a smoothing of changes in valuations. As a result, the real estate indexes suggest a low volatility that contradicts observable market behavior. In

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[1] Three Rivers Press, New York, 2005, pages. 189-199.
[2] *Wealth Management,* Harold Evensky, McGraw Hill, New York, NY, 1997, pg. 261.

other words, the standard deviation of real estate, based on traditional real estate indexes, seems absurdly low…Further, in bear markets, major holders of institutional real estate, such as insurance companies, tend to hold onto real estate; hence the real variation in market value is unlikely to be reflected in the historical data."

Financial author, Larry Swedroe, writes[3] of real estate's power to diversify a portfolio, and thus reduce risk. He uses an example of a portfolio containing 60% U.S. and foreign stocks and 40% short-term bonds, in which 8% of the stock allocation is replaced by REITs. The result is a slight reduction in expected return (14.3% versus 14.5%) but a dramatic reduction in volatility (down to 9.4% from 9.9%). Swedroe goes on to note that REITs are tax inefficient and should be held in qualified accounts.

So what are the returns on these forms of real estate ownership? The answers are quite different depending on the type of real estate investing you do and the time considered.

Regarding home ownership, a 2004 article[4] posted on the National Association of Realtors website, www.realtor.org, pegs home price appreciation at "…a historically stable 5.3%."

With respect to REITs, the National Association of REITs posts the following comment on its website, www.nareit.com :

"REITs are total return investments that typically provide high dividends plus the potential for moderate, long-term capital appreciation. Long-term total returns of REIT stocks are likely to be somewhat less than the returns of high-growth stocks and somewhat more than the returns of bonds. Because most REITs have a small-to-medium equity market capitalization, their returns should be comparable to other small to mid-sized companies."

This is followed by a chart illustrating annualized returns of several indices from 1975 to 2005. The REIT component returned 13.8%. The S&P returned 12.7%.

Returns on investments in income property or a second home are going to be individualized. Clearly, the potential to gain or lose is much greater in either of these scenarios. The former is comparable to starting a business. The latter will depend entirely on individual facts and circumstances.

<u>Bottom Line for the Investor</u>

For my young clients, looking to buy that first home and still take care of their longer term financial goals, one conclusion seems appropriate: home ownership is an important and valid goal. But it probably should not be considered an investment.

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[3] *The Only Guide to a Winning Investment Strategy You'll Ever Need*, Larry Swedroe, St. Martin's Press, New York, 2005, pg. 158

[4] *Realtor*, "Front Line: Economy, Ups and Downs of Growth", David Lereah, December 1, 2004.

In my mind, setting aside assets now to grow over time for later use is "investing". Assets dedicated to something that we use to meet our living needs and that we will continue to need for a lifetime is "spending" or "consumption."

The fact that the house appreciates over time is great. But if that appreciation will not be used to meet other long-term goals, it is not an investment. It is still consumption.

The fact that the interest is tax deductible does not make it an investment. It makes the consumption more affordable.

So having said that – and all my realtor friends will hopefully still be reading at this point – this does not mean that they should abandon the home ownership goal. Indeed, I am fairly certain that if I suggested that, they would not be listening to their financial planner any more anyway.

It does mean that we can not forego investing for the distant future – even for a few years – for the sake of a consumption item, like a house. And, when it comes time to buy the house, buying the most expensive house you can 'afford' is probably not the best strategy.

Every extra dollar of monthly income spent on the mortgage is a dollar that is not available for investing in long-term goals. Accordingly, the challenge, as with most things in life, is to find a balance.

Developing a Saving and Investment Plan

The process starts with identifying the amount available to save each month. The old rule of thumb that we should save at least 10% of our income may not be enough, depending of course on the income and the loftiness of the goals. I ask clients to spend some time sifting through their statements to get a really good number to use. For most, it ends up being about 15% of income.

Next, we set out attractive but attainable financial goals. These are the big ticket items that can not normally be covered with regular monthly cash flow. Cars, college, retirement, and the down payment on a home, are typical.

Retirement, although the furthest away in time and often the least on the mind of those under age 35, is probably, the biggest goal and the most difficult to quantify. We work hard on getting to an amount needed for after-tax living expenses in today's dollars. Next, we agree on a target date or age.

Cars and college are relatively easy. How much you spend on vehicles and how often they need to be replaced pretty much covers the first. College is a function of the number of children, known or anticipated, the ages, and the likely school choices.

For the house, we need a reasonable estimate of the market value, the likely required percentage for a down payment, and the target date.

Next, all of these goals are entered into financial planning software, along with the client's current assets and the regular additions. The financial planning program will project the mathematical probability of achieving the goals. In most cases, in the first pass, the probability is less than 100%.

At this point, the income available for saving is divided among the different goals and directed to appropriate accounts. For example, retirement saving must take a top priority and will obviously go into a 401(k) and IRA. College savings are usually best accumulated in a section 529 plan. Near term goals, like the house and cars, are assumed to be kept in more liquid accounts, like a money market fund, CDs, or maybe a short-term bond mutual fund.

The other variables that can be adjusted include the expected return on the investments, the amount of the goals, the timing of the goals, and perhaps the amount saved. For example, a plan that is less than 100% successful with respect to all of a client's goals may be adjusted to delay retirement from 65 to 67.

The college expectation may be ratcheted down in cost from DePaul to the University of Illinois, while we may just budget for Honda Accords instead of BMWs (at least for a few years). And, painful as it may be, the client's target for the house may need to ease up from $375,000 to say $350,000 and to be delayed from three years to four.

Finally, and most importantly, we may need to dig down and stretch that saving number from 15% of income to 16%, while adjusting the mix of investments to tweak returns and lower risk.

As the different possibilities are tested, the client is consulted to make sure they are comfortable with the changes. In addition, projected taxes are monitored to ensure no tax penalties are incurred by having too much saved in the wrong types of accounts.

The result: a projection of 100% achievement of all goals, including the home and the longer-term goals, in the context of a plan that, while not easy, is at least achievable.

Conclusion

Usually, there is a solution out there for just about any client situation. The keys are to be realistic about the goals and their priorities, and to fashion an approach that works.

A realistic understanding of the value and place of home ownership in the overall scheme of things is an essential part of this picture. Even more important is the buy-in and motivation that come from a client's seeing and understanding a realistic path to all of their goals in an objective, mathematics-based projection.