

Include Real Estate for Exceptional Portfolio Management

By Peter Benda, PortReal, LLC

Your home may be the biggest single asset you own, and a major factor in your retirement planning. Managing your real estate as part of a financial portfolio can make the difference between average returns and outstanding returns over a lifetime.

Ninety million American households own their homes. This translates into \$20 trillion of private investment, or a third of the net worth of the average household. In addition, Americans own up to 50 million vacation and rental properties.

Historically, real estate appreciation has been quite stable. Even so, homeowners are exposed to financial risks that most investors would never consider in other markets. Partly, this is due to the size of the transaction. Have you ever asked your broker to buy \$200,000 of any one stock? Home buyers transact on this scale, on average, every seven to 10 years. If you are affluent, you'll probably buy five to 10 homes, re-investing several million dollars in real estate over a lifetime.

The technology stock bubble of the '90s is a reminder that some real estate markets may also be at risk due to overheating. But there are proven financial practices that help manage risk while you grow wealth.

WHAT DRIVES VALUE

When we analyze real estate investments, we make a distinction between three types of value drivers (figure 1). Baseline factors are the obvious, and the largest, drivers of value. But as more of your investment dollars move through real estate over time, dynamic and portfolio factors become more important.

The least understood aspect of real estate is how it contributes value to a portfolio. Several factors determine portfolio value:

- **Portfolio risk diversification:** Real estate can provide stability by offsetting losses, such as a drop in the stock market. On the other hand, similar properties may

share undiversified risks. For example, vacation properties on the same beach are exposed in common to the risk of catastrophic storm damage.

- **Liquidity** describes how easily you can monetize assets in your portfolio when you

would never consider leveraging their financial investments. (Who would dream of borrowing \$180,000 to invest \$200,000 in a single stock?) There are excellent reasons for holding mortgages, but mortgages introduce two risks: when you have to sell a house at a loss that you can't cover with your liquid assets, or when variable interest rates go up to a rate that you can no longer afford.

- **Income generation** depends on future cash flows from rent, ongoing costs (net of tax benefits) and future capital gains. In some regions, it simply makes more sense to rent than own, and a common investment risk is that rental income doesn't cover cost of ownership.

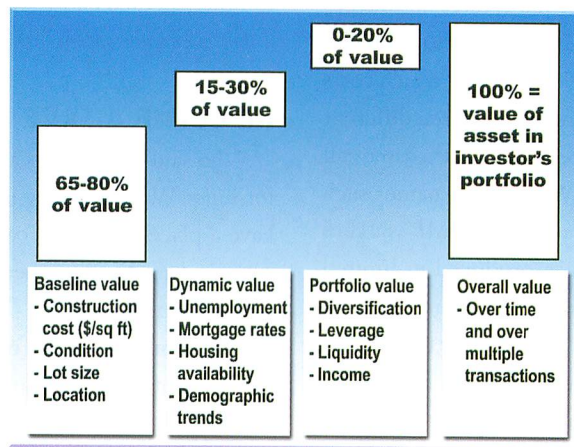
SOLUTIONS FOR REAL ESTATE

To invest over a lifetime, you have to understand your own financial needs and your investment options (figure 2). Think in terms of different scenarios (worst and best case) and time horizons (near term, long term). Next, analyze what drives value for your investments. Your real estate agent can provide comparable sales information and insight on local trends. Supplement this with the library or the Internet. Make connections between value drivers and pricing over time. What happens to real estate pricing when there's new development or when a local employer has a layoff?

Here are some Web sites that can provide you with additional information:

- **Baseline value:** realestate.yahoo.com/re/homevalues, www.wellsfargo.com/per/home_equality/tools/home_improve.jhtml, www.homeinfomax.com, www.valuemymyhouse.com
- **Dynamic value (trends and macroeconomic drivers):** www.ofheo.gov, www.realtor.org/research
- **Portfolio value:** www.portreal.com.

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Components of real estate value.

- **Plan ahead:** Forecast your income and cash requirements; consider scenarios for buying/ selling real estate.
- **Be a fortune-teller:** Look for factors that can affect future re-salability and value, especially factors not obvious in today's market.
- **Put your eggs in different baskets:** Find ways to diversify your investment choices (financial and real estate).
- **Know what you owe:** Be aware of the risks of leverage, especially variable-rate mortgages.
- **Think "cash":** Select investments that can be liquid or that generate income if you need it; consider tax benefits.
- **Review and refresh:** Periodically rebalance your portfolio to match your risk tolerance and optimize returns.

Investing checklist.

need cash. How fast can you sell your second home? Are you willing to pay penalties when you sell stock in your 401(k)? Can you take out a home equity loan?

- **Leverage**, in this context, means mortgages and lines of credit. Ironically, most investors