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REIT vs. DIRECT INVESTMENT

by

Richard L. Bain

Bachelor of Arts, Moorhead State College 1972

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An Independent Study

Submitted to the Faculty

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for the degree of

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TABLE OF CONTENTS

CHAPTER ONE. INTRODUCTION 1

Nature of Real Estate
Effect of Inflation

CHAPTER TWO. THE REIT 11

Origin
Tax Requirements
Sources of Capital and Classification
History
Future

CHAPTER THREE. DIRECT INVESTMENT 25

Objectives
Use of Leverage
Appraisal of Value
Tax Aspects

CHAPTER FOUR. CONCLUSION 40

. . . .

SELECTED BIBLIOGRAPHY 47

CHAPTER ONE

INTRODUCTION

The goal of this paper is to compare and contrast two methods of investment in real estate by an individual. Namely, these are indirect investment through a Real Estate Investment Trust (REIT), and direct investment in residential income property. There are numerous forms of direct investment in real estate including raw land, office and commercial buildings, shopping centers, motels, trailer parks, and specialty buildings leased to others after construction to their specifications. Many of the points made in this study would be applicable to certain of these areas. In order to make a more detailed study, however, it was necessary to limit the analysis of direct methods of investment. Residential income property was chosen simply on the basis that it is far more common than the other areas.

Residential income property includes all dwelling units held for rent. The principles contained herein are equally applicable to the single family home held for income, and the 100-unit apartment complex. The holdings of REITs, on the other hand, are of numerous types and will be explained in greater detail later.

The topic of this study is not intended to be a dichot-

omy in which one of the two methods of investment is preferable. For, as will be shown later, the preferable method depends on the circumstances in each case.

The methods of investment will be explored in detail in terms of their characteristics and advantages and disadvantages. Their purpose and what the individual can expect from his investment will be discussed. The decision to choose one method over the other then, depends on matching the individual's goals with the expected results of the investment. This is not to say, however, that the decision, once made, will necessarily lead to the expected results. The results are not guaranteed, but rather are expected based on generalizations of market trends and other risks.

Before going on to the detailed analysis of the two methods of investment, it will be helpful to consider the nature of real estate as an asset and the effect of inflation on this type of investment.

Nature of Real Estate

To many, real estate has an appeal that other types of investments don't have. This was summed up by one author as follows: "What, then, are the attractions that give real estate this special, almost compulsive, allure? Basically, of course, a lot of it is directly traceable to the fact that real estate is an inflexible commodity. . ."[1] It is a popular belief that because of the fixed amount of land available and the constantly increasing demand, land values must continue to rise in the

foreseeable future. Whether demand might one day level off is unknown, but this need not be of concern for the purpose here. Not only is population increasing worldwide, but evidence in the United States shows that the amount of land used by each individual is also increasing. "During the 1960s, for instance, one study of the Los Angeles area established that lot sizes had increased approximately 25 percent since the preceding decade."[2]

At this point it appears that the investor in real estate has a panacea: limited supply and growing demand. It must be remembered, however, that these facts apply to the total real estate market. The situation may be compared to the stock market about which it may be said that the long-term trend in prices is upward. But this says nothing about the small portfolio owned by the individual investor. Similarly, real estate values as a whole may be expected to increase in the long run, but this says nothing about the properties owned by the individual investor. Real estate, however, has some important differences from investments in securities.

The stock market draws investments for a spectrum of reasons ranging from an overheard conversation to an affection for the company's name. This substantial amount of subjective decision-making in the stock market makes it very volatile, and for most people, very unpredictable. Real estate, on the other hand, is much less affected by this type of investing. Certainly, there are those who invest in real estate on a whim, but generally speaking, investment in real estate is done on a more

objective basis than investment in the stock market. One reason for this greater degree of objectivity is the common involvement of a third party. Additional financing is nearly always sought by the investor in real estate, and the party providing it will also want to be satisfied with the choice and amount of the investment.

The most important point to make concerning investment in real estate is that its value at any particular time is determined by local supply and demand. Here again, it must be noted that this is a statement for general application, for one could often find a poor individual investment in a good local market. To look at this another way, a bad individual investment in a good local market is still a bad investment. Consequently, the investor is first interested in the soundness of the individual investment. A good individual investment in a bad local market, on the other hand, may become undesirable because of a further decline in the local market. Consequently, the investor next looks to the local market for real estate in evaluating an investment.

One might expect the logical consideration at this point to be the national and international markets for real estate. As mentioned earlier, however, the value of real estate is determined at the local level. National and international considerations, other than to point out trends in population and such, are not of use in evaluating real estate investments.

The connecting link between these considerations is time. Both individual investments and local real estate markets change

over time. It might appear, then, that any real estate investment, if held long enough, would be profitable because of the long-term trends mentioned earlier. Theoretically, this point has merit. However, investors, for various reasons, often do not or are not able to hold an investment for the period of time necessary to make it profitable.

To understand this area, it is helpful to consider further what makes an investment in real estate a bad investment. From the earlier discussion, the answer would be either a bad individual investment or a bad local market, or both. This leads to a very important point. Either of these conditions, a bad investment or a bad local market, can be removed or mitigated to some extent by a change in the price paid for the investment. For example, if it was undesirable to purchase a building at a certain price because tenants were not willing to pay the rent required to make it profitable, one would simply need to pay a sufficiently lower price to be able to charge a rent acceptable to tenants. In other words, a bad investment is often bad simply because too high a price was paid for it.

This ability to lower the price to gain a higher rate of return, however, applies mainly when the individual investment is overpriced. If the inability to earn a satisfactory rate of return is due to local market conditions, a profitable investment may not be possible because of insufficient demand.

Effect of Inflation

Another important aspect concerning real estate invest-

ment is the effect of inflation. Inflation is a very popular topic today but is not very well understood. Inflation is simply the rising or inflating of prices. But it is the cause of inflation which is of greater concern and this is very often what is not understood. The cause, however, can be stated very simply as people demanding more than they are worth in salary and wages. If an individual receives an increase in salary without contributing a corresponding increase in productivity, the price of the related product or service must be increased and the ultimate cost is born by the consumer. There are situations where the reverse is true, that is, an individual contributes more to productivity than he demands in salary or wages compared to other workers. As one might suspect, however, this group is a fairly small minority.

There is one other way in which an individual can satisfy demand, and that is through the use of credit. An individual who borrows money and uses it for consumption has not contributed anything to productivity. To clarify, then, inflation is caused by an excess of demand through salary, wages, and borrowing, over productivity.

In a discussion on inflation, it is not uncommon to find a good portion of it devoted to what is called "cost-push" inflation. The distinction is made from so called "demand-pull" inflation. In the former, costs are rising faster than demand and hence, are said to be the cause of inflation. In the latter, demand is rising faster than costs which supposedly makes it the cause of inflation. What is commonly not understood is that the

former, that is "cost-push" inflation, is actually a result of the single cause of inflation--excess demand by the individual. There is simply a cycle which must be completed from the time an individual demands more than he produces to when the price of the related product must be raised. The free enterprise system is designed to prevent a business from arbitrarily raising prices by promoting competition. Since this system is working quite well in the United States, it logically follows that businesses can seldom raise prices unless their costs go up. And the only way for costs to go up is through increased demand from someone else.

The preceding discussion of inflation was kept simple to help illustrate the points involved. The situation becomes complicated rather quickly when applied to the total society. For example, assume that productivity gains in a certain manufacturing area led to increased compensation for its employees. If the gain were all attributable to one employee who later left the company, however, compensation given to other employees would no longer be matched by productivity. The problem of matching compensation with productivity is indeed a difficult one, because circumstances that exist today may not exist tomorrow.

The distinction between earned income and borrowing, with regard to inflation, becomes very important when considering attempts to control inflation by the federal government. One way in which the government attempts to control inflation is through control of the money supply by the Federal Reserve

Board. The three basic actions taken by the Federal Reserve Board for that purpose are as follows:

1. The buying and selling of government securities in the open market.
2. A change in the percentage of reserves that member banks are required to keep with the Federal Reserve Bank.
3. A change in the discount rate which member banks must pay for loans from the Federal Reserve Bank.[3]

Controlling the money supply, however, affects only the <u>borrowing</u> of consumers. It has no effect on the other cause of inflation--the demand for wages in excess of productivity. It is this area that the federal government very often either fails to recognize, or, consciously ignores. There is only one way the government can control inflation in this area and that is by making up the imbalance itself. In other words, the government could eliminate inflation in this area only by taxing away the excess of wages over productivity and then not spending it for goods and services. Theoretically, demand, in the form of disposable income, would then equal productivity. Instead, the government's course of action in recent years has been to spend an increasingly greater amount than it receives in taxes. The government has thereby been a substantial contributor to inflation in recent years.

Because the chance of the government taking any action such as the foregoing is quite remote, it is reasonable to plan on inflation continuing in the foreseeable future. It is appropriate to consider then, the effect of inflation on investments

in real estate. Real estate is a nonmonetary asset, and as such, the amount of dollars it can be sold for can fluctuate. Cash or a contract to receive it, on the other hand, is fixed in amount of dollars as to the holder. The differing effect of inflation in these two areas is very important to the real estate investor.

> Holding cash or money in a checking account may bring you some real losses. Of course, you will always have the same amount of dollars if you keep your money in cash. But, will the money buy as much next year as it does today? If not, you have lost some of your money just as surely as if it had been stolen.[4]

Real estate, however, does not have this risk of loss that is associated with inflation. As authors Seldin and Swesnik point out, "The long-term value of any specific share of stock or parcel of real estate is influenced by a variety of factors, the prime factor being the ability of these assets to produce income."[5] This does not mean that the value of real estate will increase by exactly the amount of inflation. There are usually local factors which will cause the change in value to be more or less than the rate of inflation. For example, if after an investment in real estate was made, the surrounding area deteriorated rapidly, the result might be a decrease in the value of the property. This decrease could be a combination of an increase in value due to inflation, and a larger decrease in value due to local conditions. These two factors are sometimes referred to as the general and specific price changes,[6] general being caused by inflation and specific by local factors.

The investor in real estate then, will have an effective hedge against inflation. As stressed earlier, his main concern

will be with the specific price changes caused by local supply and demand.

ENDNOTES

[1]Don G. Campbell, The Handbook of Real Estate Investment (Bobbs-Merrill, 1968), p. 1.

[2]Ibid., p. 3.

[3]Maury Seldin and Richard H. Swesnik, Real Estate Investment Strategy (Wiley-Interscience, 1970), p. 115.

[4]Ibid., p. 11.

[5]Ibid., p. 13.

[6]Charles E. Johnson, Thomas F. Keller, Walter B. Meigs, and A. N. Mosich, Intermediate Accounting (McGraw Hill, 1974), p. 305.

CHAPTER TWO

THE REIT

Origin

> Real estate investment trusts were created by Congress in 1960 when it approved changes to the 1954 Internal Revenue Code giving rise to a new type of company called a real estate investment trust. The idea behind the new rules was to:
>
> 1. Create a vehicle which would inject dollars into the real estate investment field, therefore stimulating the economy, and,
> 2. Give relatively "small" investors the opportunity to participate in the rather sizeable profits to be made through real estate financing activity.[1]
>
> The enabling legislation resulted as an outgrowth of early Massachusetts law, which generally prohibited corporate ownership of real estate. The law fostered the use of trusts as an investment intermediary in real estate.[2]

However, this ended in 1935 when litigation led to the classification of real estate trusts as corporations. In 1936 legislation was enacted limiting trusts' investments to stocks and securities, thereby creating mutual funds. This concept was extended to real estate in 1960 when Congress approved the existing law.[3] In summary, the idea of real estate trusts is not new, but it is only recently that the desirability of such a vehicle was recognized by Congress.

Tax Requirements

The tax law treats the REIT as a conduit through which income from its investments passes to the shareholder with no

tax consequences to the REIT on income distributed by it. The Internal Revenue Code, however, spells out very strict rules which must be followed in order to achieve such tax benefits. Violation of any one of the following rules can terminate the REIT status resulting in the imposition of tax at regular corporate rates.

--Seventy-five percent gross income test--REITs must realize 75% of their gross income from passive real estate sources. The two primary sources REITs use to satisfy this requirement are rents from real property and interest on obligations secured by real property.

--Ninety percent gross income test--This requirement states that the sources included in the 75% test, plus interest, dividends, and gains on securities transactions must account for 90% of the REITs gross income. The REIT must be careful here to note the meanings of these terms under the tax law.

--Negative 30% gross income test--REITs must receive less than 30% of their gross income from the sale of stock and securities held for less than six months, and from the sale of property held for less than four years. This is ordinarily not a problem, one reason being that the installment sales method is available to spread income from a large sale over a period of years.

--Ninety percent income distribution test--REITs must distribute at least 90% of trust taxable income. The differences from normal corporate taxable income include the exclusion of the excess of net long-term capital gain over short-term capital loss, and

the disallowance of "special deductions" and the net operating loss deduction.

--Holding property as a dealer--REITs cannot hold any property primarily for sale to customers in the ordinary course of business. Most REITs adopt a very conservative approach here because just one sale as a dealer will remove the REIT status.

--Organizational qualifications--A corporation cannot qualify as a REIT, but a REIT is taxable as a corporation. It must be managed by one or more trustees and have transferable shares of beneficial ownership. The shares must be held by 100 or more persons and at no time during the last half of the taxable year may five or fewer individuals hold more than 50% ownership. The trust must make an election to be treated as a REIT.

--Asset diversification--At least 75% of a REIT's total assets must be in real estate, government securities, cash, and receivables. No more than 25% of a REIT's total assets may be from other than government securities.[4]

Since violation of any one of the above rules can terminate the REIT status, management must continually monitor its position to insure its REIT status. For example, if a REIT used accelerated depreciation, cash flow would exceed taxable income in earlier years. In later years, however, if cash flow was less than taxable income, there could be a problem meeting the 90% distribution requirement.[5]

There are two other timing differences, differences between when an item is reported for tax purposes and when it

is reported for financial accounting purposes, which are commonly found in REITs. One is the loan loss reserve, an expense which is usually not deducted for tax purposes until the losses occur. The reason for this is that REITs are afraid the IRS will not allow the deduction and thereby increase taxable income to a point where the 90% distribution test has not been met. The second timing difference commonly found in the REIT industry concerns fees and points received on mortgage loans. For financial reporting purposes, these items are usually included in income over the life of the loan. For tax purposes, however, they must be included in income in the year received.[6]

The timing differences mentioned above cause taxable income to exceed financial accounting income in the early years. In later years when these timing differences "turn around", it may be possible for the REIT to show a loss for tax purposes. Since the net operating loss deduction is not available to REITs, however, it appears the tax loss would be of no benefit in offsetting past and future income. One author, however, has suggested a possible method for taking advantage of such a loss. The REIT could simply violate one of the rules mentioned above, and thereby terminate its REIT status making it taxable as an ordinary corporation in a particular year or years.[7] Such an opportunity will most likely not be too common, however. Most REITs, in the normal course of business, will produce new timing differences each year causing a more or less permanent deferral of income for financial accounting purposes.

Basically then, the tax advantage to the REIT status is that the beneficial owners avoid the double taxation encountered in corporate investments. Since the REIT is not taxed on income it distributes, the shareholder benefits through a higher return on his investment.

Sources of Capital and Classification

The successful operation of a REIT hinges on its ability to obtain money and redistribute it at a profit. The sources of money commonly used by REITs include the following:

--Equity offerings--A REIT first obtains capital by selling its shares to the public. Technically, these are not common stock, but rather shares of beneficial interest.

--Bank lines of credit--Borrowing on lines of credit usually takes the form of short-term notes or notes payable on demand. The interest rate is usually at or near the prime rate and the trust is normally required to keep compensating balances.

--Commercial paper--Once a REIT has gained sufficient financial strength, it will often issue commercial paper. These unsecured promissory notes may have maturities from two days to 180 days with rates determined by present money market conditions.

--Term loans--These may be relatively large--$20 million to $50 million--and are often payable in five to seven years.

--Debentures--Such issues are of varying amounts and maturities. Additional features such as warrants or conversion privileges are not uncommon.[8]

A REIT may use any of the above sources as it sees fit.

There are different types of REITs however, and those known as short-term trusts must depend primarily on the first three sources.

Although many classifications are possible, the following appears to be a logical breakdown of the major types of REITs.

--Short-term trusts--This type of REIT specializes in construction and development loans that usually run less than eighteen months. Their fate is tied to short-term economic conditions.

--Long-term mortgage trusts--These REITs finance permanent mortgages just like savings banks or savings and loan associations.

--Equity trusts--This type of REIT invests directly in depreciable property.[9]

History

The legislation enacted by Congress creating REITs caused a flurry of activity in 1961 and early 1962. This activity tapered off, however, with the decline of the stock market in 1962. Because of a loss of investor confidence, REITs did not recover with the stock market in late 1962. Many REITs found they could no longer sell their shares and proposed offerings were withdrawn. REITs then went unnoticed until they were rediscovered in 1968. Much of the activity this time was a result of the promotional activity of underwriters and others who saw the potential for lucrative fees and service charges.[10]

From this activity in 1968 the REIT industry continued

to flourish. By 1972 REITs had become a popular sector of the stock market. In addition to yields of 12 percent and more,[11] many REITs experienced tremendous appreciation in the market price of their shares. As is so often true, however, extreme performance worked both ways. When things got bad for the investment world as a whole, they got even worse for some Real Estate Investment Trusts.

> The event that brought REIT problems to the wide attention of the financial community occurred in December, 1973. Walter Judd Kassuba, forty, a real-estate broker turned developer, found himself so overextended that he filed for protection from his creditors under Chapter XI of the Federal Bankruptcy Act. Almost unknown in U.S. real estate circles until the mid-1960's, Kassuba Development Corporation was, when it went under, one of the very largest apartment developers in the nation. In the flurry of publicity that followed the bankruptcy, it turned out that about twenty REITs had made loans to Kassuba, some of them substantial.
>
> These disclosures which set the stage for the commercial paper crisis, also helped to shock REIT auditors, who were concerned about the possibility of lawsuits, into making some unusually exhaustive examinations of their clients' fast-growing portfolios. The most striking result was the climb in an item called "provision for loan losses." For many trusts the audits had a devastating impact on earnings. . . .
>
> Trusts have an unusually complicated system of accounting, and many follow a practice of accruing interest on their books before it is received. Many construction loans are made on a discount basis, with both interest and principal due when the loan matures. In the interim the trust doesn't receive a penny, but on its books it records the interest just as if it were being paid.
>
> This arrangement enabled some REITs to keep shaky construction loans well hidden for quite a while. But eventually the trustees, sometimes prodded by auditors, have to stop putting illusory payments from problem loans on the books. Thereafter, these "nonaccruals" add to the drain on reportable earnings. This has become a substantial problem.[12]

The accounts above point out some of the problems REITs have encountered recently. The significance and magnitude of these problems was illustrated by certain additional events

occurring in 1974. In May of that year, the chief executive of one of the nation's largest REITs met with Arthur Burns, Chairman of the Federal Reserve Board. The chief executive explained that without financial help from the banking industry, his and several other companies would be facing bankruptcy. The result of this discussion was the creation of a method by which the financially troubled REITs could borrow money needed to keep them in business. A number of banks who had already made loans to a certain REIT, would form a consortium to come up with the needed capital.[13] This was an acceptable solution to many of the individual banks, because each one was able to help protect its interest without assuming the total risk for the additional financing.

As one might expect, however, not all banks were in favor of lending more money to a creditor in financial difficulty. It was usually the smaller banks who had made loans to the trusts that did not want to go along with the "revolver loans." The larger banks, on the other hand, often had very large loans outstanding with these trusts, and needed to protect them in any way possible. If one of these smaller banks threatened to sue to collect on its loan,

> . . . the agent banks or one of the other big banks in credit agreement usually tried to find someone with a close tie to the recalcitrant bank, at a senior level. The next step, in some instances, was a call from the chairman or president of a major bank to the top officer of the holdout bank. According to one banker involved in REIT credits, "This usually worked."[14]

The following excerpts answer some of the questions surrounding the activities mentioned above.

Why did the Fed step in? Basically because the REITs are pivotal financial middlemen who borrow from the pin-striped bankers and lend to muddy-shoed builders. There was no way for them to collapse without hurting banking, the tottering building business and a lot of little people. . . .

In bailing out the REITs, the Federal Reserve and the banks themselves have apparently acted on the assumption that their new wards were simply victims of tight money and the recession. This is almost certainly an overoptimistic view. A good deal of the REIT industry has indulged for many years in unsound and possibly illegal activities. . . .

The potential for abuse is built into the REIT foundation.

The trust managers make money for shareholders by selling stock, then leveraging each equity dollar with $3 to $4 of debt borrowed in the commercial paper market or from banks. Then they take that pot of cash costing, say, 9% and lend it to builders at, say, 4½% over the prime rate plus 2% (or "points") for various services. Put simply, the lending REITs make money borrowing low and lending high. . . .

But REIT entrepreneurs make money for themselves in quite a different way; they provide services to the trust and its borrowers that yield around 25% of gross profit as fees.

In other words, the public gets paid according to the quality of the meat; the managers get their cut according to the size of the carcass.[15]

The main source of the difficulties for the short-term REITs has been the construction industry. Rapid cost inflation, particularly in residential buildings, began plaguing the industry in 1973. In addition, material shortages developed which delayed progress on many projects.

Many of the developers who borrowed from REITs ran out of funds before their buildings were completed. To avoid foreclose, a REIT might advance the developer a new loan--and sometimes the interest as well. If a developer was on the verge of bankruptcy, the trust sometimes took the deed to the property and brought in a new developer, lending him enough money to complete the building and pay the interest in default. . . .
But too often REITs pumped in so much money that projects became uneconomic.[16]

A logical result of new ideas such as the Real Estate Investment Trust which show an exceptional potential for profit,

is very rapid growth. As in the present case, this is often a large part of the problem.

> Egged on by investment bankers who profited handsomely from underwriting their shares, REITs proliferated far more rapidly at the end of the Sixties than the supply of talent needed to run them. Thereafter, seized by a naive euphoria about the size of the market for condominiums, motels, and office buildings in many cities, scores of REITs began a competitive scramble to put to work the easy money flowing into their coffers. The inevitable result was overbuilding and a frightening vacancy rate.
>
> Bankers, who might have injected an element of prudence along the way, didn't. Indirectly, through the REIT mechanism, they made loans for projects they would never have financed directly, and they permitted some REITs to build a giant pyramid of debt on what was often a thin foundation of equity capital.[17]

> Until last year, money was so easy to obtain that the short-term trusts ignored a basic tenet of finance by borrowing short and lending long. Bank borrowings on a line of credit typically take the form of ninety-day notes, or demand notes (callable at the bank's option), and commercial-paper borrowings can run for as little as a few days or as long as nine months. The construction-lending REITs were putting the money out for one to three years. While the trusts were awash in funds--as they were until the end of 1973--almost no one worried about the potential for a devastating cash squeeze.[18]

While things were going well, the leverage factor worked to the great advantage of the REIT shareholders. But when the money market got tight, REITs found that they could not generate cash fast enough to meet existing debt obligations. This brought the threat of bankruptcy, which is the big fear of the banking industry.

> When it comes to bankruptcy, the REITs have a weapon of their own. If a trust files under Chapter XI, the banks lose control over the situation because only the debtor can propose reorganization terms. Moreover, interest payments stop immediately. Accordingly, some REIT officials have been able to sway their creditors merely by pointing out that they could file in bankruptcy. What the bankers seem to fear even more is a Chapter X bankruptcy, in which the whole mess falls into the hands of a trustee appointed by a federal judge.

> The big banks are not anxious to take the chance that the trustee would be clever enough to manage intelligently a large portfolio of sick loans with which he is thoroughly unfamiliar.[19]

The REIT industry did come up with a couple of alternatives in an effort to avoid bankruptcies. One is that of converting to an ordinary corporation. The company could then foreclose on accounts in default, develop or liquidate the property, and receive tax credits for any losses incurred.[20] There has been little activity in this direction, however, and this will probably continue to be the case.

Another alternative, far more favorable to the REITs, has been more common. The trusts arranged asset swaps, offering to trade loans on their books for cash and forgiveness of debt. While this was no long-term solution, it did provide at least some cash to the trusts that needed money to pay off their bankers and to meet commitments to developers.[21]

These alternatives, however, have found only limited acceptance. The first, because it is not acceptable to REIT managers who might suffer financially, and the second because banks agree to the swaps only when they feel recovery is possible. Consequently, bankruptcies have occurred, a recent example being Continental Mortgage Investors which filed under Chapter XI of the Bankruptcy Act earlier this year.[22]

It is the banking industry that must ultimately suffer the greatest consequences of the REIT difficulties, even though they are understandably reluctant to do so. Many of those concerned are now calling for action on the part of the lenders similar to the following which was suggested in a recent

editorial.

> There is only one realistic course. First, accept the unpleasant fact that losses must be swallowed; second, find solid, responsible developers and managers to work out the distressed properties; and third, negotiate deals with these people that adequately reward fast, successful workouts.[23]

Future

An interesting thing to note in the above discussion is that the financial problems in the REIT industry have been almost exclusively confined to the short-term trusts. The long-term mortgage and equity trusts have continued to perform well in spite of recent market conditions, and in spite of making short-term loans to developers just like the short-term trusts.[24]

This is not a clear indication of where the real problem lies however. The following excerpt illustrates this.

> Most trusts undertook their short-term loans without worrying about the project's permanent financing--that is, the mortgage loan that would pay off the construction-and-development loan when the project was completed. The trusts simply assumed that someone, somewhere, would provide the long-term money when the time came.
>
> But the five insurance-sponsored trusts insisted on permanent financing (often for a fee) from the beginning, before they forwarded any short-term money.[25]

The problem, then, was not the fact that the trusts were making short-term investments, but rather that many of them were making undesirable investments. It was the short-term trusts that ended up in trouble because many of their managers were so intent on maximizing profits that they forgot about risk. What made the whole situation even worse was the fact that a very large number of the trusts were caught up in this utopian-type investing. As of November of 1975, some 41 percent

of all REITs were no longer earning a profit.[26]

The well-managed trusts, on the other hand, have shown good returns in all areas of investment. The five insurance-sponsored trusts referred to above have up to 48 percent of their assets in short-term investments, but these same trusts had current yields of 10.8 to 13.2 percent for most of 1975.[27]

One author sums up the situation quite appropriately with the following. "There are lurking pitfalls in plenty. But anyone who takes the trouble to understand what he is doing can find a number of opportunities this very day."[28]

ENDNOTES

[1]Curtis L. Westbrook, Jr., "Financing Real Estate Investment Trusts," Management Accounting, May 1975, p. 56.

[2]James E. Lewis, "Examination of Real Estate Investment Trusts," Appraisal Journal 41 (July 1973):351.

[3]Ibid.

[4]"Real Estate Investment Trusts Must Follow Strict Rules to Achieve Tax Benefits," Taxation for Accountants 10 (January 1973):40-3.

[5]Ibid., p. 41.

[6]Jay Drob, "REIT Distribution Rules Create a Tax Angle," Real Estate Review 4 (Winter 1975):60-1.

[7]Ibid., p. 61.

[8]Westbrook, pp. 56-7.

[9]Harold S. Taylor, "The REITs Are Sorting Themselves Out," Real Estate Review 4 (Spring 1974):104.

[10]James J. Klink, "Getting at the Roots of REIT Reporting Problems," Real Estate Review 4 (Fall 1974):37-8.

[11]Taylor, p. 102.

[12]Wyndham Robertson, "How the Bankers Got Trapped in

the REIT Disaster," Fortune, March 1975, p. 115.

[13] Frank Lalli, "Horror Story," Forbes, February 1, 1975, p. 24.

[14] Robertson, p. 172.

[15] Lalli, p. 24.

[16] Robertson, pp. 114-5.

[17] Ibid., p. 113.

[18] Ibid., pp. 168-9.

[19] Ibid., p. 173.

[20] "NOLs Cause REITs to Convert to Corporation Status," Journal of Taxation 41 (November 1974):321.

[21] "Troubled REITs Swap Assets for Cash," Business Week, July 21, 1975, p. 68.

[22] "Three REITs Start Reading Chapter XI," Business Week, March 22, 1976, p. 130.

[23] Maxwell C. Huntoon, Jr., managing editor, "Distressed Properties: The Need For A Realistic Approach," House and Home, January 1976, p. 81.

[24] "The Quiet Ones," Forbes, November 15, 1975, p. 63.

[25] Ibid.

[26] Ibid.

[27] Ibid.

[28] Taylor, p. 105.

CHAPTER THREE

DIRECT INVESTMENT

As stated in the introduction, the subject of this section will be residential income property. The property is considered directly owned by the investor, although it may or may not be managed by him. The significance of this fact when compared with a REIT investment, is that the investor has broadened his investment to include additional risks and responsibilities. These include such things as property taxes, insurance for property damage, liability insurance, maintenance and repair expenses, bad debts, and vacancies. In return for the additional risks and responsibilities, the investor expects to be compensated. In effect, he is replacing the management of a REIT by handling those duties himself, and as a result expects to receive the compensation which would have been distributed as management fees.

As stated earlier, the key to choosing an investment is matching one's goals to the type of investment which can be expected to achieve them. In the opinion of author George Mair:

> Deciding what your objective is may be the most important single thing you do before you sink hard-earned money into an investment.
>
> It is sad to see how many people commit their financial resources to this investment or that one, without giving any thought to what they want the investment to do for them. It is as if everyone believed that each investment returned the same benefits to every investor, and those benefits

were ideally suited for what each investor wanted out of his money. This is not the case.[1]

A distinction is often made in the investment world between types of investors by using the terms speculator and investor. In general, a speculator tries to make money by trading his investments, and an investor tries to make money by holding them. As pointed out by Campbell, however:

> This question of speculation versus investment in the real estate business is, of course, a matter of intent on the part of the individual. Any speculation has some qualities of an investment in it and, conversely, every investment has some of the aspects of a speculation in it.[2]

These terms do not relate to the success of the investment, but merely define certain terms used to describe investors. The important thing to consider is the objectives of these types of investors.

Objectives

The more common objectives of the individual real estate investor include increased income, protection of capital, tax shelter, appreciation, forced savings program, decreased expenses, prestige, and freedom from work and worry.[3] Since the list is rather self-explanatory, emphasis will be on the first four of these objectives because they are by far the most common.

The measure of income which the residential property investor is concerned with is cash flow. This is what is left after paying all cash expenses. It is different from taxable income because tax laws permit the deduction of depreciation as an expense, but it does not require an outlay of cash. This is a very important advantage to most investors. For example, if

a piece of property had depreciation expense of $100 per month and cash flow of the same amount, taxable income would be zero and the investor would receive $100 of spendable cash per month. This amount is not entirely tax-free however. Depreciation must be deducted from the purchase price of the property when it is sold, and any excess of the sales price over this amount is subject to tax. In other words, if the value of the property has not decreased by at least an amount equal to depreciation taken, the depreciation is said to be "recaptured" and tax must be paid on it. However, if the property has been held over six months, which will normally be the case, the gain on the sale in excess of recaptured depreciation is subject to tax at the more favorable capital gains rates. Residential investment property then, will nearly always give the advantage of some income being taxed at lower than normal rates.

One factor that offsets the advantage of the depreciation deduction is that the "amortization", or paying off, of the principal portion of a mortgage is not deductible for tax purposes. That is, it reduces cash flow, but not taxable income. Since this portion is smallest at the beginning, however, the tax advantage is greatest at the beginning and decreases as the principal payments on the mortgage become larger.

The objective of protection of capital is explained by the earlier discussion concerning inflation. Since holding cash will cause a loss of purchasing power, it is to ones advantage to hold another form of investment which will increase in value with inflation. As stated earlier, residential property is that

type of an investment.

One of the tax aspects of investment in residential property has already been mentioned. Since this area is more complex and covers a number of topics, however, it will be discussed in greater detail later. At this point, suffice it to say that tax savings are definitely available from investment in residential property.

The objective of appreciation relates closely to the earlier discussion concerning the limited supply of land. The continually increasing demand for land combined with the unchanging amount available causes land to become more valuable. Investors often fail to realize that appreciation in residential real estate is attributable, for the most part, to the land. The building must be losing its value because it will eventually become worthless, or nearly so. This loss in value to the building, however, is often obscured by the gains which are attributable to inflation. There may be periods of time in which a building will appreciate in value, but generally, appreciation is attributable to the land. It is important to note that appreciation, in this discussion, applies only to the specific price change in the property, and does not include the general price change caused by inflation, which is covered by the objective of protection of capital.

Author George Bockl states that an investment in residential real estate provides four benefits. He calls these, cash flow return, amortization return, gain from tax shelter, and return from inflationary gains.[4] These relate to the four

objectives previously discussed. The second benefit cited by the author, amortization return, relates to the objective of appreciation. Bockl uses the term "amortization return" to refer to the amortization of principal on a mortgage. His analysis in this instance would not be correct, however, unless appreciation of the property happened to equal such amount of amortization. The investor does not benefit by the amount he pays for property if it eventually becomes worthless. The principal amount of the mortgage is part of what the investor must pay for the use of the property. There can be no economic benefit from simply paying off that amount. The benefit lies in the fact that the property may be saleable at a price greater than its depreciated value.

Use of Leverage

An important aspect of real estate investment is the ability to use leverage. Leverage is simply using someone else's money to make money. For example, if a person could earn 10% on an investment, it would always be advantageous for him to borrow money and invest it as long as it cost him less than 10% to borrow it. The only problem is that there is always some risk involved in an investment and one could lose the total amount of his investment.

The amount of risk involved is an important aspect of any investment. The investor will usually weigh this against his expected return before deciding whether to make an investment. It is generally held that risk and return are directly

related--the higher the risk, the higher the return. An investment in residential property is somewhat unique, however, in that risk is actually quite low when compared with return. The reason for this is that there are other factors which make this type of investment less desirable. The most important of these factors are lack of liquidity, management problems, and lack of statistical information for investment purposes.[5] Because these factors are disadvantages to the investor, he will require a larger return for accepting them. As one author states: "You can be very handsomely compensated for giving up liquidity."[6]

Because risk is not commensurate with return, it would normally be to the residential property investor's advantage to use leverage. Consequently, using debt to finance residential property investment is the general practice, even though the investor may have the ability to pay in full. It is important to note, at this point, that the interest the borrower must pay is not his effective cost of capital. Because interest is tax deductible, it will result in a tax saving to the individual which will, in effect, lower the cost of borrowing. For example, if an investor is in the 50% tax bracket and borrows money at 8% interest, when the total interest is deducted from his income, his taxes will decrease by half of that amount. Since this is an amount that the investor would otherwise have been required to pay, his effective interest rate is only 4% rather than 8%.

Appraisal of Value

Once an investor has established goals, including the type of property desired, the next step is to make a purchase. The investor faces a very uncertain task here, namely, that of appraising the value of the property. If the value of the property to the investor does not equal or exceed its price, he would normally not make the investment. A danger, however, lies in the fact that the appraisal by the investor may not be sufficiently accurate. The appraisal need not be exact. It should be accurate enough, however, so that the results obtained are acceptable to the investor. Author George Mair illustrates the problem facing the investor as follows:

> An appraisal is simply defined as, "an estimate of value." The operative word is "estimate." Ten appraisers evaluating the same piece of property on the same day, for the same purpose, will probably come up with ten different figures.[7]

Numerous methods of appraising the value of residential property are undoubtedly in use. Three of the more common ones will be discussed here.[8]

One method calls for simply valuing the property at its cost of construction. Because of changing prices and the effects of inflation mentioned earlier, however, this method becomes unreliable very quickly as the property ages. In fact, even at the time of construction, this method may not be desirable for determining investment value. An article to appraisers noted the following distinction:

The appraiser's probable selling price of the subject

> property is not affected by the particular problem or decision that confronts the client; it would be the same dollar figure for every client. On the other hand, warranted or investment value is a personalized value and will differ among clients with different investment objectives, financial situations, tax brackets, propensities for risk-taking, and composition investment portfolio.[9]

Because of these deficiencies in the cost method of appraisal, it should not be used for investment purposes.

A second method of valuing residential property is the comparison approach. This method calls for comparing the property with recent sales of similar property in the area, and making adjustments for any differences. Normally, the more comparable properties there are, the better the appraisal will be. It can be argued, however, that again in this case, the investment value of the property may differ from its expected selling price. In other words, an investor may be willing to pay more than the appraisal obtained in this manner because he will still receive a satisfactory return on his investment.

One other point regarding this approach should be noted with respect to the sales prices of other properties. "Such things as forced sales, money pressure for other purposes on the seller, tax pressures, salesmanship, interfamily transfers, and so on could all affect the sales price."[10]

Consequently, the comparison approach, by itself, should not be used for making investment decisions. It is still very important to the investor, however, in that it helps assure him that he is not paying too high a price in relation to the local market.

A third method of appraisal is the capitalization method.

Using this method, the value of the property is obtained by dividing the investor's desired rate of return into the annual income after fixed expenses such as utilities and property taxes. Author Robert Kent explains how a minimum rate of return rule was established:

> If the return on his money in the real estate investment is to be only the same or a little more than he would receive as dividends on blue-chip stocks, he is better off buying stocks. . . .
>
> For these reasons the fifteen per cent rule gradually became almost universally standard.[11]

The problem with such rules-of-thumb, however, is that they are often too strictly adhered to. Kent, later on, explains that income should be adjusted for any unusual expense or profit items.[12] This still leaves too much importance attached to the fifteen per cent rule, however. As mentioned earlier, the rule was established by comparing an investment in real estate with such investments as blue-chip stocks for which a rate of return was known. A better course of action for the investor then, is to establish a rate of return by comparison with current rates from other investments.

One additional point should be noted with regard to the amount used for annual income. The investor should satisfy himself that rents presently being charged on the property are consistent with the local market.

In the above discussion it was noted that an appraisal is not a precise value of the property. Consequently, when an investor is trying to determine the value of property for the purpose of purchasing it he should not be concerned with a specific value. A good approach is to establish both a "fair

or median value" and a "maximum value" using the capitalization method. The investor would then use the comparison method to make sure that neither of these amounts exceeds the local market value. This puts the investor in a position to bargain using the "median value" as his goal and accepting any price up to the "maximum value."

Tax Aspects

The tax aspects may be one of the most important reasons for many investments in residential income property. The advantage gained from the deduction of depreciation was mentioned earlier. The reason for Congress allowing such a deduction is explained by Campbell as follows: "Without this incentive, risk capital would simply dry up and leave us with a sterile economy in which everyone sits quietly on his money in the safest form of investment possible. . ."[13]

Because of its effect of offsetting or postponing income, depreciation should normally be taken up to the maximum allowed. New residential buildings are eligible for the 200 percent declining-balance and the sum-of-the-years-digits methods. Used residential buildings having a remaining life of at least twenty years when acquired, are eligible for the 125 percent declining-balance method. If the life of the building, when acquired, is less than twenty years, only the straight-line method can be used, unless permission to do otherwise is obtained.[14]

The appropriate accelerated method of depreciation

should be used during the early years after acquisition. At a certain point, however, a switch to the straight-line method becomes desirable.

> An optimal switch should be made in the period when the depreciation charge computed by the straight line method for the remaining life of the asset is equal to or greater than the charge that would result from continued use of the accelerated depreciation method.[15]

Often investors in residential property may have as their main objective, the tax shelter of a portion of their income. In an effort to maximize this benefit, an investor could sell the property when it reaches a point in time when cash flow is no longer offset by depreciation and interest. In other words, as soon as the investment started to produce taxable income, he could sell it and replace it with a new investment which would provide the tax shelter benefit.

A better alternative available in this situation would be for the investor to refinance the property. First of all, the investor would be able to obtain additional tax shelter benefit because of the increase in interest expense. Secondly, he would obtain an amount of tax-free cash which could be put into another investment.[16] The advantages to refinancing are readily apparent whenever the investor faces the situation of a large taxable gain if the property were sold. The tax shelter is retained and any taxable gain is postponed. At some point, however, the building will have reached the end of its useful life, and refinancing will no longer be available. The investor will quite likely face a gain on the sale of the land. This can be avoided, however, by taking advantage of another provision

in the tax law.

> Under Section 1031, no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged for property of a like kind to be held for either purpose.[17]

Rather than sell the property at a gain, it could be exchanged, for example, for a smaller investment property which would produce a tax shelter. The basis of the old property becomes the basis of the new, and the exchange is tax free. A number of these smaller properties could, in turn, be exchanged for a larger one. The result is a new investment with the desired tax shelter and no immediate tax consequences.

It may appear, in the above discussion, that all that has been done is to postpone the recognition of gain and the related tax consequences. There is also an immediate monetary advantage, however, in that taxes that would have been payable as a result of a sale are instead invested and add to the cash flow of the investment.

It is possible to manage the initial cash flow and taxable income to some extent by varying the size of the mortgage. In this respect, it would be desirable to know the optimum structure of debt and equity. First of all, a negative cash flow position is never advantageous because one cannot gain anything by paying out a dollar to save a portion of it in taxes. Secondly, the same reasoning would apply to a tax loss position. For example, if the investment showed zero cash flow and a $100 loss for tax purposes, the investor gains only the amount he would have paid in taxes on the $100; a maximum of $70. If the cash flow were $100, however, and the

taxable income was zero, the investor would be better off by at least $30. Consequently, the most desirable debt to equity structure would be the one that would produce zero taxable income. Since interest expense, and possibly depreciation, are decreasing each year, however, this would occur only at a single point in time. The investor's strategy, then, would be to determine the optimum division of the expected holding period between tax loss and taxable income years. This could be done by figuring the total income using different combinations of income and loss years. The result would, at best, be an approximation, however, because of the necessity of estimating the holding period and the investor's future tax position.

As mentioned earlier, the investor's objectives would be best satisfied by following a policy of exchanging rather than selling property whenever possible. Should he decide to reduce his total investment, however, certain tax advantages may be available to the investor.

If there is any gain on the sale of residential income property, all depreciation of personal property[18] and any excess depreciation on real property above straight-line[19] is subject to "recapture." This means that any gain up to such amounts is taxed as ordinary income. Any gain above the amount recaptured, however, would be eligible for capital gain treatment provided the property was held longer than six months. This provision of the tax law sets a maximum tax of 25 percent on the first $50,000 of such gain, and a maximum of one-half of the individual's effective tax rate on any amount above $50,000.[20]

In addition, there is a provision in the tax law which allows profit to be recognized over a period of years. It is called the installment sales method, and allows the recognition of profit in the same proportion as payments are received. To be eligible for the installment method, payments in the year of sale cannot exceed 30 percent of the selling price.[21] Consequently, an investor in residential property, upon deciding to liquidate part or all of his interest, may elect to use the installment method and report the capital gain, if appropriate, over a period of years.

ENDNOTES

[1]George Mair, Guide to Successful Real Estate Investing, Buying, Financing, and Leasing (Prentice-Hall, 1971), p. 25.

[2]Don G. Campbell, The Handbook of Real Estate Investment (Bobbs-Merrill, 1968), p. 18.

[3]Mair, pp. 26-7.

[4]George Bockl, How Real Estate Fortunes Are Made (Prentice-Hall, 1972), pp. 170-1.

[5]Campbell, p. 14.

[6]Maury Seldin and Richard H. Swesnik, Real Estate Investment Strategy (Wiley-Interscience, 1970), p. 17.

[7]Mair, p. 44.

[8]Ibid., pp. 44-54.

[9]Richard U. Ratcliff, "Appraisal Is Market Analysis," Appraisal Journal 43 (October 1975):488.

[10]Mair, p. 55.

[11]Robert W. Kent, How to Get Rich in Real Estate (Prentice-Hall, 1961), pp. 74-5.

[12]Ibid., pp. 86-7.

[13]Campbell, p. 8.

[14]Clarence F. McCarthy, The Federal Income Tax Its Sources and Applications, 3d ed., (Prentice-Hall 1974), p. 260.

[15]Charles E. Edwards and Jack S. Goodwin, "An Evaluation of Tax Shields from Declining Balance Depreciation at 1.25 Times the Straight Line Rate," Appraisal Journal 43 (October 1975):542.

[16]Seldin and Swesnik, pp. 104-5.

[17]McCarthy, p. 418.

[18]Ibid., p. 488.

[19]Ibid., p. 493.

[20]Ibid., p. 459.

[21]Ibid., p. 591.

CHAPTER FOUR

CONCLUSION

The reason for the popularity of real estate as an investment becomes evident rather quickly. Basically, it is a low-risk, high-yield investment.

Some would undoubtedly disagree with the statement that real estate is a low-risk investment, citing, for example, the situation in the REIT industry. Any investment can entail more risk than necessary when money is spent foolishly, however, which was the case in much of the REIT industry. It would not, therefore, be appropriate to consider such investments as being typical of the risk involved in real estate investment.

One can intuitively assess the risk involved by comparison with the stock market. Anyone familiar with investments in the stock market would probably agree that losses are not an uncommon occurrence. Consider the typical investor in an apartment building, however. He will normally be much more confident about his expected results than if he were to invest the same amount in the stock market.

This whole idea of relatively low risk relates back to the discussion of the increasing demand for real estate. In recent years, the demand for improved real estate, in total, seems to have continually exceeded the supply. In certain instances

where overbuilding did occur, it was often only a short time until demand increased sufficiently to meet the supply.

The statement that real estate is a high-yield investment, on the other hand, would probably find general agreement. It is not uncommon to find REITs yielding 10-15 percent, or investments in residential income property yielding 15-20 percent, when the investments are properly managed. The importance of good management in any investment is well recognized. As one author speaking about REITs has stated: "In the situation as it has actually developed, the quality of management comes to the front as the most desirable factor--and the quality of management is something that can only develop--and be confirmed--over the longer term."[1]

The discussion of the two methods of investment, investment in a Real Estate Investment Trust and direct investment in residential income property, will be summarized by comparing them in terms of their advantages and disadvantages. The objective is not to show that one method is better than the other, but rather, to point out the differences between them from the standpoint of the individual investor.

One of the advantages to a REIT investment is that the investor is not faced with the problem of managing the property. As mentioned earlier, many investors consider management problems the major drawback to direct investment. The average REIT investor will normally have no contact with the customers of the REIT. Hence, he need only concern himself with the return he is receiving on his investment.

Another important advantage of the REIT investment is

its liquidity. Their shares are traded on the local and national stock exchanges just like stock of ordinary corporations. Hence, a ready market is available and investments can be bought and sold on very short notice. The existence of a market with an established price also helps the investor by giving him a constant appraisal of the value of his investment. As discussed earlier, however, the value of the investment is much less certain for the direct investor.

The other major advantage to REIT investment is the availability of reliable statistical information. Earnings records and other similar information are normally available in the same manner as with ordinary corporations. This information is usually helpful to the investor in assessing the ability of the trust's management.

The main disadvantage to investing in a REIT is the risk that management may not perform up to expectations. The usefulness of statistical information in assessing management's ability was mentioned earlier. Such information is not a perfect indicator, however, since management's ideas as well as the personnel themselves are subject to change. This risk can be minimized by careful selection and continued assessment of the investment. Even though the risk may be relatively small, however, the amount of the possible loss may be very large.

Another disadvantage to REIT investment is the amount of capital needed. Leverage is available in the form of margin accounts, but one usually cannot borrow more than 50 percent of the current value of the investment. Consequently, a

50 percent or more equity would normally be needed and many financial people recommend that an investor never use a margin account because of the possibility, mentioned above, of a very large loss.

A third disadvantage to REIT investment is a loss of a portion of the tax shelter available through direct investment. Since all expenses, including depreciation, are those of the trust, any amounts received by the investor are taxable income to him. The investor does have the ability, however, to treat capital gain income from the trust as such on his personal return, regardless of how long he has held his shares.[2]

The following list summarizes the major points to consider before investing in a REIT:

Advantages:
--Absence of management problems
--Liquidity
--Availability of statistical information

Disadvantages:
--Risk of loss due to poor management
--Limited use of leverage
--Limited tax shelter

In the direct investment area, the tax shelter benefit must be considered one of the main advantages. There are very few times when one can receive cash which he does not have to pay tax on. But the investor in residential income property has this situation as long as depreciation expense exceeds principal payments on the mortgage. It was also explained earlier how the investor can increase his earnings by deferring taxes, which makes the amount deferred available for investment. The time value of money to the investor, in this case, is the rate of return on his additional investment. When these factors are

combined, the economic advantage to the investor can become substantial.

Another important advantage to direct investment is that its value in relation to other goods and services is not lost because of inflation. When prices in general rise, all real estate becomes more valuable. In fact, it is quite likely that the increase in real estate values will exceed the rate of inflation in the long run. As real estate becomes more scarce, increased demand will cause its price to increase relative to other goods and services.

A third advantage to direct investment is the ability to be highly leveraged. Because of the low risk of this type of investment, the investor is often able to obtain financing for 90 percent or more of the purchase price. The investor's rate of return can become astronomical when computed on the basis of the small amount of equity he may have in the property.

The disadvantages to direct investment are the same as the advantages to REIT investment. As mentioned before, the main disadvantage to direct investment is the problem of managing it. The problems can be substantially mitigated, however, by establishing firm policies and following them. It should be kept in mind that the investor need not handle every problem himself, but rather, he must be willing to accept responsibility for them. It is possible, and in fact, often necessary, for the investor to delegate much of the responsibility for day-to-day management.

A second disadvantage to direct investment is its lack of liquidity. If the investor wishes to dispose of an investment,

it may often take many months to accomplish. It should be kept in mind, however, that if the investor's only reason for selling was because of a need for cash, refinancing may be a possible solution.

A third disadvantage to direct investment is the lack of statistical information available to the investor. Reliable earnings records are available for REITs from their inception. The records available to a direct investor, however, may not be accurate because needed expenses have been postponed or not all expenses have been recorded. The difficulty of appraising the value of an investment in residential income property was discussed at length earlier. The investor's best ally in overcoming these problems is his own experience.

The following list summarizes the major points the direct investor should consider before making his investment:

Advantages:
- --Tax shelter
- --Hedge against inflation
- --High leverage possible

Disadvantages:
- --Responsibility for management
- --Lack of liquidity
- --Lack of statistical information

One of the biggest factors in determining what type of investment is most appropriate for an individual is that person's personality. For instance, the most common objection to owning residential property is the problem of managing it. One must stand ready to accept unexpected repair bills, questionable tenant complaints, and a host of similar items. If one feels uneasy about such things, then a better alternative would be a

more passive form of investment such as the Real Estate Investment Trust. This would mean giving up some compensation, but this loss would not begin to compare with the return of the investor's peace of mind.

On the other hand, if the investor can accept management problems as merely a part of doing business, then direct investment is usually the more profitable approach.

As stated in the introduction, the purpose of this study was not to determine which of the two methods of investment is more desirable. This will depend on the individual's objectives, and, on his personality as an investor. The most appropriate method will be the one whose characteristics best satisfy the investor's requirements in these two areas.

ENDNOTES

[1]Harold S. Taylor, "The REITs Are Sorting Themselves Out," Real Estate Review 4 (Spring 1974):103.

[2]Federal Tax Course (Prentice-Hall, 1975), p. 1705.

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