SHOULD YOU ADD REAL ESTATE TO YOUR PORTFOLIO?

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If you like the possibility of having an income stream to enhance either your current lifestyle or retirement years, you may want to consider adding real estate to your investment portfolio. One of the most popular ways to generate income from real estate is to purchase physical properties and lease or rent them to individuals, families or businesses.

While adding real estate to a traditional investment portfolio can be a cash flow generator and complement stocks and bonds as a hedge for inflation, it's not as simple as navigating and negotiating your way around the classic board game of Monopoly®. To help prepare for the numerous challenges you may encounter if you're thinking about making such a move, consider the following before jumping into the rental market.

REAL LIFE VS. REAL ESTATE

In real life, there's one way investing in real estate is very similar to the game of Monopoly. The price of a property — and its ability to command above-market rental income — is related to perhaps the three most important factors in real estate: Location, Location, Location. In real estate, just as in Monopoly, you can always change the features of a building or the layout of a property by adding houses or hotels. But you can never change the location of a property. You cannot turn Baltic Avenue into Boardwalk or Park Place.

CONSIDERATIONS BEFORE PURCHASING RENTAL PROPERTY

Before adding real estate to your investment portfolio, it's wise to develop a plan based on your goals and what you hope to accomplish with your investment. Answering a few basic questions may help guide the planning process:

- Are you purchasing an older home or building to rehab and flip or rent?
- Do you want to buy a house in a quiet neighborhood, or a condo or multi-family unit near a university or city center?
- Are you interested in owning a second home in a vacation community to rent weekly or monthly when you're not occupying the property?

MORE THAN ONE-THIRD OF U.S. RESIDENTS RENT HOMES

As home ownership becomes less attainable for many young Americans — even with low interest rates — renting statistics indicate younger individuals and families rent for longer periods of time and at higher rental rates. According to recent rental statistics 44 million, or 36% of U.S. households, rent rather than own their homes. Of the 109 million Americans living in rental properties, 17% of renters earn $75,000 or more annually and 26% spend $1500 or more per month on housing. As many as 41% of renters spend more than 35% of their income on rent.[1]

- Do you prefer investing in an older building in a commercial area to potentially rehab as loft living spaces or for small business occupancy?

Regardless of your long-term objective for adding real estate to your investment portfolio, it's important to seek objective advice from a licensed real estate professional who can help you answer the following questions and address any concerns you have in order to avoid unnecessary future costs or significant losses. For example:

- What documentation on the property can be accessed from local/county government records?
- Are there any outstanding liens or delinquent taxes due on the property?
- Is the property located in a flood plain?
- Does the structure require extensive plumbing, carpentry or electrical repairs in order to pass inspection?
- If there is a home owners association (HOA) fee, what does it cover, and is it in line with similar communities in the area?
- Does the HOA impose rental restrictions related to pets, maximum occupants allowed at one time, or limits on the number of times you can rent the property per year?
- Is the location of the property in an area or neighborhood where you or a loved one would feel safe living? Letting children play in the yard or common area? Walking a dog around the block after dark?
- What external factors might detract from the property's appeal (e.g., railroad tracks, traffic noise, busy roads, insufficient parking, minimal outdoor lighting, etc.)?
- Is the property within walking distance to the downtown area, parks, schools and shopping? Is it located in a sought-after school district?

Answers to each of the last five questions above could have a significant impact on the rent you might be able to command from tenants. But perhaps the most significant factors to consider revolve around your commitment to the property itself:

- Are you willing to give up a portion of your busy life to manage and perform ongoing maintenance or tend to emergency situations like a leaky sink at midnight on a holiday weekend?
- Will you manage lease agreements and rent collections, or will you hire a property management company to handle administrative details? A property management company can range from 10–15% of the rent.
- Can you readily access cash or borrow funds for emergency repairs or damages to the property if required?
- Can you gather a team of professionals to assist you with your investment when necessary (e.g., real estate attorney, CPA, tax advisor, property and casualty insurance agent, and financial advisor)?

Individuals who invest in real estate say they enjoy it because it's a tangible asset — not just three letters that represent ownership in a share of XYZ corporation. However, you have to do your homework and decide if owning and managing rental property is the right move for you.

OTHER REAL ESTATE INVESTMENT OPTIONS

If you're not handy and don't have the time, interest or ability to maintain property on an ongoing basis, there are other options for adding real estate to your portfolio. Talk with your financial planner about investing in real estate exchange traded funds (ETFs), mutual funds, or real estate investment trusts (REITs) — all of which provide portfolio income and a similar hedge against inflation without requiring you pick up a hammer, draft a lease agreement or fix a leaky faucet on a holiday.

PAYING FOR RENTAL PROPERTY

Adding real estate to your investment portfolio is a complex decision that should align with your long-term financial goals. With the help of a financial planner, you should weigh the possible return from investing in real estate as compared to other investment alternatives, most notably the stock market. Your tax advisor can also help you project the tax implications of real estate investing.

Should you decide to proceed and finance your rental property rather than pay cash, we can help. Financing alternatives include placing mortgage debt on the subject property or using the equity in your residence for either the down payment or entire rental property debt. Home equity lines of credit are one attractive option if you plan on reselling the property.

The Private Bank at Commerce Trust Company offers financing alternatives based on your unique situation. We offer conventional mortgages, home equity lines of credit or depending on the terms of an existing first mortgage, a refinance cash-out mortgage on your primary residence. Contact The Private Bank today for more information.

[1] ipropertymanagementl.com, “Renting Statistics [2021]: Facts & Trends in Rental Market,” https://ipropertymanagement.com/research/renting-statistics, accessed May 7, 2021.

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Rob is a senior financial planner for Commerce Trust Company. He is a member of the financial advisory services team — a dedicated financial planning practice within Commerce Trust that provides objective financial advice to clients. Following a thorough assessment of a client's unique situation and thoughts regarding wealth, Rob develops holistic and coordinated plans to help clients meet their short-term and long-term goals as well as take full advantage of various planning, tax, and investment strategies along the way. With more than 16 years of experience, he specializes in building relationships with clients and providing comprehensive financial planning services to business owners and individual investors to help them achieve their goals. Rob holds the CERTIFIED FINANCIAL PLANNER™ designation. He received his bachelor of administration degree in business finance from Loyola University in Maryland and his master of business administration degree from the University of Delaware. Rob serves on the Allocation Panel for the United Way of Greater St. Louis. Additionally, he is an Eagle Scout.