

# When to Sell an Investment Property In a Cooling Market for Real Estate

Wall Street Journal *April 12, 2006; Page D1*

It's time to skip town.

As many real-estate markets soften, speculators are finding they can't flip their investment properties for a quick gain. That leaves them with a tough decision: Should they hang on and rent or should they bail out, possibly at a loss?

Here's a look at that agonizing choice -- and why selling your investment property is likely the best strategy.

- **Cutting losses.** Got caught up in the real-estate fever? Let's start with the painfully obvious: If you have no choice but to sell, then you ought to sell -- and you should probably sell quickly.

To find out if you're in the "no choice" camp, simply run the numbers. Take the rental income on your investment property and subtract your costs, including the mortgage, property taxes, insurance and maintenance. If the house or condominium is a sizable cash drain and there's no way you can keep covering the shortfall, you've clearly got a problem.

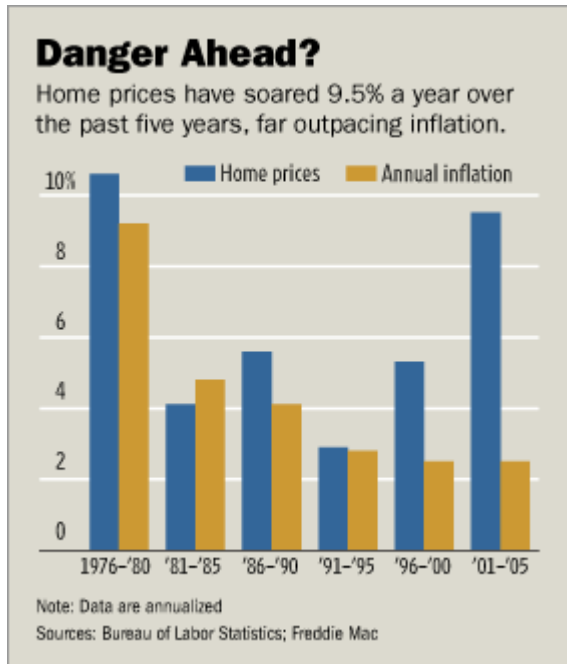
"I'm not selling anything," says John Schaub, author of "Building Wealth One House at a Time" and a real-estate investor in Sarasota, Fla. "But you have to be able to afford to hold your properties. Most of these people ought to sell, because they don't have the aptitude to be a landlord and they don't have the cash flow."

And don't kid yourself: If you have a cash-flow problem now, it could get a lot worse. What if you have trouble finding tenants, or your tenants stiff you on the rent? If the property is already a cash drain, imagine how grim things could get without any rental income coming in.

To make matters worse, you could be hit with rising borrowing costs, as the rate adjusts upward on your mortgage or as principal becomes due on your interest-only loan. "A lot of the people who bought investment properties are using these exotic loans," says Karl Case, an economics professor at Wellesley College in Massachusetts. "You could have the double whammy of falling prices and rising carrying costs."

True, the property market could perk up again, allowing you to unload at a profit. But that doesn't look likely. Chris Mayer, a real-estate professor at Columbia University's

business school, notes that home sales are slowing. That usually foretells a period of stagnant or falling house prices.



"I still don't believe that we are at the beginning of a crash," he says. "But people shouldn't count on big appreciation in the future."

Even if real-estate prices simply stagnate, many property speculators will be reluctant to sell their homes and condominiums, because they will be under water once they figure in the 5% or 6% selling commission.

Indeed, this reluctance to sell at a loss helps explain why a slowdown in home sales typically precedes a price decline.

Homeowners have a target selling price -- it might be the price they paid, or the price they could have got at the market peak -- and they initially refuse to accept anything less.

But waiting to "get even, then get out" could be a huge mistake. Not only will you have to cope with the property's monthly cash drain, but also you could be hit with leveraged losses. If you bought that Florida condo with 5% down, all it takes is a 5% price decline to wipe out your equity.

"When prices start to fall, they usually continue to fall for a while," Prof. Mayer warns. "You want to be aggressive in setting a price that allows the property to sell, rather than slowly lowering your asking price and following the market down."

• **Gauging returns.** On the other hand, maybe your situation isn't quite so precarious. Maybe you are collecting a healthy amount of rent or you have a small mortgage, so the property's income is covering your costs.

Even then, you may want to sell. The key question: Could you earn a higher return by investing your money elsewhere?

Over the past 30 years, home prices have outpaced inflation by two percentage points a year. But over the past five years, that inflation-beating margin has jumped to seven percentage points a year. The implication: Recent returns are unsustainable -- and modest gains may lie ahead.

Indeed, for today's property investors, rental income is likely to be the biggest source of profit. Suppose you're collecting rent equal to 5% of your property's likely selling price.

Meanwhile, assume your investment property's price merely matches the 3% inflation rate.

Put it together, and you have a respectable 8% annual total return. Problem is, that 8% is before costs.

How much are those costs likely to be? Let's ignore all taxes, which you should be able to minimize by depreciating the property and by deducting your various expenses. Let's also ignore the mortgage. While that's clearly a big cost, it doesn't affect the underlying property's investment gain.

Instead, take your 8% total return and knock off the annual amount you spend on homeowner's insurance and maintenance, including occasional big expenses like replacing the roof or replacing the furnace. Those expenses might amount to 2% a year or more.

"That gets your return down to 6% or below," says Columbia's Prof. Mayer. "Remember, you can get 5% on bonds. If you're south of 6% on a risky, idiosyncratic investment, I don't think that's a smart investment, especially when the downside risk appears to be a lot greater than the upside potential."