Financial Planning

INVESTED IN ADVISERS / JULY 2017

AWAY FROM HOME

There's a lot more to real estate investing than thinking locally

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JULY 2017 | VOL. 47 | NO. 7

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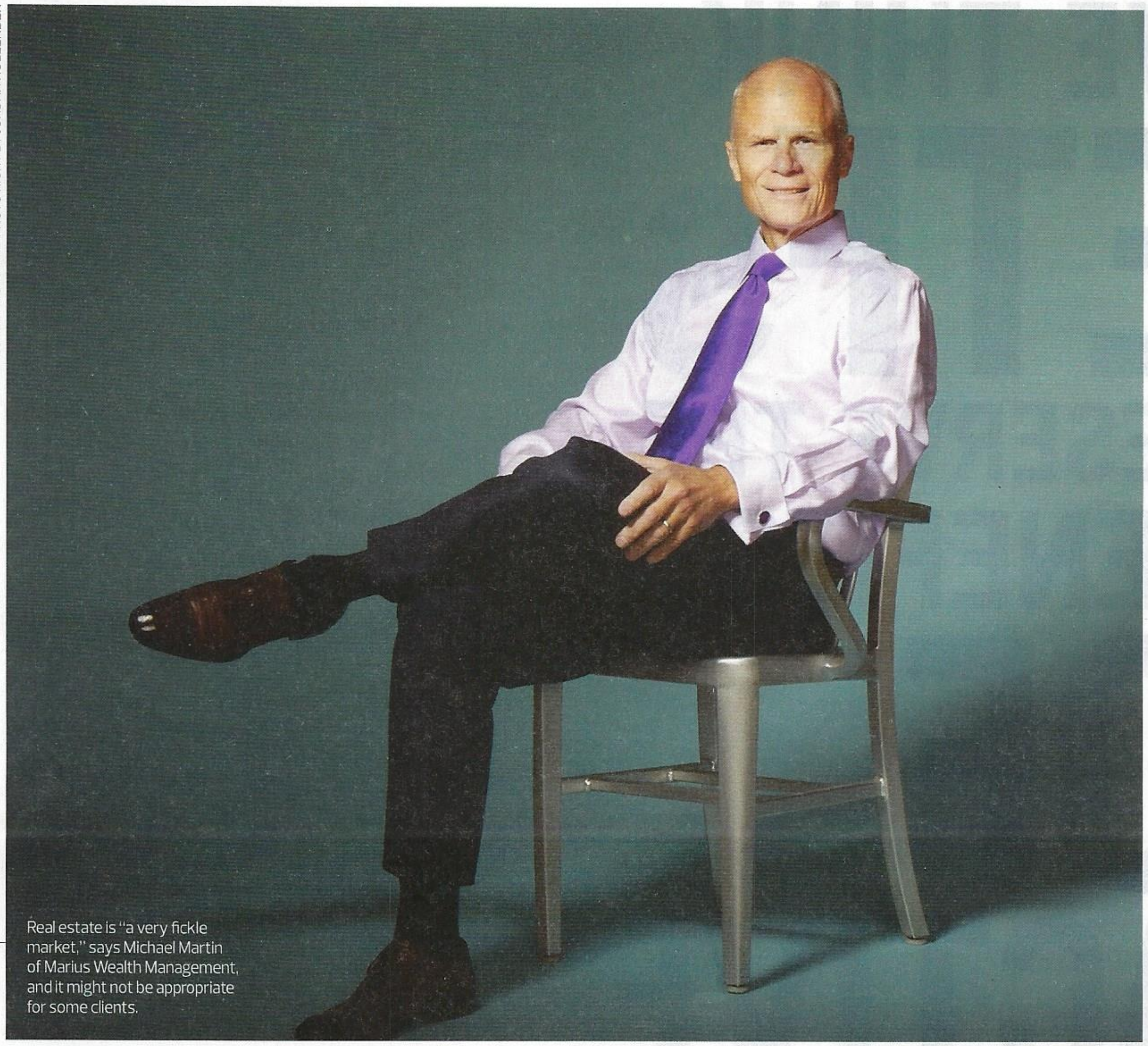

Real estate is "a very fickle market," says Michael Martin of Marius Wealth Management, and it might not be appropriate for some clients.

Financial Planning Vol. 47/No. 7 (ISSN 0746-7915) is published monthly (12 times a year) by SourceMedia, One State Street Plaza, 27th Floor, New York, NY 10004-1505. Subscription price: $109 for one year in the U.S.; $129 for one year in all other countries. Periodical postage paid at New York, NY and U.S. additional mailing offices. POSTMASTER: Send address changes to *Financial Planning*, SourceMedia, One State Street Plaza, New York, NY 10004. For subscriptions, renewals, address changes and delivery service issues contact our Customer Service department at (212) 803-8500 or email: help@sourcemedia.com. Send subscription orders to: *Financial Planning*, SourceMedia, One State Street Plaza, New York, NY 10004. Please direct editorial inquiries, manuscripts or correspondence to: *Financial Planning*, One State Street Plaza, 27th Floor, New York, NY 10004-1505. Back issues, when available, are $10 each, prepaid. *Financial Planning* is a trademark used herein under license.


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AWAY FROM H

There's a lot more to real estate investing

BY CHARLES PAIKERT

When it comes to discussing real estate with clients, adviser Michael Martin is able to draw on his own hard-earned experience.

In 2001, Martin, principal and founder of Marius Wealth Management in New York, left a career at Smith Barney to spend what became a decade as a real estate investor, buying, rehabbing and selling properties in New York and Florida.

"I learned some valuable lessons, I can tell you that," Martin says. Fortunately for his clients, they are lessons he is now able to impart to them.

The native New Yorker had some home runs renting, buying and selling properties in the Hamptons, the fashionable beach towns on Long Island.

"I knew what renters and buyers wanted in a Hamptons house, and where they wanted to be," he says. "I knew how far a house could be from the train track, for example. And after seeing a house for the first time during the day and being initially sold on it, I would always go back at night or weekends to uncover any negative surprises, such as crazy neighbors, loud noises or unpleasant odors from, say, a nearby duck farm."

But Martin didn't fare as well in Florida.

In 2005, he overpaid for what appeared to be desirable vacant lots fronting

OME

than thinking locally

Being caught at the wrong end of an economic cycle is a major risk in real estate, says Derek Newcomer, director of investment research at Beacon Pointe Advisors.

a canal in Coral Gables, Florida. What Martin now owes on his mortgages is more than the fair market value of the lots. His waterfront properties are, in real estate lingo, now underwater.

Martin learned the hard way that "vacant lots do not produce rental income if the numbers turn against you at market highs, especially if you need to derive income while you wait for the market to improve."

REAL ESTATE LESSONS

Don't mortgage vacant lots," Martin says, "which I did. Don't have your wife on the mortgage, too, which I did."

Martin also warns against replicating two other mistakes he says he made: succumbing to FOMO — a fear of missing out — and being "persuaded and influenced by a commission-hungry salesman."

Martin returned to the advisory business in 2012.

"I realized I liked being an adviser better," he says. "Real estate was ultracompetitive, and it's easier to differentiate yourself as an adviser."

After two year at Wells Fargo Advisors, he started his own firm in 2014. When high-net-worth clients say they want to invest in real estate, excluding their primary residence, Martin doesn't mince words.

Key Terms for Real Estate Investments

Capitalization rate: Often just called the cap rate, this is the rate of return on a real estate investment property based on the income that the property is expected to generate. The cap rate is used to estimate the investor's potential return on his or her investment.

$$\text{Capitalization Rate} = \frac{\text{annual net operating income}}{\text{cost (or value)}}$$

Cash-on-cash return: This measures the annual before-tax cash flow divided by total cash invested.

The cash-on-cash return is used to evaluate the cash flow from income-producing assets. It is also sometimes used to determine if a property is underpriced. The initial equity investment is the total purchase price minus any loan proceeds.

$$\text{cash-on-cash return} = \frac{\text{annual before-tax cash flow}}{\text{total cash invested}}$$

"REAL ESTATE IS NOT FOR THE FAINT OF HEART," MICHAEL MARTIN SAYS. "YOU CAN'T BE EMOTIONALLY ATTACHED. AND THE LACK OF LIQUIDITY IS A HUGE ISSUE."

"Real estate is not for the faint of heart," he advises them. "It's a very fickle market. You can't be emotionally attached. And the lack of liquidity is a huge issue. You're married to a property until you're able to sell it, and the options for liquidity are far less than any other investment."

Martin and other wealth managers stress the need for a detailed and candid conversation covering asset allocation, risk, tax liability, income needs and the consequences of owning an illiquid asset.

Advisers generally recommend that high- and ultrahigh-net-worth clients allocate anywhere from 5% to 30% of a portfolio to real estate as an asset class, with many caveats, of course.

Age and income needs are primary considerations. For older clients who will need income, Ross Fox, founding partner at Cardan Capital Partners in Denver, puts "a higher emphasis on cash flow versus total return. We want to have serial liquidity events in investments that mature over time."

For HNW clients, Fox recommends allocating approximately 5% to 15% of assets into real estate investments outside their primary residence. For anything exceeding 15%, clients should "have an affinity with the space" — that is, be real estate professionals themselves.

Being caught at the wrong end of an economic cycle is a major risk, cautions Derek Newcomer, director of investment research at Beacon Pointe Advisors in Newport Beach, California.

Property location is another critical variable. "If you have a real estate asset in Houston, and the energy business takes a dive, you're left very exposed," Newcomer explains. One way to mitigate the risk, he advises clients, is to diversify their holdings with multiple assets in different geographic areas.

SCRUTINIZE COSTS

Clients should closely scrutinize maintenance costs, Fox notes. They must analyze tax obligations. And while real estate investments can provide tax relief in some cases, Fox and other advisers say this should not be a primary reason to buy property.

"You can certainly receive favorable tax treatment for some investments, but clients can get too cute by half by trying to [minimize] their taxes," Fox says.

Lois Basil, principal of the Basil Financial Group in Chicago, says her real estate advice doesn't vary much, no matter what her client's tax bracket. "I think there's a place for real estate in every portfolio, whether mass affluent or high net worth," Basil says. "Leveraged real estate is an excellent hedge against inflation, and tax efficient. Our goal is to have our clients' net worth divided one-third interest-earning, one-third equities and one-third real estate."

Only after risks have been discussed and understood can the potential benefits of real estate investments be presented to clients, advisers say. Indeed, it's imperative.

For wealthy clients, real estate is simply "too big to ignore," says Alex Stimpson, founding partner and co-CIO of Corient Capital Partners in Newport Beach, California. "Real estate plays an important role as part of overall asset allocation in their portfolios," he says. "It provides risk diversification because it has a low correlation to the stock market."

Real estate is also a good source of income diversification, he adds. While corporate bonds are yielding around 3%, real estate investors should be rewarded with a higher yield – an additional 2% to 5%, Stimpson says – in exchange for taking on lower liquidity.

THE ILLIQUIDITY PREMIUM

This "illiquidity premium" is a key concept when discussing real estate with clients, says Marty Bicknell, chief executive of Leawood, Kansas-based Mariner Wealth Advisors.

Just as clients need to know the risks associated with an investment that isn't publicly traded, clients "with the patience to ride out economic cycles" can also benefit from illiquidity, Bicknell says, although the premium he seeks is less generous than Stimpson's.

"The illiquidity premium should be around a 2% to 3% increase over more liquid alternatives," he says. "If not, it wouldn't make sense to tie up the capital."

A leading way clients can invest in real estate is through publicly traded REITs. But with yields at historic lows (the Vanguard REIT Index Fund yields a little over 4%), advisers interviewed did not recommend REITs as an optimal real estate strategy.

Direct investments or investments in a private fund were preferred real estate vehicles, and investors can benefit greatly from the capitalization rate [see sidebar], say Stimpson and other wealth managers.

"The cap rate is a powerful predictor of future return and future risks," Stimpson says. "What you see is usually what you get."

What are some of the common and not so common real estate strategies wealth managers are employing for clients? See examples below.

AIRBNB

How it works: One of Michael Martin's clients in Denver bought two luxury recreational vehicles to rent to Airbnb customers. They're in a trailer park just outside the city, and the client is a model host; he leaves maps of the city, puts in fresh flowers and makes himself available by phone or text.

In the winter, the client moves the vehicles to Vail, Colorado, home of the popular ski resort.

The client bought two Grand Design Solitude Fifth Wheel vehicles for $70,000 each. He is financing 80% of the purchase at 4% simple interest (a type of interest applied to automobile and short-term loans).

Upside: Denver is booming, and demand for accommodations is high.

After adding the $14,000 down payment to the annual financing costs per unit and dividing that number by the net annual income of approximately $37,000, the client achieved a return on his investment of about 48%, according to Martin.

Risks: The RVs are not appreciable assets, and if there is a market downturn, there is no guarantee of rental income. What's more, the client's business depends on Airbnb, which could mandate a reduction in rates. "His fate is in someone else's hands," Martin says.

UNLOCKING HOME EQUITY

How it works: "We analyze the equity in a client's home," says Lois Basil of Basil Financial Group. "If it is less than 50% leveraged, we recommend thinking of ways to unlock that real estate equity. This approach is markedly different than what is in the financial press, where the advice often is to prioritize paying off your mortgage.

"While not having a mortgage may make sense for some people, we have found that always having a mortgage is a sound and tax efficient strategy," Basil says.

"Our goal when working with clients is to minimize their tax liability. People often misunderstand that much of their income in retirement is taxed at ordinary income rates. We want to work to make sure our clients are taking advantage of every available deduction to reduce their taxable income."

For example, Basil Financial Group will even recommend 30-year mortgages for 80-year-old clients. "Their retirement income is still being taxed at ordinary income rates, and we want them to keep more of their money," Basil says.

Upside: The strategy reduces taxable income. For most clients, their home is their largest asset. "Having your house illiquid does not pay for health care, does not fund education and doesn't buy groceries," Basil says.

What's more, mortgage interest rates are declining after a postelection spike.

Risks: There might not be enough income to pay the mortgage. It's also possible the value of the real estate will go down, property taxes will rise and unexpectedly large home-improvement repairs will be needed. "The biggest problem we have with this strategy is overcoming clients' objections based on the psychological freedom they have that comes from not having a mortgage," Basil says. "Sometimes, emotions can't trump a sound financial rationale."

CHARTER SCHOOLS

How it works: Summit Trail Advisors, a wealth management firm in San Francisco, has partnered with American Infrastructure MLP Funds to buy around 50 buildings housing charter schools in 13 states over the past two years.

Clients from other independent firms can also invest. American Infrastructure is a private equity fund that charges a 2% management fee and 20% of profits above and beyond an 8% preferred return to investors.

The fund hopes to take the portfolio of schools public in an IPO, says Tom Palecek, a Summit Trail founding partner. "To get there, we need to acquire enough schools to where the aggregate of the portfolio income is in excess of around $100 million," Palecek says.

Upside: Investors were collecting an 11% yield in June while the partnership continued to add schools.

If an IPO proceeds and the stock rose in value, investors could "stand to make a substantial amount" from share price appreciation, Palecek says. If the stock did indeed gain, he estimates the yield could drop to 6% to 8%.

Risks: Charter schools in the portfolio need to keep seats full for years to come, have high test scores and demonstrate "really great management and operations," Palecek says. Anything less could mean problems. A regulatory change in charter school funding at the federal or state level could also spell big trouble.

PRIVATE PARTNERSHIPS

How it works: While there are thousands of real estate fund managers whom advisers can work with, "it takes time and a dedicated effort to find managers whose strategies are most suitable to meet clients' needs and goals," Derek Newcomer says. "The adviser needs to ensure that a client [is qualified and willing] to invest in an illiquid investment strategy such as private real estate.

"Some managers have very high minimums," Newcomer explains."We have been successful in negotiating minimum investment sizes for our clients so that we can obtain greater adoption from a wider universe of clients."

Newcomer's firm, Beacon Pointe Advisors, places clients in partnerships with such firms as Kairos Investment Management, Southwest Value Partners and Buchanan Street Partners, which invest in a wide variety of properties, including office buildings, multifamily properties, industrial properties and retail assets.

An internal committee at Beacon Pointe determines a client's appropriate asset allocation, usually no more than 10%, before investing in a partnership, Newcomer says.

Investment managers typically charge a 1% to 2% management fee on either committed or invested dollars, as well a performance fee of 15% to 20% after investors have received their original dollars invested and an 8% to 9% preferred return.

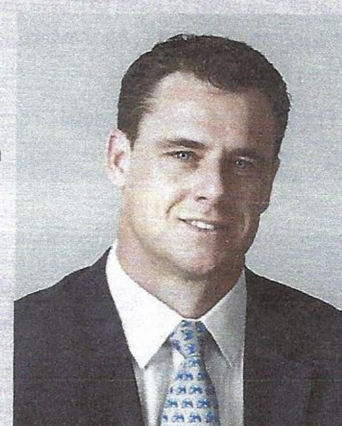
"Some funds are structured differently," Newcomer says, "so it is extremely important to understand how fees are generated and what the fund pays out to the manager as fee income."

Upside: Distribution of income: Beacon Pointe targets approximate total return combining income and profit to around 12% to 15% over the life of the fund.

Risks: Investments could be illiquid for up to 12 years.

"Fractured management teams can lead to trouble, particularly when you are in a long-duration life fund that can last 10-plus years," Newcomer says. "Poorly managed assets can lead to increasing costs and decreasing income-generating capabilities."

The manager may also utilize too much debt when acquiring a property, become too reliant on one tenant or concentrate holdings in one geographic region. What's more, a partnership may collapse as a result of fraud, disagreements within management or other reasons.



It is extremely important to understand how fees are generated in private partnerships, says Beacon Pointe's Derek Newcomer.

"Advisers should thoroughly review the fund offering documents to fully understand what the consequences of such an incident would have on underlying investors," Newcomer says. "Certain clauses within the offering documents will outline what would happen should such an event take place.

"There may be arbitration clauses, mediation, or assets may be placed into a liquidating trust," he says. "Investing with the right management team that has a long history of working together successfully can help to minimize such an event."

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Charles Paikert is a senior editor of *Financial Planning*. Follow him on Twitter at @paikert.