Real Estate

by Sophia

WHAT'S COVERED

In this lesson, you will explore why some investors prefer to hold and invest their wealth in real estate. You will consider how agility and technology skills can help you make the right moves when it comes to real estate. Specifically, this lesson will cover:

1. Overview of Real Estate
    - 1a. Types of Real Estate
    - 1b. Value of Real Estate
    - 1c. Real Estate as a Use Asset
    - 1d. Buying Real Estate as a Dual-Purpose Asset
2. Real Estate Investment Trusts
    - 2a. Advantages of REITs
    - 2b. Purchasing REITs
3. Real Estate Risks
    - 3a. Underwater Mortgage
    - 3b. Foreclosures and Short Sales
    - 3c. Using Real Estate as a Rental

1. Overview of Real Estate

1a. Types of Real Estate

Real estate refers to land, buildings, and other structures permanently attached to the land. As shown in the following illustration, investors further classify real estate into two categories:

1. **Residential real estate**, which includes dwellings that are individually owned and where people live (e.g., houses, condominiums, and duplexes).
2. **Commercial real estate**, which is the land and buildings used by businesses and other income-producing activities (e.g., office buildings, hotels, apartment buildings, warehouses, malls, and factories).

TERMS TO KNOW

Real Estate
Refers to land, buildings, and other structures permanently attached to the land.

Residential Real Estate
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1b. Value of Real Estate

Real estate can be extremely valuable. Consider these recent U.S. statistics:

- The value of commercial real estate investments exceeds $8 trillion.
- The value of private residences is more than $25 trillion.
- In total, real estate accounts for more than $33 trillion in wealth, compared to the total market capitalization of all publicly traded U.S. stocks of $20 trillion.

BIG IDEA

Clearly, investors and non-investors see tremendous opportunities in real estate!

1c. Real Estate as a Use Asset

Ironically, despite the tremendous investment opportunities in the real estate market, most individuals purchase real estate as a use asset rather than an investment.

- **Use assets** are those things that people purchase with the primary intent to use and maintain their current lifestyle (e.g., clothing, furniture, and electronics).
- Similarly, most people purchase real estate because they need or want a place to live.

However, residential real estate can also be considered a dual-purpose asset. We discuss how next.

TERM TO KNOW

Use Asset

Things that people purchase with the primary intent to use and maintain their current lifestyle (e.g., clothing, furniture, and electronics).

1d. Buying Real Estate as a Dual-Purpose Asset

Although real estate does serve a practical use as a place to live, real estate can sometimes also be viewed as an investment because real estate has the potential to appreciate in value over time. How does this work in practice? Consider Jason's situation.

EXAMPLE

- Jason wanted to move out of his parent's home to be closer to school and work, but rent seemed too expensive.
- Jason soon realized that he could buy a three-bedroom condominium, live in one bedroom, and rent the other two bedrooms to his friends.
- The rent that Jason planned to collect would almost be enough to pay his mortgage payment, property taxes, insurance, and condominium association dues each month.

Jason knew that he would end up paying the difference between the rent he collected and what he had to pay each month, but that was a small amount compared to the rent that he would have to pay elsewhere.

- Jason borrowed the money to buy the condominium. He was responsible for paying the mortgage, property taxes, property insurance, and the condominium association dues. Jason not only found an inexpensive place to live, but he also ended up owning a property.
- Although Jason was taxed on the rental income, he also received tax benefits from owning the property. He was able to deduct the mortgage interest, property taxes, rental-related fees, and depreciation on the condo as deductions on his personal tax return, saving him thousands of dollars annually in taxes.
- If housing prices increase, Jason can potentially increase his equity, which is calculated by subtracting what is owed on a home from the fair market value:

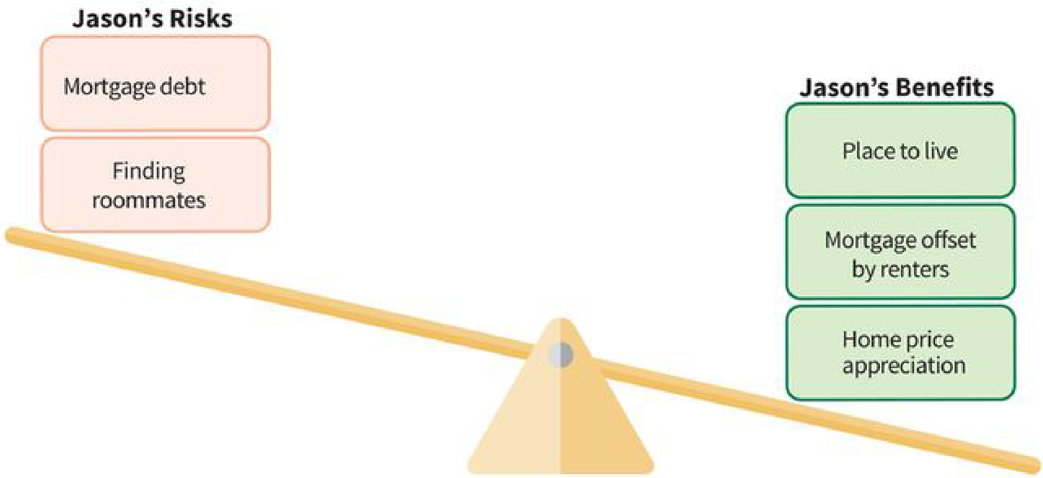
FORMULA TO KNOW

Equity

Equity = Fair Market Value of Home − Mortgage and Other Housing Debt

As you can see, Jason’s purchase of a house provided three benefits, as depicted in the following illustration:

1. A place to live.
2. A mortgage payment offset by income from renters.
3. An investment that he can possibly sell later for a profit.



It's important to have a financial plan so that when things change, you can clearly see how to pivot with purpose. Pivoting with purpose means changing your plans to ones better suited to your situation. This is an essential part of your agility skill . Perhaps it is time to consider a real estate investment. Maybe you're ready to set a financial goal so you can make that move. Your financial plan can help guide those decisions.

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2. Real Estate Investment Trusts

What if you want to invest in real estate but are not comfortable becoming a landlord and assuming the responsibility to pay the mortgage each month as well as maintain the property? What options do you have? More importantly, how does an investor purchase a diversified portfolio of real estate? After all, in the example, Jason’s wealth is tied up in one property. It would make more sense if he owned multiple properties in different locations, thereby diversifying his holdings as a way to reduce his risk. One way to do this is to purchase a real estate investment trust.

2a. Advantages of REITs

Real estate investment trusts (REITs) provide a way to add real estate to your investment portfolio at a relatively low cost.

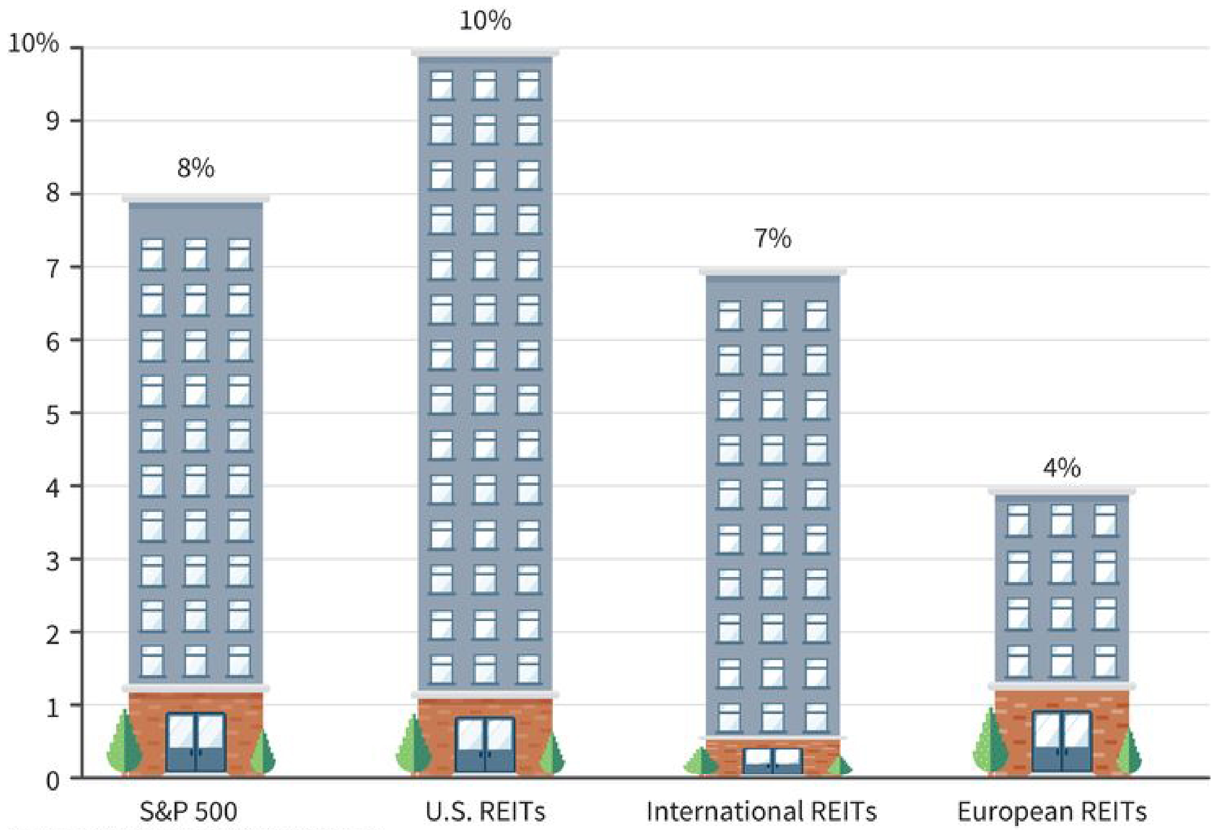
- REITs are similar to mutual funds in that investors pool their money to hire professional managers to obtain sufficient investment capital to purchase multiple properties (sometimes REITs purchase mortgages secured by real estate).
- REITs borrow additional money from banks to maximize the number of properties that can be purchased.

- REITs provide a solution to the real estate investment dilemma by allowing investors with limited capital the opportunity to own part of a diversified portfolio of commercial real estate without having to take on debt or become a landlord.
- REITs pay dividends to unit holders (similar to shareholders).

As with other investments, those who invest in REITs hope that there may also be price appreciation in the value of the REIT. As shown in the following column chart, the recent long-term, 5-year average return of REITs is fairly competitive with other investments (see Hint). As with any investment, however, there are risks. As was seen during the economic recession of 2007–2009, real estate prices fell, causing significant decreases in the value of REITs.

HINT

Owning REITs in your investment portfolio can add valuable diversification and potentially high returns.



Source: MSCI and S&P 500 indices.

TERM TO KNOW

Real Estate Investment Trust (REIT)

An investment that provides a way to add real estate to your investment portfolio at a relatively low cost.

2b. Purchasing REITs

You have two main options when it comes to purchasing REITs.

1. You can purchase REITs that specialize in different areas of commercial real estate, including warehouses, apartments, retail stores, hospitals, and regional malls.
2. You can purchase a REIT index. A REIT index invests in the entire market of commercial real estate – usually using other REITs and mutual funds – so that investors can further diversify their holdings and decrease their risks.

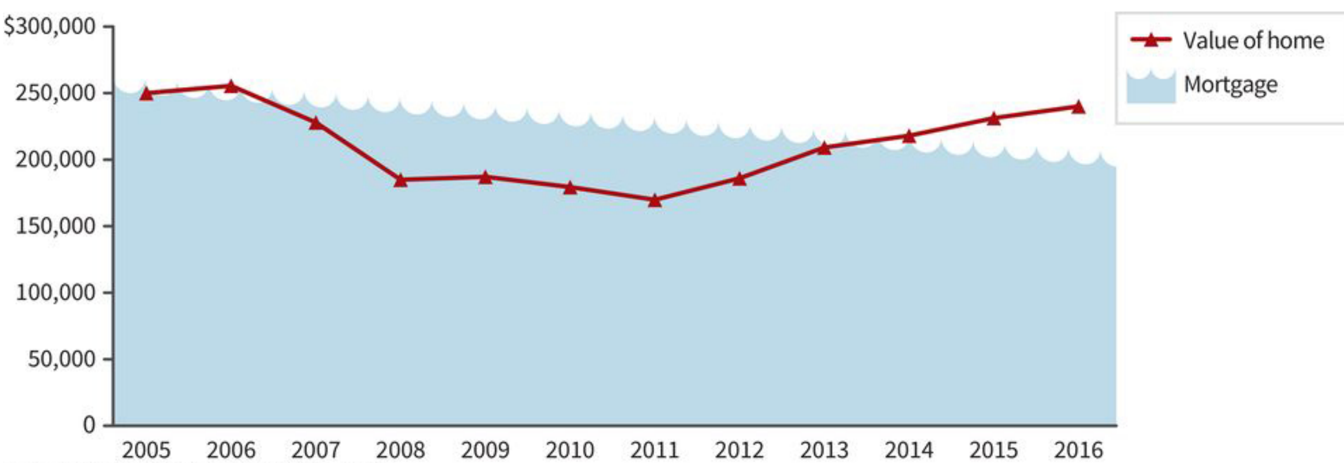
To buy a REIT, you usually need a brokerage account. However, you can also sometimes purchase a REIT directly through a mutual fund company or your employer.

3. Real Estate Risks

Most people do not think very much about the investment aspect of real estate when they are purchasing a home in which to live. Yet, when it comes time to sell, some are left in a financial bind when they realize that their home has depreciated in value.

3a. Underwater Mortgage

During the global financial crisis that started in 2008, real estate values decreased dramatically. The individuals who had extra cash during this time were able to make great investments. They were able to buy houses at very low prices and then sell them a few months or years later at much higher prices. However, as shown in the following line graph (the graph assumes that a home was purchased with 0% down and a 30-year mortgage), typical borrowers during this time period owed more on their mortgage than their homes were worth, commonly referred to as being **underwater**.



Source: Federal Reserve Bank of St. Louis.

- Generally, being underwater is a short-term problem. If homeowners continue living in their homes for an extended period of time, their house values will generally increase again over time as they will continue to pay down the balance of their mortgage.
- However, homeowners who lost their jobs during this time were trapped. They could not afford to move to higher-paying jobs because they could not afford to sell their homes.

HINT

Recall that moving to higher-paying jobs where an individual's skills and knowledge (human capital) is valued is an important part of enhancing financial well-being.

- If a home is worth less than the mortgage, the seller must pay the difference between what is owed and what the home sells for. During the global financial crisis, this difference ranged from a few thousand dollars to several hundred thousand dollars for millions of homeowners.

Since few people had that much money available – too few Americans even had an emergency savings fund – they ended up turning down better job opportunities elsewhere. Worse still, because so many homeowners could not sell their homes, they were forced to turn the keys over to the mortgage lender or go through foreclosure, a short sale, or a similar process.

10 SKILLS **Technology: Skill in Action**

Troy and Nicole had to move for Nicole's job. They needed to sell or rent their current house. They used their strong technology skills to research the value of their current home. They determined that if they could sell their house for the market value of $159,000, they could pay off their mortgage, pay the realtor, and make a small profit. Without taking the time to research, they might have put the house up for sale only to find they were underwater.

TERM TO KNOW

Underwater

The state of owing more on a mortgage than the current fair market value of a house, generally a short-term problem.

3b. Foreclosures and Short Sales

When individuals go through foreclosure:

- They lose their home to the lender (often a bank) and any equity in the home.
- They continue to pay the difference between what was owed and the eventual selling price the bank is able to receive for the property.

During a **short sale**:

- The lender takes back the home and forgives any amount owed.
- The amount forgiven is usually considered taxable income.

In either case, a homeowner's credit score will be hurt for at least 10 years if a foreclosure or short sale occurs. Recall that a credit score summarizes your credit history as collected in your credit report. Credit scores help lenders predict if you will repay a loan and make payments on time. Lenders may use credit scores when deciding whether to grant you credit, what terms you are offered, and what interest rate you will pay on a loan.

During and after the global financial crisis, many people found that they could no longer obtain credit easily or inexpensively.

TERM TO KNOW

Short Sale
The process whereby a lender takes back the home and forgives any amount owed. The amount forgiven is usually considered taxable income.

3c. Using Real Estate as a Rental

Rather than go through a foreclosure or short sale, many homeowners decided to rent out their houses and move for new employment. The advantages associated with this strategy include:

- Retaining home ownership.
- Generating income to pay the mortgage.
- Preserving a credit score while owning the property until the value of the house eventually increases.

Although never intending to become a landlord, tens of thousands of homeowners ended up choosing this route as a way to cope with the consequences of the global financial crisis.

SUMMARY

In this lesson, you studied an **overview of real estate**. There are two main **types of real estate**, residential and commercial. Many investors and non-investors appreciate the **value of real estate**. Strong agility skills can help you make the move into real estate if the time is right. If you buy real estate as a dwelling, you're treating it as a **use asset**. However, if you buy **real estate as a dual-purpose asset**, you're viewing it as both an investment and a personal residence.

Some consumers do not wish to become homeowners or landlords, so they **purchase real estate investment trusts (REITs)** to get into the market. The **advantage of REITs** is that the trusts are similar to money market accounts where one's portfolio is diversified to mitigate real estate risks. Risk types include **going underwater on a mortgage** and **foreclosures** and **short sales**. Strong technology skills can help you avoid these risks. A short sale is when a lender takes back a home and the remaining amount owed is forgiven. Some homeowners avoid foreclosures and short sales by **using their real estate as a rental** property to generate income to pay off money that they owe.

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