Some real estate investment basics by John T. Reed

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I have long been astounded that anyone would pay for the sort of garbage put out by the many bad real estate gurus. I have been further astounded that they would be happy customers and get mad at me for pointing out the errors and omissions in that material. But then I actually had a dialogue with one Kiyosaki follower and was stunned at the man's profound ignorance of basic real-estate-investment principles. No wonder Kiyosaki and the others can sell this stuff. They target people so completely ignorant of the field that they can tell them practically anything and get away with it.

It reminds me of an event in George Plimpton's book *Paper Lion*. Plimpton asked the Detroit Lions to tell their players that he was an obscure quarterback from the Canadian Football League. He was, in fact, a writer planning to do a book on what it felt like to be a quarterback in the NFL. The players immediately saw that Plimpton was a lousy athlete and asked their coaches, "Who is this guy really?" Plimpton's roommate on the Lions then chewed Plimpton out for his grotesque lack of respect for the athletic ability and training of the NFL players. He said something to the effect of, "Are you nuts? Did you actually think you could pretend to be an NFL prospect and we would fall for it? Do you really think NFL football players are so similar to Joe Average that you could fool us? That's ridiculous!"

I and others in real estate have a similar feeling about the followers of Sheets and Kiyosaki and the rest. Do you think real-estate investment is so easy that you can spend a few hundred dollars on some TV infomercial crap and you're ready to invest in real estate or notes? Those of us who are pros in real estate investment spent years studying and more years working and investing in the field. It's like any other business. If you want to be an exterminator, you have to study pertinent chemistry and biology and law then take a test to prove that you know what you are doing. There is no test to be a real-estate investor because you are risking only your own money, but that doesn't mean it requires any less knowledge than is required for licensed occupations like beautician, real-estate agent, or embalmer. If anything, it requires **more** training.

Consultant Steve Roulac says real estate is a "multidisciplinary" field. By that he means you must master a number of academic disciplines to be competent in real estate, namely:

- the real estate law of your state
- federal income tax law
- property management
- real estate finance
- real estate leasing
- real estate sales
- real estate appraisal
- construction (in some strategies)

- securities law (in some strategies)

The typical TV infomercial sucker could not fill a thimble with his knowledge of **any** of these subjects, let alone **all** of them. Some novices try to dismiss these subjects with an "I can hire people who know that stuff." It doesn't work that way. In order to succeed, you have to have considerable expertise of your own. You may hire out **parts** of your chores, but you can only hire out a minority of the brainwork in any field. Furthermore, if you are a total ignoramus about, say, federal income tax law, you can**not** tell **whom** you should hire or **whether** the guy you did hire is **doing a good job**. Even when you hire out some aspects of your operation, you must still be generally knowledgeable about the subjects in question.

One of the things real estate investors need to understand is the **time value of money**. Here's a quick test. If you cannot answer these questions, do **not** invest in real estate or notes. Learn the basics, like the time value of money first, then you can get into real estate.

Quick time-value-of-money test
1. You are borrowing $130,000 at 7.75% annual interest using a 30-year self-amortizing note. What are your monthly payments?
2. You are taking over a mortgage where the monthly payments are $437.31, 231 payments remain, and the interest rate is 7%. What is the remaining balance of the mortgage?
3. Which is worth more, a note that pays $350 per month for ten years or a note that pays $300 per month for 13 years?

For a competent real estate investor, these are easy questions. He or she would simply reach for their Hewlett-Packard 12-C or similar financial calculator and tap in the numbers. It would take them about 20 seconds to answer each question. Until you can do likewise, stay out of real estate or note investing. You are a babe in the woods. One place to learn this stuff is my book How to Use Leverage to Maximize Your Real Estate Investment Return. It is also taught in the CCIM courses and in college business courses.

All potential investments should trigger three questions in the mind of the prospective investor.

- **How much** do I get?
- **When** do I get it?
- How **sure** am I of getting it?

You sometimes hear this referred to as the two dimensions of **risk** and **reward** . Reward has two aspects: the **amount** of money you receive and the **timing** of when you receive it.

An old joke in real estate is that that you can easily satisfy a seller whose property is overpriced by agreeing to **his** price, but insisting that **you** get to name the **terms**. The classic example of this is the guy

who wants a million dollars for his property. You agree to his price then set the terms at a dollar a year for a million years.

Even a Kiyosaki cult member ought to recognize that a dollar a year for a million years is not the same as a million dollars to be received right now.

State governments have long played on laymen's ignorance of the time value of money with their "million" dollar lotteries. Actually, if you win, you do not get a million dollars. You get $50,000 a year for 20 years. In Kiyosaki math, that's $50,000 x 20 = $1,000,000. But what happens if a millionaire lottery winner says to the state lottery commission, "Actually, I would like my million all at once?" The state will say, "No way!"

The reason is a million dollars to be received over twenty years is **not** worth a million to be received now. The twenty payments of $50,000 are worth substantially **less** than $1,000,000. Judge Wopner has been doing TV commercials for a company that buys such lottery winnings and gives the winner a lump sum. Why do they do that? The lump is far less than the sum of the remaining payments. The difference is called a discount and constitutes the profit or return of the company Wopner represents.

The reason money to be received **now** is worth **more** than the same amount of money to be received **later** stems from three factors:

- Inflation
- Risk
- Opportunity cost

I will assume even a Kiyosaki or Sheets cultist understands **inflation**.

Receiving money in the future is risky because **stuff happens**. Recessions, unemployment, bankruptcy, etc. The longer you have to wait, the greater the chances that something may occur to prevent you from getting the money you are owed.

Opportunity cost is the profit you lost on good investments you were unable to make because your money was tied up in the note or lottery contract or whatever. If you had received **all** the money in a lump **up front**, you could have invested in bonds or stocks or real estate and so forth. By not getting it up front, you lose out on those potential profits.

Now relate this to Kiyosaki's bragging about creating five notes for $190,000. It appears the notes are 10%, interest-only for 30 years and the buyer-borrowers put nothing down to buy the properties in question. Interest-only means the buyer-borrowers pay only the interest due each month for the first thirty years. Then they have a balloon payment of the entire principal balance due in one lump. In other words, Kiyosaki will receive $190,000 x 10% = $19,000 per year or $19,000 ÷ 12 = $1,583.33 per month. He will report that as interest income on his tax return. The buyer-borrowers will deduct the

entire payment as home-mortgage interest.

Normally, home mortgages are **self-amortizing,** which means part of each payment is principal (pays down the loan balance). The amount of principal in each payment goes up each month and the amount of interest goes down each month (because the loan balance is declining). The payments on a self-amortizing mortgage are such that the loan is paid off at the end of 30 years. The final payment is almost all principal and only a tiny bit of interest. With an interest-only set of notes, Kiyosaki would receive $1,583.33 per month for 360 months (30 years) then receive a balloon payment of $190,000 on the 30th anniversary of the notes' origination, if the borrowers do not default on the balloon payment, a common occurrence.

The key question is what are those notes worth on the day Kiyosaki creates them? The way you find that out is to try to sell them. As I stated in my analysis, real note buyers would typically pay only about $90,000 to $120,000. So Kiyosaki is bragging about creating $190,000 when he really only created $90,000 to $120,000---a little more than half what he claimed. One guy asked what difference it made what someone would pay for the notes if Kiyosaki has no plans to sell them. That's beside the point.

Childish investors frequently refuse to sell stocks or bonds that went down in value because they figure they haven't lost anything until they sell. That's silly. If you own a bond that you paid $100,000 for, and it drops in value to $80,000, you have just lost $20,000. It should be carried on your balance sheet (net-worth statement) at its **current market value**, **not** your **original cost**. If you told a prospective lender your bonds were worth $100,000 when you knew they had dropped in value to $80,000, you would be committing fraud. (Bonds drop in value because of an increase in market interest rates.)

When I was interviewed by Morely Safer on *60 Minutes,* he criticized a ploy by real estate guru Joe Land to take advantage of people who were ignorant of the time value of money. Safer said something to the effect that, "Land's technique requires convincing a note **seller** that the note is **not** worth what it says it's worth, then convincing a note **buyer** that it **is** worth what it says it's worth." (Land said to buy, at a discount, notes that sellers had previously taken back, then use those notes as down-payment money at their face value. For example, he might buy a $20,000 note for $12,000 cash, then use it to make a $20,000 down payment on a house by convincing the seller to accept the note as down payment at its face value of $20,000. In other words, Land is buying a note for $12,000 then trying to trade it for $20,000 worth of real estate equity. Nice work if you can get it---and if you can sleep at night after taking advantage of some elderly couple in that manner.)

Kiyosaki is trying to play a similar game when he tells you he made $190,000 with his notes. That is their **face** value, but it is far from their **real** value. By the time Kiyosaki gets his $190,000, in the year 2029, the median home could cost $420,000.

And what about risk? The main reason people default on their mortgage payments is lack of equity in the house in question. They figure, "Why should I pay Kiyosaki all this money when I could rent a place for less. If I had some equity, that would be one thing. But with no equity, what's the point?"

In fact, there is an **extremely high likelihood of default** when the borrower has put nothing down. And that risk rises if the mortgage is interest only because the buyer-borrowers can only build equity from increases in property value. I doubt these deals ever happened. But if they did, I would expect that four or five buyer-borrowers defaulted within two years. That is, they stopped making payments to Kiyosaki on the mortgages. In that case, Kiyosaki would have to foreclose to protect his interests. Foreclosure is an expensive and traumatic process.

Kiyosaki seems to be saying that the real estate he is selling to create the $190,000 of notes is worth $190,000. If so, it is colossally stupid to trade it for paper that is only worth $90,000 to $120,000. Kiyosaki apparently figures his readers are too ignorant of basic real-estate principles to understand that. Now that I have talked to some of them, I am afraid that he's right.

Good luck,

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