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Location, Location, Location

This newsletter will be focused on real estate as an investment and how it possibly might fit into a portfolio. This is a deep subject and certainly not encapsulated in detail in this brief article. Hopefully this will lead to better insight for our clients moving forward.

But first, a disclaimer, as I was raised by a single mother who was a real estate agent and the subject of location, location, location was part of our daily lives. Actually, for additional clarity, my mother, Marcia, was not just a real estate agent; she was a real estate maven. Marcia was one of the first women to become a licensed broker, one of the first women to have her own real estate firm, and she helped launch the Help-U-Sell model in the San Fernando Valley. Plus, of course, she bought, sold, and rented properties, thereby giving me firsthand knowledge of the entire process, including being a landlord in California.

So my personal experience is skewed from the average real estate investor because I have also witnessed: rising interest rates until they reached 18%; middle-class friends using leverage to become multi-millionaires and then going bankrupt all within a short time; repair calls late at night; refurbishing and marketing; terrible tenants; special assessments for HOAs; and countless more stories. I have also seen great wealth created from real estate when investors flipped their new home lottery slots, divided raw land into commercial success, or just bought an amazing location that appreciated.

I believe real estate belongs in almost every investor's portfolio, and the only questions become What type? and How much?

When I say "type" in real estate, the first thing that probably comes to the mind of the reader is home, apartment, commercial, land, 1st trust deeds, etc. In my opinion, investors should separate their real estate holdings into only two types: Liquid and Illiquid.

I will briefly share my thoughts on the various types of real estate investments, but let's first examine my points on liquidity. Prior to the severe market correction of 2007 I urged my clients to consider the possibility that liquidity would be a real problem in a credit crunch and that banks might not loan against real estate capital. Fortunately, most of my clients were not negatively affected by the liquidity crisis that ensued, but many others were not so lucky. In a 2009 Milken Institute meeting I attended with Sam Zell—a person considered to be one of the world's savviest real estate investors—Mr. Zell explained how the '07-'08 crisis and liquidity impacted his thinking and, moving forward, how liquidity must be thought of as a premium. He

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also espoused some of his observations on the benefits of a Real Estate Investment Trusts (REIT) structure. Mr. Zell is one of many professionals whose opinion on real estate I follow. Besides other individual names, I subscribe to economic institutes' publications, broad trends, and also certain mutual funds as well as private equity for commentary. If any of this type of research interests you, please let us know, and we will be happy to assist in your education process.

"Real estate should be purchased for the housing of self/family, and anything else should be thought of as an investment to make a profit." This is just the author's humble opinion.

A profit is measured as Return on Investment (ROI) or, more often in real estate parlance, CAP rate. Capitalization Rate = Yearly Income/Total Value. But there are two huge intangibles; the first I have already identified, which is *liquidity*, and the second is the Hassle Factor. If you invest in real estate and are OK with getting the same returns by doing it all yourself (DIY) as you can in public investing, then you may be a glutton for punishment or perhaps enjoy the thrills and downsides of entrepreneurship. For many people, their interest in real estate is its Tangibility. Real estate: they can see it, visit it, and touch it, whereas many other forms of wealth, such as stocks and bonds, are paperwork stored in some computer. The irony in this thinking is most likely that the real estate mortgage/title is probably now being held on a computer, and I believe the amount of crimes of stolen identity for housing are far greater than other forms of investing I have mentioned.

There are tremendous advantages to both owning and controlling your own real estate or investing in REITs, so we will examine some of those choices.

REITs are publicly traded investment vehicles that have been characterized by an underlying investment in some form of real estate and whose owner distributes a minimum of 90% of their taxable income to shareholders. Many REITs' payout target is a 100% distribution of their income, thereby having nothing left in the corporation to be taxed. The shareholders receive taxable income in the form of dividends. This REIT income is classified as Ordinary Income, not Qualified Income, which have separate tax rates. This taxation is a moot point in retirement accounts. If your investment has gone up or down in value when you sell, then your REIT will still have gains or losses depending on your cost basis and sale price. For many long-term investors, appreciation is part of the total-return story of REITs. Some portion of your income distribution from a REIT might comprise a return of principle and not be taxed as income but deferred by lowering cost basis, and some portion might include gains from sales or adjustments that lower your cost basis. For more information you may wish to read Morningstar article. REITs rarely offer the same, if any, tax depreciation that individual ownership might.

REITs are not new; Congress created laws for their structure in 1960 (source NAREIT-National Association of Real Estate Investment Trusts). As of January 31, 2014, there were 204

REITs registered with the Securities and Exchange Commission in the United States, with a combined capitalization of $719bb, plus there are REITs in countries outside the United States.

Liquidity: that precious advantage that is hard to quantify. But let me try anyway. When I buy a REIT for clients, I know my Schwab fee of $7.95 allows me to be in or out of my trade within seconds (barring any unusual market conditions or thinly traded positions), whereas most other forms of real estate transactions are measured in a span of weeks, months, or even years. Also, private investments typically require a higher minimum capital outlay and sometimes additional financial commitment past the original investment to preserve the original investment. REIT investments don't call in the middle of the night with problems. REIT investments don't require shareholders to have additional insurance such as fire and earthquake. REIT investments don't end up in court between best friends trying to develop a property together. REITs do have drawbacks as well, and that we will soon highlight.

Transparency has its disadvantages because of the psychological effects of seeing constant pricing adjustments or the madness of crowds in cases of terror/jubilation. This effect is extremely difficult to predict and react to, so let's examine some real-life examples.

1. REIT owners see their price move every second during trading hours, whereas a private owner might use Zillow for monthly or quarterly estimates.
2. Based on market panics I have witnessed, there is a trend where the publically traded REIT sold for a Book Value far less than a private property transaction recently concluded. This becomes a great buying opportunity, and it led to one of our firm's biggest positions, but you must be prepared to buy while others are selling.
3. Perceptions of rising interest rates have an effect on owning yield-oriented investments such as real estate. If you own private real estate, you will probably raise rental rates according to inflation when contracts renew. REIT owners do the exact same thing. One of the main differences is some REITs can use financial markets to offset some of their rising rate risk by converting pools of mortgages into LIBOR based adjustable loans, also known as Floating Rate Senior Loans. When there is a hint of rising rates, there is a strong chance that yield-oriented stocks (including REITs) will be down that day, regardless if a REIT is hedged against rates, whereas the private owner will have mostly likely been immune to this daily fluctuation.
4. Leverage plays a role. In my opinion, smart use of leverage can be extremely effective in the wealth creation afforded to real estate investing. REITs and Private Investors both use leverage, but it looks different. However, the potential negative effect for an individual is often bankruptcy, whereas the REIT might have a severe price reduction in its market value

Now with all this said, I personally think the greatest way to build the ***highest level of wealth*** in real estate is ***direct ownership using leverage***, which seems like a contradiction to all the benefits I talked about with REITs. The caveat to my opinion in direct ownership in real estate is typically a ***single individual, a Maven***. You know the type of person I am talking about: lives and breathes real estate; does not get emotionally attached; knows their numbers off the top of their head for every line item in all their properties; maybe developed the land into final use, or is involved in the refurbishment and development; deals with disaster calls at inappropriate times or collecting rents from bad areas. It takes a certain individual to be this strong and smart, and I have met a few of these investors during my lifetime. Interested sellers call this real estate maven knowing that a quick decision can be made, however the maven rarely overpays due to their expert knowledge. In all likelihood the only bargain to be found is not in price but in the low Hassle Factor for the seller. The downside I have witnessed is when these real estate experts sometimes pool together less knowledgeable investors for a limited partnership; in the authors personal opinion "it typically works best when one person controls everything, otherwise own a REIT".

REITs are available for some of the following categories: commercial, financing, office, industrial, mixed, shopping centers, regional malls, free standing, apartments, manufactured homes, diversified, lodging/resorts, self-storage, health care, timber, infrastructure, and home financing. For brevity I will not delve into each of these REIT categories but rather provide a summary of my observations and opinions for those real estate investments my clients are most exposed to.

Principle Residence Single Family Home – One of the single greatest investments our clients own is their principle residence. For those fortunate to have bought at a good time or location, then this has been a strong basis for their retirement plans. I rarely suggest someone look at their principle residence as part of their retirement plan. In fact, most financial firms want to exclude someone's home for their net-worth summary. However there are times when the home will have a material impact on someone's ability to retire. I have a client who moved his entire family to Mexico where they are enjoying semi-retirement in their early 50s because they refurbished homes in San Francisco and sold for a nice profit. I also have clients that are high-income professionals that simply bought in a good area near the beach years ago, and now their property rivals the worth of their business and investment portfolio. The problem with the mentality of "I will buy my personal residence, and it will make me rich" is the fact that it rarely turns out this way because of inflation and other ongoing ancillary costs such as maintenance, taxes, and insurance. You get rich from the use of ***leverage***, but advisors constantly hear clients aspiring to being *Mortgage Free* in retirement. At Goldey Capital we stick to our philosophy: "There exists no blanket advice; each client and situation is unique; analyze all the choices."

Single family homes have traditionally been one of the only major groups of real estate investing that was not strongly represented by a REIT. This category holdout is now represented because the recent financial crisis created an opportunity where banks and other note holders sold thousands of homes to sophisticated intuitions and investor groups. Those buyers of delinquent homes or Non-Performing Loans (NPL) have recently been converting their portfolios into REITs. I have been following this trend with great interest and have invested in this area for our clients. I am quite curious how this will play out because a trend I am following has been the increase in price and the decrease in margin on real estate sold at auction. When a reality show is filmed around house flippers in Arizona, then you know we might be at a top, and that happened. Big hedge funds with their computers and algorithms combined with deep investment pools eager to get income and possible long-term appreciation were ready to pounce on this mom-and-pop way of buying homes. The hedge funds and intuitions completely changed this entire way of buying homes.

One of the stocks I closely follow and own for clients states that their strategy is to skip the auction process and buy up the NPLs directly from lenders and do it in bulk. In one single transaction banks shed a host of problems and free up cash reserves, while the buyer gains an opportunity to convert loans to either performing status or collect on those loans and take over property. The conversion of outstanding loans into paying loans is one of the most important economic numbers I follow along with new home starts. Real estate is the very foundation of economics in our country, and when this category is sick, it typically has an effect on everything. It's better to have ownership at a lower price than allow decay to ensue. Lost taxpayers have a trickledown effect that hits everyone within the municipality, so it's in everyone's best interest to convert these Zombie Non-Performing Loans into something positive.

There are many tax-advantages to owning real estate individually rather than through a REIT or other collective measure, which is why we stress that our clients have a strong relationship with their tax professional and seek guidance before buying/selling real estate. At Goldey Capital we are in the business of advice for individual stories, and one example is a client who had over $500k in unrealized gains in their former home, which had been rented for the last 18 months, and the client wanted to keep their former principle as a rental. When I illustrated the tax-free gains benefit for a married couple selling their principle residence under qualifying conditions, then our client changed their minds and sold the property. When your analysis includes looking at how many years it would take to save as much as $500k (after tax) then you realize the impact of being extremely smart with your choices under our current tax system. Now that the client had extra savings, we encouraged them to increase and maximize their retirement account contributions, which helped to lower their taxable income. With the remaining savings, we suggested the client **<u>NOT</u>** invest the extra cash with Goldey Capital but rather buy their own commercial building for their daily business. In our opinion, you might as well own the building you go to everyday if it makes financial sense. Knowing the tax laws, having a long-term plan, and good advice are the cornerstones for individual real estate investing. Goldey Capital is not built on generating a commission on transactions, so all we have to do is give the best honest advice to each client as it pertains to him or her individually. In recent years we have encouraged many clients to keep millions of dollars away from our direct management and in some individual real estate investments that fit their own needs.

Trust Deeds – Rarely have clients asked about 2nd trust deeds, which simply means that you are behind someone else to collect in case of default. I am sure some good deals might exist for 2nd trust deeds, but I have never recommended one. However, 1st trust deeds are a different story, and my clients have been getting offers for as long as I can remember. I have mixed feelings about 1st trust deeds.

- Why does someone need to borrow at high rates from an individual or group versus a bank or other institution when they have 70% Loan to Value (LTV) or better? I have a natural distrust and skepticism about investments that sound too good to be true. But the truth is, our banking system is still broken, and there are some interesting opportunities in this area because, for whatever reasons, banks won't make the loans with favorable terms. Plus, the Hassle Factor with banks is a huge negative, so some borrowers are OK with paying higher fees just to avoid the bank process. I am a reader of Mr. Barry Sternlicht, who I consider to be on par with Mr. Zell for real estate expertise. In his quarterly summaries, Mr. Sternlicht has commented how his firm takes advantage of a present market disconnect in commercial banking. For example, some real estate developer wants to buy a building in Times Square, but in today's current broken system, banks have maximum limits and lots of paperwork and other delays. Who would want to possibly deal with 10 banks for one deal? That's why some are happy to pay a slight premium if it can reduce the Hassle Factor and get a firm commitment. Trust deeds are typically illiquid, so I prefer my clients not own them at all, or if they do, to limit their overall exposure in case of another credit crisis. I also prefer some diversity geographically, but rarely does this happen because most buyers purchase within their areas, typically within state and county. Someone's overall net-worth and income needs should be a major factor in the decision process to purchase 1st trust deeds.
- Many underlying properties for trust deeds are not insured for earthquake and other protective insurance, and rarely do I have a discussion with trust deed buyers that know the truth about their underlying protection.
- Does it pay anything similar to a publicly traded REIT is the first question I ask when reviewing a client opportunity in trust deeds. If the yield is similar, why would I want all the hassles of an illiquid investment opposed to something that is transparent, can be

easily sold, and I can margin/borrow against? Sometimes simple math is best for the quickest decision, but also consider a REIT is not a guaranteed payment.

- However, I have witnessed some interesting deals for clients that they found on their own or through friends that made sense for that particular client. Recently, we had one sophisticated client who is a tax professional purchase some portions of trust deeds notes using their 401k monies. This requires some specific strategies, including reporting requirements by the IRS, but the deal made sense to our client because it was a great yield relative to other choices and is compounding tax-deferred, plus he had an intimate knowledge of the operators involved. In another incident, a friend of mine was offered an opportunity to take part in a 1st trust deed on a church that had a 50% LTV for a 5-year loan. The banks would not loan because it was listed as a commercial property, and the terms were not favorable.
- Also, an advantage of buying individual trust deeds is when they pay without problem; they do pay the same amount and pay on time. They can provide steady, reliable income, and you know what the return amount of your principle will be upon maturity, whereas the price and yield of a REIT fluctuates every trading day, plus there are no guarantees of what your principle return will be upon maturity or sale.
- On property default an individual property investor has recourse, whereas a REIT stockholder does not. The REIT manager will try and collect on default, and any proceeds would be distributed, but the shareholder does not own the property, just shares in the REIT.

1031 Like-Kind Exchange – Swapping an apartment building or other “like-kind” real estate investment for a 1031 exchange is something I have reviewed over the years. For many of our clients this is typically one of the biggest financial decisions they will make in their lives, and it can affect generations, depending on the size of the deal. Again, this area of real estate investing dictates a close relationship with your tax professional. The story for me is almost always the same in the types of deals that I have been asked to analyze. For example, the client bought or developed the building some time ago and can’t believe how much it has appreciated and wants to sell but doesn’t want to pay the gains taxes. For some, they let the tax-tail wag the dog, when in my opinion, this should not be the sole reason for a 1031 exchange. Taxes are important but so are Positive Leverage, Diversity, and Professional Management to see if a 1031 exchange makes sense. You might go from being the owner of an 80-unit building that has no mortgage throwing off tons of cash per month to a fractional owner of a diversified pool of real estate being managed by professionals. Many of my clients that choose the 1031 route find their own replacement real estate because they are passionate about real estate and quite comfortable with the work that goes along with being an active owner. I have also viewed how family dynamics greatly impact decisions because the family matriarch/patriarch typically built the portfolio from scratch, and the kids may want nothing to do with real estate.

Risk Exposure Litigation – When you own real estate, you are a potential target of litigation whether you like it or not and whether it's fair or not. The more real estate you own and, depending on what states they are in, the more exposure you have. My typical advice for clients is to accept lower margins and pay for quality insurance and higher limits on everything, including Personal Umbrella Insurance. Also, hire a lawyer who is knowledgeable in the type of real estate, the location, and the type of investment structure. Get your advisor team in place so you know if your investment should be held in an LLC, C-Corp, Personal Trust, Family Limited Partnership, or something else. At Goldey Capital, we would be considered one member of that team along with tax, legal, mortgage financier, insurance agent, and real estate salesperson. Depending on the account relationship with Goldey Capital, we typically waive our hourly fee to our clients for our part of this analysis. Goldey Capital's relationship is typically based on assets held, longevity of relationship, and professional courtesy.

I Gotta Guy – Review this situation and see if this has happened to you. Friend or acquaintance in construction wants investors to help fix properties to flip or develop raw land. This story was being told to me each month, it seemed, in the late 1990s (condo conversions) and again after the recent crash (buying Real Estate Owned [REO]). I avoid the "Told You So'" in discussions with clients because it is graceless and nobody wants to be reminded of their mistakes, plus as a portfolio manager, I constantly have purchases I wish I hadn't made when I reflect back. One area of real estate investing where I wish clients would simply say "No" right away is the shared-pool deal with people they don't have a deep relationship with. Even when they do know the person, are they worthy of a kidney donation or simply a golfing buddy? Currently I have multiple clients that are involved in real estate transactions that they would desperately like to extract themselves from but can't due to the structure of their investment. Goldey Capital had nothing to do with the placement of these investments, but they affect our clients, so we try to give advice and counseling as part of our clients' overall financial holdings.

Pooling resources in a limited partnership is not uncommon but has its own pitfalls. One of the first concerns is the character of the General Partner (GP) and type of compensation and expectations of their job duties. I've had countless conversations with clients that were mad at the GP for taking too much money or not doing enough to resolve a problem or their lack of control as limited partners. Limited Partners are also subject to annual K1 tax forms and other taxable nuances that add another dimension (and cost) to their annual tax return plus the often annoying frustration of having to file for extension as you await your K1 statement from a single company. On a positive side note, based on my experience, the one area that theory has not been true and resource pooling has been successful is when Doctors get together to buy a building, such as an MRI or Dialysis clinic.

Pooling resources between friends for a vacation home or other property is another common item I have reviewed, and this rarely works out for the best based on my experience. Take for example a real case I know where two couples who have known each other for decades and traveled and shared Thanksgiving meals together decided years ago to buy a small apartment in Manhattan. Well, that nicely located 800-square-foot apartment appreciated greatly, and in early 2000 one of the couples wanted to sell while the other couple wanted to keep. To compromise, one couple bought out the other at fair market value, which created a stressful cash crunch for the buyers at the time. Now years later, that property value skyrocketed, and the sellers have remorse for selling. Bottom line, the relationship became strained the first moment someone wanted to go in a different direction, and the friendship has never been the same. Understand that the total price paid for your real estate partnership could include the loss of a personal friendship.

Landlord – This job of landlord is probably one that makes most individual people shudder as they project all the problems with owning and collecting rents. There are reasons why professional management companies keep busy and owners are willing to accept lower profits by using their service. If you want to maximize your wealth in real estate, it typically requires keeping your costs as low as possible and maintaining constant positive cash flow. So, the Hassle Factor will affect your bottom line and must be included in the analysis. Another landlord phenomenon I have witnessed multiple times is the **Under Rent Tenant.** This type of lower-rent tenant rarely gets price increases or other normal adjustments because the landlord fears asking for more or simply worries the tenant will move out and it will cost far more to replace this missing revenue. There is absolute truth in this process, which is why private ownership and being a landlord has more nuisances and sometimes does not follow a clear path to analyze. In my 30 years of analyzing real estate, one common conclusion is that most people don’t consider all the costs and nuisances.

Ego and the trophy property – What can I say on this subject that hasn’t been discussed in the quiet office of a divorce lawyer or therapist? This subject also encapsulates remodeling to personal taste versus the intention to make a profit. Dream vacation homes and personal homes are exempt from this rule, but everything else should apply.

I have met and/or worked with some extremely wealthy people that owned auto salvage yards, mobile home parks, cemeteries, public storage, and many other interesting areas that don’t get discussed at cocktail parties. Unless you are a well-known real estate investor who likes to put your name on every building, why should you care about bragging? One advantage of a trophy property is the higher liquidity because there are typically many buyers for a quality location, plus if purchased for a good price, a trophy property can have some outsize appreciation. The rule-of-thumb for developing trophy properties is "It's the second buyer, not the original developer, who profits."

Amazon Effect – Amazon has forever changed retail, and that consequence has an impact on real estate. I don't think you can purchase real estate in certain commercial markets without considering the Amazon effect. Look, 20 years ago, Circuit City was a great anchor tenant, and now some locations are still sitting empty after seven years with an occasional use for temporary holiday costume sales. In the Inland Empire and many other communities, they have seen an uptrend in jumbo warehouse space as more companies look for economies of a scale to quickly distribute to highly populated areas. So the new single family house in Riverside with marble countertops and stainless steel appliance sits empty while down the road a big empty steel cavern with concrete floors is in high demand.

Piggy bank of home equity – I am a big believer in having credit available at all times, which is why I encourage most clients to have a Home Equity Loan available via their bank if the annual costs are reasonable for them. Now, for some people that translates into "the piggy bank is open and we can redecorate, buy new cars or plan glorious vacations." For some others it can be a safety net that provides access to already approved cash in case of emergency. In almost two decades as a consultant, I have happily watched many clients use their home loans for smart short-term choices such as max funding a retirement account, meeting payroll, paying taxes, etc. I also believe if you want to build great wealth in real estate, then you will need to leverage your equity, which equals risk. I have friends that followed their gut and took a calculated risk at the right time and borrowed to purchase more, and now they own income properties that have nicely appreciated. I have sadly watched the reverse of this as well when leverage worked against someone, and the results were devastating to their finances and their physical health.

I have owned or analyzed countless REITs over the years, and most likely I will continue in this endeavor for years to come. Here are a few areas that have continued interest:

- Health-care REITs in the housing of seniors or rehab is an area I appreciate based on population demographics.
- Commercial REITs that take advantage of large loan sizes and a streamlined process as traditional banks struggle to compete.
- Businesses with Triple Net Lease (NNN) as I like predictability of controlled costs, but some real estate experts say this also hampers growth potential.
- Timber and other natural resources.

- Apartments, including locations in densely populated areas.
- Single family homes.
- Housing based on college campus proximity.
- Storage facilities are an area I really like, and ironically, a few years ago, an analysis of this sector led me to a non-REIT purchase of an individual storage facility stock. Valuations are currently high for storage REITs for my analytical taste.
- A sector I really like and want to own with lower valuations is cellular tower owners. The world needs more towers, and there is consolidation, so this is attractive for me. However, the companies I am looking at have a debt ratio outside my current parameters.
- Boring stories to me are sometimes the best, which is why I like the area of mobile home park REITS and have a few on my radar screen.

To conclude, let me restate some points:

- "If it's not your personal home, it's an investment."
- Real estate has only two types, *Liquid and Illiquid.*
- Avoid emotion and rely on analytics.
- Assemble your team and Goldey Capital in the process of evaluating your choices. We are honored to assist our clients as part of such a big decision.

All the Best,

Ian Goldey

Ian Goldey

President