What Was The Best Investment Of The Past Decade?

If you were an investor in the 1 990s would you have done better with stock or real estate?

No doubt a lot of money has been made with stocks. At the same time, the last few years have been a blow-out on Wall Street. Between dot-corns, cable firms and Enron, predictions that the Dow Jones Industrial Average would one day hit 36,000 now seem far removed. Indeed, the Dow has fallen nearly 15 percent in the past two years, from 11497.12 at the end of 1999 to 10021.50 at the end of 2001.

But what about real estate? Has it done any better?

Speaking before the National Press Club, Fannie Mae Chairman and CEO Franklin D. Raines offered this analysis:

It's January 1990. Three individuals have just received a $10,000 year-end bonus. And they're trying to decide what to do with the windfall.

John decides to invest his $10,000 in the stock market, and being conservative with his finances, he puts the money in an index fund of S&P 500 stocks.

Bill is excited by the possibilities of the Internet and all the new technology companies, so he puts his $10,000 in a Nasdaq index fund.

Mary has never invested in the stock market. But she's tired of paying rent every month with nothing to show for it. So she put her $10,000 down on a bungalow listing for about $80,000.

It's about 12 years later. Assuming they all had to pay for shelter every month, how would you say John, Bill, and Mary did on their $10,000 investment? Who came out better?

Since 1990, the value of the S&P 500 more than tripled. So from his initial investment of $10,000, John made about $22,000, pre-tax.

During the same period, the value of the Nasdaq quadrupled. So Bill's gain was roughly $30,000, pre-tax.

What about Mary? During the same period, home values increased roughly 4 percent per year nationally. At that rate, the house that Mary bought for $80,000 is now worth about $126,000. And if she sold it, she would have a profit of about $46,000. And that gain would be free of capital gains taxes.

"It is extraordinary," said Raines, "that after the longest, strongest bull market in history, the average American built more wealth owning a home than she did in the stock market." "Most Americans invest and earn more in their homes than they invest and earn from their savings accounts, IRAs, stocks, bonds or other investments," he said. "During the past ten years, the average stockholder earned $23,000 in the stock market, while the average homeowner earned $44,000 in home equity. Home equity remains the cornerstone of most family wealth."

But even if the returns from stock market investments and homeownership were the same,

real estate would still yield a better net result. Why? While profits from the sale of stock are generally taxable, profits of up to $500,000 for a married couple (and as much as $250,000 for single owners) are typically shielded from taxes when a prime residence is sold.

Great Reasons to Invest in Real Estate

According to recent statistics published by the U.S. Census Bureau, 75% of multifamily investors are over the age of 45. Over half of these (51.6%) own less than five units, and they earned approximately 31% of their income from ownership of rental properties.

These statistics may surprise you, but some logical reasons explain these numbers. Most real estate investors come to the market later in life because they are concerned about their retirement and are at their highest potential earning power, or some have inherited money or real estate; the U.S. Census Bureau reports that 48% have inherited a home.

There are four major reasons that an investor might choose real estate for investment.

1. Cash flow: Yes, it is still possible in some parts of the country to have a cash flow return. In other words after all expenses have been covered: mortgage, vacancy factor, repairs, property management etc., there still can be some money left on the table. Most banks will not lend money to buy a property if there is no hope of a cash flow.

2. Appreciation: As a result of our growing population—a net gain of one American every 14 seconds, according to the U.S. Census population clock - we could expect to have a population in excess of 400,000,000 in 2050 compared to today's population of 286,401,757 (2/6/2002 at 10:08:34 AM EST). Loosely applying the rules of supply and demand, we can rest assured that with our current immigration patterns as well as our population growth, there will be a continued need for housing over the next 50 years. You can safely assume a 4% appreciation level. Of course, some years will better than others depending upon supply and demand and the escalation of costs and the increased costs of construction and land/infrastructures. As long as governments keep up major increases in impact fees for developers, your real estate investments will continue to appreciate.

The average single family home sold for $23,400 in 1970; in 2000, a similar average home sold for $169,000. That is an approximate 8% annual increase. Of course, appreciation will vary with the location and condition of the property as well as the condition of the local economy.

3. Equity build-up: You reduce your mortgage and increase your equity with every mortgage payment made on underlying debt. A portion of your payment goes toward reducing the principal. The shorter the loan period, the faster the equity builds.
4. Tax savings: Uncle Sam allows everyone but dealers in real estate to depreciate their investment properties on schedule E when filing annual tax returns, Residential properties depreciate over 27.5 years and commercial over 39 years.

You probably like all of these opportunities to make money. Bear in mind, though, that the government needs to pay its bills and they get their share when you sell one of your investments. When you sell a property, you will be faced with a 20% capital gains tax on the increase in value of the property and the recapture of the depreciation. This cost could be

deferred if you complete a 1031 tax deferred exchange to trade up from property to property.

Think through the following example: With $500,000 you can buy a $1,500,000 investment that may give you an 8% cash flow, an annual 4% appreciation, an annual equity build and a depreciation of $43,000 a year (1,500,000X.8 = 1,200,000 (minus the land value); 1,200,000/27.5 = 43,000). This comes in at over a 20% annual return and should make you feel like you have made the right investment decision.

Regardless the size of real estate investment, you can make a return and build up your retirement. It is important to not buy the first investment that comes along: rather you should buy the best investment. Pick an investment that you are the most comfortable with, maybe your grandmother's duplex. This will give you a chance to make some small mistakes and plan a long-term future investing in real estate. Choose a real estate agent that has some of his or her own investments to help you and a property management company with good references.

(Note: Not all real estate investments have a fairy tale ending. It takes time, experience and a good eye for location and detail to achieve these kinds of results. On the other hand they are achievable results.)

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