JOHN T. REED'S
Real Estate Investor's Monthly

Volume 21, Number 12 January 2007

The nature of expertise

I am an expert on expertise. I have written over 4,000 nationally published how-to articles and 64 nationally-published how-to books including a book on how to write how-to books. The purpose of this newsletter is to impart expertise to readers.

Coach

I've also coached 35 athletic teams, which is a how-to exercise where you can see the progress or lack thereof as well as get tested by competition once or twice a week during the season.

Yet I sense in the questions and emails I get daily that few people understand the fundamental nature of the expertise they seek, including its limits.

Best practices

In the business world, they lately have adopted the phrase "best practices" to mean business expertise. It's a good phrase that describes lessons that have been learned by businesspeople with regard to **what works**.

Scientific method

In the scientific world, they call it the results of the application of the scientific method. There is a good article about what that is and what it is not at http://www.freeinquiry.com/intro-to-sci.html.

My recollection of the scientific method from junior high school is that it consists of five steps:

1. State the question.
2. Research everything that has been written about what the answer is.
3. Posit a hypothesis as to the answer.
4. Test your hypothesis.
5. Draw a conclusion based on the results of the experimental results.

The problem is the vast majority of people just do steps 1 and 3 before jumping to 5: drawing a conclusion. Their logic seems to be, "I'm so smart that my theory **must** be correct, so I don't **need** to test whether it is."

Learning

The venerable **Bloom's Taxonomy** enumerated the different forms of learning:

1. Knowledge—memorization of words, facts, and concepts
2. Comprehension—understanding and articulating your learning
3. Application—ability to use learning to solve a new problem
4. Analysis—ability to break down into parts and understand connections
5. Synthesis—transmutation of old info into valid new applications
6. Evaluation—ability to judge new ideas based on past learning

Trying to memorize

Most investors in my experience are struggling with form Number 1: Knowledge. That is, they are trying to **memorize** real estate investment. I did the same when I first started. Real estate seemed an overwhelming mass of details and definitions to be memorized.

One of my West Point classmates and company mates was very smart and tutored a bunch of my other company mates in our academics there. He was famous for admonishing his tutorees, "Don't spec it! Understand it." "Spec" is a cadet slang word for memorize.

In fact, you have **inadequate understanding** if you **memorize** real estate or any other field.

Basic principles

Now, I see real estate investment, football coaching, and the various other things in which I am an expert as a **series of basic principles**. All the seeming myriad details are just variations on a few simple principles.

For example, in my book *Fundamentals of Real Estate Finance*, I said that all real estate finance techniques are just different recipes using the same few ingredients. All lenders want to know three things:

- **How much** money will you pay me?
- **When** will you pay me that money?
- How **sure** is it that you will pay me?

(Continued on page 2010)

Inside:

2012 The emotional cycle of real estate
2014 The other side of tax liens: cheap money
2014 Whitney news
2014 Risks of 'exotic' mortgages
2014 Apartment vacancies rising due to condo failures
2015 Tenant meth lab damage not covered by owner's insurance
2015 Investors chasing appreciation that they themselves caused
2016 More developments

John T. Reed's Real Estate Investor's Monthly (ISSN: 0887-1922) Published by John T. Reed, 342 Bryan Drive, Alamo, CA 94507 FAX, 925-820-1259. Web site: www.johntreed.com/realestate.html, 925-820-7262, E-mail: johnreed@johntreed.com $125/year. Copyright 2007 John T. Reed. All rights reserved.

Three Cs and payment patterns

The latter question is generally defined by what lenders call the Three Cs: character, capacity and collateral. The "how-much" and "when" questions are simply about **payment patterns** which are almost infinite in number as long as the lender ultimately gets back their principal and interest.

Similarly, I have written six books about football coaching. There, everything stems from two principles: the principle of **offense** is strength against **weakness** and the principle of **defense** is strength against **strength**.

Input X = Output Y

I define expertise very broadly as simply knowing specific inputs that produce certain outputs. That is, if you do X, Y will happen. For example, if you plant corn seed, corn plants will grow. That is expertise.

On the other hand, saying that if you buy real estate it will go up in value and you will make money is **not** expertise. It **is** something that sometimes happens, but sometimes doesn't.

Whether it will happen in a given case depends on various factors **beyond your control or ability to forecast**. The fact that some say this result will occur, followed by its actually occurring, proves nothing. To believe otherwise is to fall prey to the *post hoc ergo propter hoc* (after which therefore because of which) logic fallacy.

Probability

Action X producing result Y rarely occurs 100% of the time. Expertise like knowing that raising the temperature of water to 212º F at sea level causes it to boil and turn to steam is an example of a 100% correlation bit of expertise. (correlation coefficient of -1 or +1 in technical terms)

Gambling

Gambling operations are at the other end of the probability spectrum. There, a mere 53% or so correlation produces a profit. In theory, a 50.1% would be enough, but it has to be about 53% to cover the overhead and such.

Minimum success probabilities required for different situations

So each type of expertise has a minimum probability required before the expertise in question is profitable. For example, a **plastic surgeon** must have a **much higher correlation** between his or her actions and the result than a **general surgeon** operating on **emergency-room** patients.

Since plastic surgery is to correct **cosmetic**, not **health**, problems, there must be a **high probability of success** in order for the patient to go ahead. On the other hand, in an emergency room, where the patient is in imminent danger of dying or suffering other severe consequences, there need only be a probability of good health that is greater than the probability of good health if the surgery is **not** performed to warrant proceeding.

Risk preference

That is sometimes characterized as a "risk preference" or "marginal utility" matter.

Risk preference says that we have preferences for certain risks over others such that we are **not consistently logical**. For example, virtually everyone would take a **one-dollar bet** that a roll of a die (singular of dice) would show a number higher than two because there is a probability of 4/6 or 67% that it would.

But few people would take that **same** bet if the amount wagered were **their entire net worth**—even though the probability is still the same. *Star Trek's* Spock would dismiss the latter decision as "illogical." The bettor would protest that he would not mind losing one dollar, but would very much mind losing his net worth.

Marginal Utility

Marginal utility relates to a similar place on the effect-on-your-life spectrum, but comes at it from the other direction.

In the current movie *Pursuit of Happyness* [sic], which is excellent and based on a true story, the hero managed to go from homeless to living in a hotel room when he sold a single $250 medical device. Later in his life, he became a millionaire. No doubt his acquiring, as a millionaire, an additional $250 would have virtually no effect on his life. That's because the more money you have, the less useful additional amounts are.

Minimum probability needed is a function of the stakes

Accordingly, the minimum **probability** of an effect resulting from a cause would have to be quite high in the case when the **stakes** are quite high like betting your entire net worth. On the other hand, the probability of success when the stakes are just $250 for a millionaire could be down around 51% and the bettor would probably take the bet.

Varies by situation

So what constitutes valid expertise in some situations and for some people would **not** constitute valid expertise in another situation for another person. To claim that you have valid expertise, your success rate at causing desired effects must be high enough that a similarly situated, reasonable person, as opposed to a thrill seeker, would be willing to proceed with the gamble based on your recommendations as to how to proceed.

Lots of iterations

All reasonable persons should be willing to take the gamble when the **number** of iterations is **high** and the **stakes per iteration** are **low**.

For example, you would **not** be willing to bet your life savings that a die would show a number greater than two if the die were only to be rolled **once**, but if the bet were on whether it would show greater than two **on average** in **1,000 rolls**, you **should** take the bet.

That means you can make money with a much lower level of expertise, approaching the 51% to 53% success rate level on **even** bets, if the activity in which you engage has a high number of iterations, each of which entails only

(Continued on page 2011)

a low-stakes bet.

Asymmetrical

Sometimes the amount that you win or lose is **not** an **even bet**. Rather, it's **asymmetrical**. The example I often cite is investing in real estate indirectly by buying **judgments** against persons who own real estate in your area. There is a chapter about that in Volume 2 of my book *How to Buy Real Estate for at Least 20% Below Market Value*.

In that approach, you buy small claims court judgments for about $400 to $500 each. If you buy the **right** one, you make about **ten times your cost in profit**. If you buy the **wrong** one, you **lose all of your investment**. The actual investor I wrote about said he was able to buy about one per day once he got going.

Wrong 9 of 10 times

With those numbers, you can buy the wrong one nine times and the right one once and still come out ahead. Since you do it 250 times a year with low-stakes bets, you can be confident that the **average** results will be stable, predictable, and profitable.

Arthur Conan Doyle's fictional Sherlock Holmes once said, "As an individual, man is an unsolvable puzzle, but in the aggregate, he is entirely predictable." That is, you can**not** predict the outcome of **one** roll of the dice or the lifespan of a single person, but you **can** predict the outcome of a **million** rolls of the dice or the average date of death of a million people.

Now contrast that with the behavior of the typical real estate investor. He makes very few, relatively high-stakes bets on outcomes in which he cannot possibly have much expertise.

Expertise varies

The public tends to behave as if pertinent expertise were always available. The medical profession is a good place to show otherwise. The expertise to set a fractured bone is quite readily available and success rates are quite high.

But the expertise to cure metastasized cancer is quite low. It matters not how much you study or practice at this time. No one can, at present, achieve a satisfactory level of expertise in curing metastasized cancer.

Screening? yes

Similarly, in real estate investment, you can relatively easily achieve a satisfactory level of success at screening prospective tenants. See my book *How to Manage Residential Property for Maximum Cash Flow and Resale Value*. But you can**not** achieve any level of expertise whatsoever at predicting or controlling **interest rates**.

Conclusion: it's OK to put yourself in a position where forecasting tenant success rates affects your income, but **not** where forecasting mortgage interest rates does. To put it another rough way, it's OK to be a landlord if you have a 30-year, fixed-rate mortgage. Actually, there are more variables than that, but if there were only those two, the statement would be correct.

Talent expertise

Not all expertise is acquired. Much is **congenital**. In other words, many people can possess a level of expertise in a particular area that others have no hope of acquiring no matter how hard they try. Running speed is an example. You can improve at the margins with diet, exercise, and technique, but fast runners are born that way. And so are slow ones.

You must take care to avoid going into a field or an approach to real estate where you lack the **talent** expertise required to compete and succeed. People skills, negotiating, and so forth are talents that are very important in some aspects of real estate.

For example, to be a pre-foreclosure investor, you need great people skills to negotiate a favorable deal with the person being foreclosed upon, but you need **zero** people skills to buy the same property **at the foreclosure auction**.

Subtle expertise

Some expertise is super subtle, so much so that most people would **never** recognize its existence. For example, great generals have an ability to recognize that men die in battle and to make the necessary cold calculations to expend some lives to save others. That particular expertise may make the general in question a near useless human being in most other contexts.

Many real estate approaches require high toleration of **rejection**, a characteristic of successful salesmen. Again, you may not want to hang around with such people. You may even cross the street when you see one coming, but you should want to **hire** them for your sales force and, if you are one, it is a type of expertise you can capitalize on by pursuing certain real estate investment approaches.

Zen

The most subtle form of expertise of all is zen. The classic admonition in zen activities is, "Don't **make** it happen. **Let** it happen."

My book on baseball coaching talks much about the zen which governs pitching, throwing, hitting, and fielding grounders in the infield.

In most areas of life, the harder you try, the more you succeed, but in the zen areas, **trying too hard** results in **failure**. Sales and relations with the opposite sex are other examples of somewhat zen activities.

In real estate, it would pertain to negotiations. It also pertains to renovations and other problem solving.

Once, when I was in junior high school, I became so frustrated trying to solve an algebra problem that I was crying. I finally gave up and went to bed.

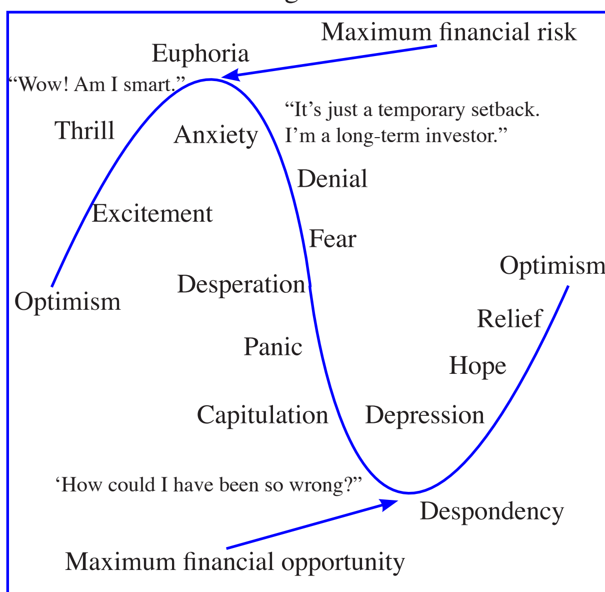
The next morning, while eating breakfast, I saw the text book open and was reminded of the problem which I instantly and easily solved just by glancing at it. Zen.

You are right to seek expertise pertinent to succeeding in real estate investment, but remember that there is no expertise to be had with regard to many important variables. Remember also that expertise is knowing the correlations between certain causes and effects and knowing how high that correlation has to be to produce a profit in given circumstances. Finally, some expertise is real and important to success, but it's subtle and congenital, and not acquirable. JTR

The emotional cycle of real estate

A reader sent me a link to an annotated description of the real estate cycle, saying it buttressed my cover story last month called, "Red lights." I searched in vain for attribution or a copyright notice. So someone created this and may own the rights to it, but who it is is unknown to me. I would be glad to give them credit if I could. Nevertheless, it is interesting and I will use it to teach readers better understanding of real estate ownership.

In one respect, I think this diagram is brilliant. In another, I think it manifests human folly and misunderstanding.



Emotions

The brilliant part is the emotions it depicts including the statements of the owner at each stage of the cycle. Generally, this graph would also apply to the stock market as much as to real estate.

People tend to think real estate values are **stable** while the stock market is **unstable**. Nah. They're both the same.

There is just an **illusion** of price stability in real estate because it takes so long to get an appraisal. The slowness of appraisers is **not** price stability. It is merely **ignorance** of the underlying fluctuations.

Stocks

In the stock market, in contrast, the same underlying fluctuations are there, but always visible because of the various mechanisms for keeping up-to-the-second track of sales and the lack of need to decide which sales are "comparable."

Brokers, too

The graph depicts the emotions of investors. But it also reflects—perhaps more so—the emotions of brokers, both stock and real estate.

The first upswing portion of the curve depicts what Wall Street calls a **bull market**. The quote, "Wow! Am I smart," is another version of the old saying that, "In a bull market, everybody thinks he's a genius."

I remember my first bull market in 1970. And I remember thinking how much smarter I was than my college classmates, most of whom had invested in the stock market. We graduated in 1968. According to the Web site http://www.fiendbear.com/bearenc1.htm, the period Dec. 3, 1968 to May. 26, 1970 was a bear market during which the Dow-Jones Industrial Average fell 36%.

Better to be lucky than smart

Did I make a lot of money on my first investment which I purchased in 1969? You bet. I sextupled my money. Or more accurately, my equity sextupled in spite of my total ignorance of how to predict of control the pertinent forces.

Just wanted some control

Did I **know** that the stock market was going to go down 36% when I bought my first duplex? Nope. I had no clue whatsoever about that. I was simply suspicious about an investment that I had **no** control at all over—the stock market—versus one that I had **some** control over: a duplex.

The nature of real estate investment

That brings up an issue that I think the vast majority of real estate investors misunderstand. Put simply, **real estate is not an investment**.

I know. The title of this newsletter and some of my books say it is. But I cannot put esoteric definitions, no matter how accurate, into as important a marketing feature as my titles.

Pure investments, like stocks, bonds, and commodities are **passive**. With those you only get to make three decisions:

- What to buy
  - When to buy it
  - When to sell it.

You have nothing whatsoever to say about the value of it during the time you own it. That is determined solely by the market.

Great control

At the other end of the spectrum are economic activities where you have **great** control over your income like the richest man in the world: Bill Gates.

He creates software which he copyrights so no one else can use it without paying him. He is not totally insulated from outside forces. He has to worry about things like competition, government regulation, piracy, and the successes of hardware manufacturers and designers who produce the machines that use his software.

Hybrid

Where is real estate on this spectrum? **In between** pure investments like stocks and bonds and pure businesses like software creation. Real estate is best described as a capital-intensive business.

The fact that you have some control and make many more decisions than just what to buy and when to buy and sell makes it like a business. But the fact that there is a lot of capital tied up in the property—either yours or a lender's, makes it partially an invest-

(Continued on page 2013)

ment that you have no ability to control or forecast.

Nautical analogy

Perhaps a nautical analogy makes the investment-business spectrum more clear.

Buying stocks, bond, or commodities is like going out in the ocean in a raft while wearing a blindfold. You cannot see the sun or stars. You have no paddle, oar, or sail. You are at the total mercy of the currents, wind, and tides. If you go any where, it will be where those forces happen to be going. You can neither predict nor control them.

Raft with a sail

Buying real estate is like going out in the ocean in a raft where you have a sail, a rudder, oars, and you can see the sun and stars. Can you go the direction you want regardless of where the currents, wind, and tides are going? Somewhat.

You have limited power to overcome the forces of nature. If you can see the sun and stars, you have limited power to choose a direction other than the one chosen for you by the natural forces.

But if the wind, current, and/or tide is too powerful, your sail, oars, and rudder are irrelevant. In a storm, you'd better pull your sail down before it gets ripped to shreds and your oars and rudders are of little use when they are out of the water half the time because of high waves.

Motor boat

Having your own **non**-capital-intesive business is like having a motorized boat. You have much power to go where you want, when you want regardless of the currents, wind, or tide, but not total power.

Many a great steamship or diesel-powered huge ship has been thrown off course or sunk by hurricanes, icebergs, or typhoons.

Advantages

The advantage of the raft is that it takes little effort to make or ride. The raft with a sail, rudder, and oars takes more effort and skill to make and to operate.

The motorized boat, of course, takes the most effort to make and the most skill to operate. But if you are trying to get somewhere, the motorized boat is the most reliable way to go.

Thrill seeking

In real life, raft riding is thrill seeking. In the stock market, you can moderate the thrills by buying broad-based index funds. In real life, there can be aesthetic satisfactions from sailing. There is some aesthetic pride of ownership in real estate, but the analogy breaks down otherwise.

Anyway, you get the idea. Investments are forms of economic activity where you give up most of the sort of control that you have in your own business.

Intelligence and diligence

As I have often said, control gives you an opportunity to use your intelligence and diligence to make money. Lack of control renders your intelligence and diligence irrelevant.

Accordingly, to me, passive investments are merely places to park money that you do not currently need for your business or to avoid the risks of business and simply preserve the money. Again, you have to use extremely broad-based index funds to avoid picking the wrong stocks or bonds.

Peaks and valleys

Back to the diagram. The author labels the high point as the "Point of Maximum Financial Risk" and the bottom of the valley as the "Point of Maximum Financial Opportunity."

I disagree. Risk is the possibility of many different outcomes some of which are unwelcome. I do not know of any reason to believe the number of outcomes or adverse outcomes are greatest at the peak.

Hindsight-based graph

When the graph was drawn, the author had the benefit of hindsight and knew that the peak was the peak. But when you are living it, you cannot tell if you are part way up the peak, most of the way up the peak or at the peak.

Maximum irrational exuberance

What that peak really is is the point at which the **market value** of the asset in question reached its maximum **ratio to the net income** of the asset in question—what the stock market calls a price-earnings ratio and the inverse of what the real estate market calls a cap rate. Put crudely, the peak is really the point of **maximum irrational exuberance** of the mob of persons interested in buying real estate.

Minimum popularity

Similarly, the bottom of the valley is **not** the "Point of Maximum Financial Opportunity" if you are not prescient. Rather, it is the point at which the mob is most down on real estate and the point at which the ratios are most favorable in terms of return on investment. That is, the cash-on-cash return from net rental income on a free-and-clear purchase will be highest.

Whether that return will be **adequate** is another question. It may **not** be. The mob's optimism about appreciation has created a **perennial** willingness to buoy real estate values above any value that can be attributed to the property's income alone is legendary. Although this optimism waxes and wanes, it never seems to go away so completely that "income property" is valued strictly by its income, as it was intended to be and was before about 1970.

Emotions

The emotions depicted by the words on the graph are quite accurate representations of how the ignorant and inexperienced feel when their property values are at the point depicted by the cycle curve. The emotion at all points **should** be, "*C'est la vie* in real estate." Like a veteran sea captain, your emotion should be, "steady as she goes." Take the appropriate actions. And recognize that the emotions were largely based on the erroneous notion that you were in control. You are not. JTR

The other side of tax liens: cheap money

Tax liens are supposedly a hot investment now. I always thought it was a tiny niche that became overrun with too many investors.

One reader tells me he now uses those idiot investors as a source of cheap money. He simply does not pay his property taxes, thereby letting the government sell a tax lien certificate on his property. Then, years later, but before the deadline, he pays it off. The first one had a yield to the investor, and a cost to the property owner-borrower, of 5.75%. The more recent one was 2.00%.

The investors, hopped up on TV infomercial B.S., thought they were going to get the **property**—real cheap. Nope. Just the shaft.

Some caveats. It is possible that not paying your property taxes on time may adversely affect your **credit**, thereby raising the interest rates you pay on **every** loan you get or may trigger a **clause** in your credit-card agreement that lets the lender **jack your interest rate** on credit-card balances way up. Also, not paying your property taxes on time may not be an option if your **mortgage lender** requires you to pay 1/12 of the property taxes to them monthly or if the lender lets you pay them on your own, but lists failure to do so in a timely manner as a **default** on the mortgage. Typically, the mortgage lender would be immediately notified if you were late paying the taxes. JTR

Whitney news

Real estate guru Russ Whitney sued me in 2002. The suit was settled in 2005 as I previously reported here. His publicly-traded Whitney Information Network, Inc. recently issued several news releases that might be of interest to readers who followed his suit against me.

Whitney Information Network, Inc. Receives Notice of SEC Investigation

Nov. 21, 2006--Whitney Information Network, Inc. … announced today that on the evening of November 14, 2006, it had been notified by the Securities and Exchange Commission that the Commission was conducting a non-public investigation to determine whether the Company has violated any securities laws in connection with (i) the efficacy or trading success of the Company's stock market education programs, and, (ii) the Company's acquisition of certain other companies. The Company intends to provide the Commission with any requested information.

Whitney Information Network, Inc. Receives Grand Jury Subpoena

Dec 15, 2006 Whitney Information Network, Inc. … announced today that the United States Attorney for the Eastern District of Virginia has notified the Company that it has commenced a grand jury investigation into certain of the Company's marketing activities. The Company received a subpoena on December 11, 2006 in connection with this investigation requesting documents and information from January 1, 2002 to the present relating to its marketing activities. The Company intends to cooperate fully with this investigation.

Separately, the Company also announced today that it intends to withdraw its EduTrades, Inc. registration statement filed with the Securities and Exchange Commission.

Whitney Information Network, Inc. Announces Departure of Officers

Dec. 19, 2006--Whitney Information Network, Inc. … announced today the termination of employment of Nicholas S. Maturo, President and Chief Operating Officer and Rance Masheck, Vice President, Sales and Marketing of EduTrades, Inc. (a subsidiary of the Company).

Risks of 'exotic' mortgages

The National Association of Realtors® has issued a news release expressing concern over the rising rates of default and foreclosure resulting from home buyers not understanding the risks of "exotic" mortgage.

Talk about closing the door after the horse has gone! I do not recall their complaining about "exotic" mortgages during the boom. I did a Google search to see if I could find any use of that phrase associated with the Realtors® prior to 2005. I did not find any in the first couple of Google result pages. If they did protest against "exotic" mortgages during the boom, I stand corrected.

Of course, there **is** something they can do now if they want: return to the people being foreclosed the commissions they earned from deals done with "exotic" mortgages. Or show us the waiver forms they got their buyers to sign attesting that the agents informed them of the risks of such mortgages at the time of the purchase.

Until the Realtors® do either, their recent "concern" rings hollow. JTR

Apartment vacancies rising due to condo failures

New condos that failed to sell are being converted into rental apartments which, in turn, raised the apartment vacancy rate in the fourth quarter of 2006. On the other hand, people fleeing from the much more expensive and no-longer-attractively-appreciating, for-sale home market has also been driving apartment rents up.

If the market were as fluid as it should be, home prices would have dropped more to prevent would be home buyers from fleeing and vacancy rates would remain about the same. But that's the old rational-man theory of economics. The more recent, more realistic **behavioral** economics theory

(Continued on page 2015)

would note that owners of real estate are crybabies and deny reality with regard to falling prices and therefore refuse to cut them as fast as the market warrants. Also, prospective home buyers were part of a mob psychology that changed directions when prices of homes stopped appreciating. •

Tenant meth lab damage not covered by owner's insurance

Tualatin Valley Housing Partners rented to a couple who manufactured methamphetamine in their apartment. The process caused considerable damage to the apartment. The landlord filed a claim with his insurance company: Truck Insurance Exchange. They refused to pay the claim on the grounds that the policy **excluded damage caused by the criminal acts** of anyone with an interest in the property, including but not limited to, owners and tenants.

An Oregon court said that a leasehold interest comes within the exclusion clause therefore the insurance company was in the right not to pay the claim. [*Case #A126232, 2006 Ore. App. LEXIS 1464 (Ore. App. 9/27/06)*]

So now you have another reason not to rent to drug dealers and to get rid of them ASAP if you accidentally rent to one or find them in a building you buy. JTR

Investors chasing appreciation that they themselves caused

Like a dog chasing its tail faster and faster, real estate investors often chase appreciation caused by the collective effect of their own chasing.

I wrote about **cap rate compression** in a past article. That is appreciation caused by investors' willingness to accept lower and lower cap rates. Why are they willing to accept lower and lower cap rates? Because the properties are appreciating so fast who needs cash flow, of course. If this sounds a bit circular, you understand it perfectly, which puts you in a distinct minority.

The 1/8/07 *Wall Street Journal* told this story about Naples, FL. They probably could have written a similar article about every "hot" market of 2004-5—although Naples **was** named "the most overvalued" housing market in the U.S. by National City Corp.

In 2005, investors in the Naples area were extremely eager to buy as many properties as possible because the prices were appreciating so fast—it turns out, in part because the investors were buying so many of them.

Home prices there fell from near $500,000 in 2005 to near $400,000 in 2006. The lotteries to see who would be allowed to buy new homes are no longer held. Having pumped the market, investors there are now endeavoring to dump it. Pump and dump is a crime when you inflict it on **others**. No arrests are expected in Naples, however, because pump and dump's not a crime when you do it to **yourself**.

Part of the problem in Naples is the age-old failure to recognize the difference between quality and value. Naples is reportedly very nice and attractive. Fine. We have that same situation here in California.

But the fact that a given real estate market is relatively more attractive with regard to climate, etc. does **not** mean that it cannot be **overpriced**. Everything everywhere can be overpriced. Naples and California are nicer than, say, Detroit. But that does **not** mean the incremental niceness can support an **infinite** price premium over Detroit. The incremental niceness is **finite** and the incremental price premium must be as well.

The *WSJ* tells of a particular investor who tried to auction off 28 of her properties in Naples. Some bids were 40% below what she paid for the homes. The woman in question now says you can't look at just one year. You have to be a long-term investor. Yeah. We heard that line in the article on page 2012 of this issue.

That woman also insists she never overpaid citing the fact that she had appraisals on each property Ha! Like that matters. Appraisers who did not "support" the loan application values would get no more assignments—as always in that business. Appraisers exist because lenders need external CYA paperwork. Investors are generally a different kind of person and regard appraisers as an annoying expense. I do not recall ever previously hearing an investor blame appraisers for the investor's overpaying or citing appraisers as proof that they did not overpay.

The "long-term investor" who insists she never overpaid has had notices of foreclosure filed by lenders on two of her houses. She says she is not in financial difficulty—which reminds me of another word on that diagram on page 2012 of this issue: "denial."

It must be noted that the investors had some help making this mess. Lenders lowered their standards going "sub-prime" and "exotic." Realtors® hired new agents to push, among other things, the "exotic" mortgages about which they now express "concern." Some builders went back to their old habits of building whenever they could get a construction loan regardless of the market need.

The *Journal* quotes Naples agents as saying that as many as 50% of buyers there were investors in 2004 and 2005. The Realtors® association put out a news release around then saying that **28%** were nationwide—abnormally high.

They quote one investor as saying it's all about **timing**. No, it's not. Timing is useless as a strategy and dangerous for its seductive lure. It's impossible to tell when the right time is. Timing is only useful as a Monday-morning-quarterback academic discussion.

The investor that the *Journal* holds up as the shrewd alternative to the woman who is having trouble selling bought one of the troubled woman's houses at her auction for $275,000, which is especially interesting when you

(Continued on page 2016)

consider that he sold that same house to her previously for $435,000. JTR

50%

One of the common ways tapped-out young real estate investors do deals is to get equity money from friends or relatives. Often, they promise the investor 50% of the profits. Let's think about this from both the money-raising investor and the money-providing investor.

At Harvard Business School, one of the lessons we learned was that one's cost of capital was an indication of one's competence as a businessperson.

More recently, I read a number of books about securities markets and one made a similar point about a **nation's** cost of capital. The most successful, stable nations throughout history going back to the Roman Empire have paid the lowest interest rates to persons who bought their bonds. It is still true today with nations like the U.S. and Great Britain paying the lowest interest rates on their federal bonds.

Loan sharks charge extremely high interest rates and everyone knows why that and other reasons make borrowing from them is a bad idea. Don't loan shark yourself.

To put it briefly, if you are paying 50% interest or 50% of your profits to your silent partners, you are an incompetent businessman. Some successful investors would protest that was how they got their start. I don't doubt it. I know some of them. But it was still a dumb move and the investors in question are lucky such terms did not blow up in their face and ruin their reputations before they got started.

Similarly, the person putting up the money to get the 50% interest or 50% of the profits needs to think about what they are doing. First, there is the too-good-to-be-true rule. Typically, they would protest that they know the investor in question—maybe they are related to him or her. They are absolutely certain the person is **trustworthy**.

First, someone once said, "You never know a person until you split an inheritance with them." Actually, it doesn't have to be an inheritance. The same statement would apply to splitting lottery winnings or big real estate profits or, perhaps most telling, business **losses**.

So no matter how long you have known someone, if you have not split an inheritance, big profits, or big losses with them, you are probably **not** in a position to evaluate their sincerity or character.

Plus, their character may be **irrelevant**. Suppose they sincerely believe the investment will be profitable, but they just **get it wrong**. They are too optimistic or incompetent or both. Since these deal terms are typical of **beginning investors** who cannot get financing from traditional sources, overoptimism or incompetence is **likely**.

Also, if for whatever reason you need to sue, how do you think it's going to sound to the judge or jury? "You were supposed to get **how much** return!?" A silent partner, who is typically older, wiser, wealthier, and more experienced than the beginner who failed to pay the 50% is going to look pretty bad trying to sue to extract 50% "blood" from tshat young, inexperienced, poor investor "stone."

The thought of the pertinent laws boggle my mind. Such a deal sounds like a **security** that is supposed to be registered and only sold by a **licensed securities broker**.

I expect a competent securities lawyer could structure the deal so as to avoid that—private placement and all that. But the beginning investors and their silent partners typically are blissfully unaware of such legal niceties. And the beginning investors would not have the money to pay such a lawyer anyway.

Then there are **usury** laws. If a 50% return rate were guaranteed, it would arguably be a loan and a 50% interest rate might be illegal as usury.

If the silent partner is part owner of the property either on the deed or an **equitable owner** (owner in substance and for most legal purposes in spite of not technically being not named on the deed). That has a zillion implications.

My book *Single-Family Lease Options* catalogues the many, scary ramifications of what seemed to be a lease being construed as an equitable mortgage by a court. Just as a lease can sometimes be construed to actually be equitable mortgage for legal purposes, so can a purported "loan" be construed as equitable title.

For example, a **personal-injury suit** against the property and its owners could probably name as a defendant the silent partner who was in line to get 50% of the profits.

The key question in law is who gets the "benefits and burdens of ownership," not whose name is on the deed. Appreciation is typically the biggest "benefit of ownership." If you get 50% of the appreciation, for example, you **are** the owner or one of them under the legal doctrine that is often explained as, "if it looks like a duck, talks like a duck, and walks like a duck, it **is** a duck, no matter what you call it."

Paper Source newsletter (www.papersourceonline.com) in its 1/07 cover story tells how well-known mobile home investment guru Lonnie Scruggs lost $500,000 by investing with disbarred attorney and well-known real estate speaker Troy Titus. One of the terms was silent partners like Scruggs supposedly got a 50% interest in the property in question—one of seven people who got that deal from the same property. JTR

New girl

My wife retired from the FDIC on December 31, 2006. After a lengthy vacation, she tells me she will be working **part-time** for John T. Reed Publishing. She's telling her friends that she will be my, "Gal Friday." I think that means she's only going to work Fridays.

One word of warning. Around our house, my sons and I refer to my wife as "The Queen," e.g., "The Queen is not amused." You may also call her, "Your Royal Highness."

Please do **not** do as a caller did back in 1989-90. Referring to a prior to call to my number he said, "I talked to your girl the other day."

That was no girl. That was my wife. JTR