David Sirota, PhD,
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13th EDITION

ESSENTIALS OF REAL ESTATE INVESTMENT

Dearborn
Real Estate Education

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INTRODUCTION

Democracy as a political system, when coupled with capitalism as an economic system, is based on the private ownership of real and personal property and the right to vote on measures to protect property rights.

Our legal origins in England were feudal. Only the King or Queen could own real estate. Everyone else was a tenant, sub-tenant, sub-sub-tenant, and so on. That changed over time to allow private ownership, called fee simple absolute ownership. *Fee* comes from *fief*, which is a reference to the feudal system. Simple was added to indicate the owner could sell or will the property to anybody, as opposed to a fee tail, which said the property had to go to male heirs. Absolute meant no one could take it away, unless by foreclosure or similar means. A different kind of ownership, not absolute, might say that if owner stopped operating a farm, the land would go to somebody else.

In the United States, we call this system of fee simple absolute ownership the allodial system. The word comes from *alods*, who were people who owned land "through the grace of God" and not because someone else allowed them to use or own the land. Alods were typically kings and queens or similar.

The American system allows owners to build wealth in real estate, sell to whomever they want, or leave the property to whomever they want, without restrictions. As a result, owners may effectively translate their work efforts into tangible real and personal property assets, and thus, accumulate an estate to enjoy and control into the future.

The desire to accumulate a measurably valuable estate and generate a revenue stream is no doubt one major reason for the tremendous interest in the ownership of real property in this country. It appears that almost everyone gives high priority to the ownership of real estate—from the smallest condominium to the largest shopping center.

Real estate values steadily increase over time in the United States. Short term changes such as the dot-com boom in the late 1990s or the banking and real estate crash of 2008 might result in rapid and great wealth or losses. In reality, such fluctuations cause changes in real estate strategies, but never affect the core attraction and value of real estate investing. That is why values increase in the long term.

This 13th edition of *Essentials of Real Estate Investment* examines the current real estate market and describes the various opportunities for real estate investors. Real estate may provide a profitable alternative for an investor's portfolio, with much of the income sheltered by deductions for operational costs, interest expenses, and depreciation.

ACKNOWLEDGMENTS

David Sirota received his Ph.D. in Real Estate from the University of Arizona in 1971. He taught real estate subjects at many universities, including the University of Arizona in Tucson, Eastern Michigan University in Ypsilanti, National University in San Diego, and California State University in Fullerton, and at one time, headed the Department of Real Estate at the University of Nebraska in Omaha. Dr. Sirota has also written state licensing exam questions for the Arizona Department of Real Estate and ETS. He was involved as a consultant in the development of a congregate care center in Green Valley, Arizona, and acts in a consultant

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UNIT 1

Real Estate Investment Characteristics

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Describe the nature of the real estate market.

KEY TERMS

bundle of rights	highest and best use	real property
buyer's market	integration	relative scarcity
cycle	longevity	risk
demand	market segmentation	seller's market
disintegration	market value	supply
easy money	personal property	tight money
equilibrium	property	value in use
fixity	real estate	

INTRODUCTION

Property is anything that can be owned. **Real property**—also called **real estate**—is land and all natural and human-made improvements permanently attached to it. Real property also includes rights related to the land, such as minerals and air rights. All other property is **personal property**. When we acquire real estate, we also gain a **bundle of rights** in the property. These are the rights of use, possession, control, enjoyment, the right to exclude other people, plus the right to transfer the property either during one's life or after death. At times in history, people were not allowed to own all of these rights. Today, some of those rights can be sold separately to other people. An example is a lease, which is a temporary sale of the right of possession.

THE NATURE OF THE REAL ESTATE MARKET

Characteristics of real property investments

Each piece of real estate is unique and requires an individual investment analysis. However, all real property has certain common characteristics that affect its value. These characteristics include fixity, longevity, permanence, risk, and market segmentation.

Fixity

Real estate is fixed in location, which greatly restricts its marketability. As a result of this **fixity**, real estate values are affected by any political and economic activities occurring in the immediate area. Fixity is related to the expression, "The three most important things about real estate are location, location, and location."

Longevity

Real estate is generally considered to be a long-term investment because of the durability of the improvements and the permanence of the land. This quality of **longevity** enables investors and lenders to estimate, with some degree of reliability, the present value of a future stream of income from their properties. It is the attribute of permanence that forms the basis for our system of long-term mortgages. Investment in real estate usually involves relatively large dollar amounts that require complex financial arrangements. These complexities require the expertise of lawyers, accountants, brokers, property managers, real estate consultants, and other specialists.

Risk

Real estate investment is a relatively high-**risk** venture because of the uncertainties of a somewhat unpredictable market. There is no readily identifiable, organized national market for real estate as there is for stocks and bonds. This increases risk because the real estate market is a combination of local markets that react quickly to local changes. It decreases risk because those same markets react more slowly to regional and national events. Investors who stay up to date on such trends can make plans before these trends reach the local markets.

Market segmentation

The real estate industry also suffers from **market segmentation**. It is unorganized and largely unregulated. There is no standardization. Many of the market's participants react intuitively, giving little attention to formal feasibility or marketing studies. The real estate investment market is divided into submarkets such as retail, warehouse, residential, and others, increasing the complexity of investing. However, the investor who obtains qualified help and takes advantage of available protective measures can often minimize some of the risks.

Many government activities also directly or indirectly influence property values. At the federal level, things like income tax laws can provide incentives or disincentives for particular types of investments. Some can change rapidly, while others remain stable for years and even decades. The government's regulation and control of money dictates the extent of real estate activity by affecting the paperwork and the cost of mortgage loans.

Environmental controls and impact studies add time and costs to the development of land. Local political attitudes regarding zoning and growth restrictions increase costs. They can also prevent competition if new development is no longer allowed. Some anti-development attitudes are known by the expression NIMBY (NIMBY is spoken as if it were a word—"Nim Bee"), or Not In My Back Yard.

Changing nature of the realty market

The realty market has changed over the last several decades because of its importance to the national economy.

Starting with the bank failures and real estate busts in the mid-1980s, the federal government recognized a need to enforce safeguards. Wildly optimistic (or sometimes crooked) real estate developers and investors could not be allowed in bed with wildly optimistic (or sometimes crooked) lenders without some sort of accountability. The cost of bank closings alone was close to $200 billion, according to the FDIC. Real estate prices dropped dramatically. The federal government stepped in with loans to the FDIC, prosecution of lenders and appraisers, and more strict regulations for real estate lending.

The next large crisis came about because of two inventions not anticipated by the regulators. One was a method of bundling real estate mortgages into packages that were then split into pieces. Investors in one piece were paid back with low returns in the earliest years of the mortgage—when defaults were less likely. Other investors had to wait longer for their money, but received higher returns. The highest returns were for packages of loans to less creditworthy borrowers with high default risks. Through manipulations with bond rating agencies, the packages all had great bond rating scores that allowed them to be sold to large investors such as pension funds. In other words, the optimistic people originating the mortgages were not going to suffer the consequences if that optimism were misplaced.

The second invention was insurance that mortgage investors could buy to insure against credit losses in their loan portfolios. That turned optimistic people into wildly optimistic people, because nobody would be hurt except some nameless, faceless, insurance company.

Debt Relief and Taxes

If a bank loans you $1,000 and then tells you that you do not have to pay it back, the IRS considers you made a $1,000 profit on that relationship. It is income. That is why debt forgiveness is taxed. The only exception is for special circumstances spelled out by the IRS, such as bankruptcy and federal laws related to rescue attempts for the economy.

It all came crashing down in the late 2000s. The federal government stepped in with bailouts, regulations to force loan workouts instead of foreclosures, and protections such as the Protecting Tenants at Foreclosure Act. That prevented residential tenants from being thrown out of properties after foreclosure. Borrowers were not taxed if they were given debt forgiveness. It also passed more laws and regulations to close the loopholes that led to that crash.

The next crisis came in 2020 with the COVID pandemic. The economy shut down. People were out of work or afraid to go to work. The real estate markets suffered. Again, the federal government stepped in with outright grants of money, subsidies, and forgivable loans. Servicers of residential mortgages with some sort of federal connection—such as Fannie Mae loans—were told to offer generous workout terms to borrowers. Most had programs that allowed borrowers to make no payments at all for many months, with all of the accrued interest tacked onto the end of the loan.

In short, the changing nature of the realty markets is a recognition that as the residential markets go, so goes the rest of the economy. As a result, there is increasing federal oversight, regulation, and rescue.

Supply of and demand for real estate

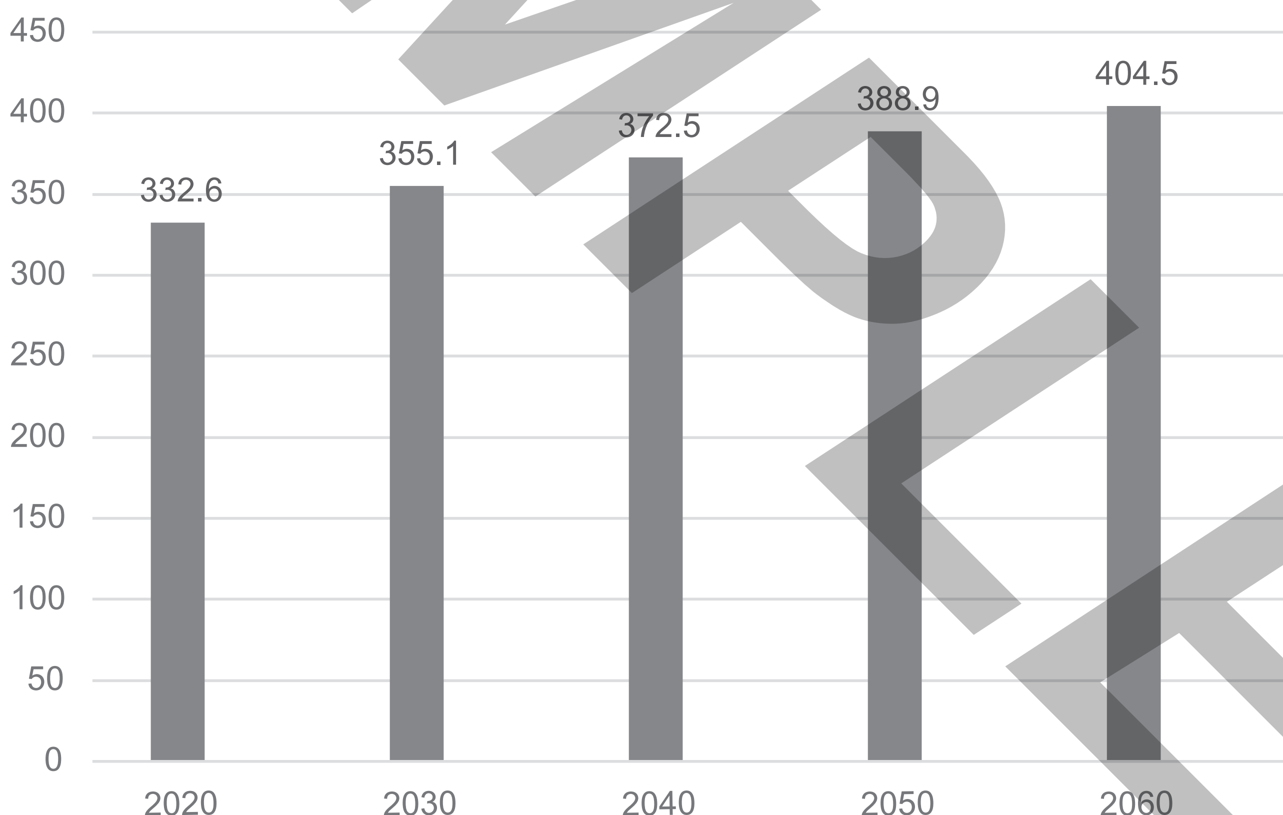
In the broadest sense, the **supply** of land is unlimited. Although it is true that the earth represents a fixed supply, it is also true that this supply can be extended indefinitely by building under and over the land and water, and by separating ownership into pieces of time. One example is time-shares for vacation properties. Owners have use privileges for only a certain number of weeks per year. Another example is life estates, in which one or more owners can use the property during their lifetime and then it passes to someone else on death. Mineral interests can be separated from the surface rights, and even separate minerals can be sold to separate owners. Oil and gas rights can be sold to one owner, sand and gravel to another, and the surface rights to a third person. Still, there are huge expanses of land that remain unusable at the current time, but that could change with technology and lifestyle changes.

It is the **relative scarcity** of usable land, however, that is important to real estate as an investment vehicle. Relative scarcity is what establishes the basic value for real estate. The economic worth of property fluctuates with the effective **demand** for strategically located and relatively scarce parcels of land.

Supply can be reduced artificially. Every regulation regarding water use and pollution limits building. Zoning laws can set minimum lot sizes for homes, maximum number of homes in a development, and minimum amounts of green space in each development. That limits the supply of land available to users. Height restrictions for office buildings reduce supply, even though demand might be high. One of the principal components of demand is population, not only in terms of the number of people, but also of subgroupings according to age and income.

At the end of 2022, the U.S. Census estimated the U.S. population at 333,331,745. At that time, there were 9 births per second, 9 deaths per second, and one net migrant addition every 130 seconds. The population is expected to grow to more than 398 million by the year 2060 (see Figure 1.1).

Figure 1.1: Projections of the Population for the United States: 2020 to 2060



Projected Age Groups and Sex Composition of the Population: Main Projections Series for the United States, 2020-2060.
Source: U.S. Census Bureau

Migrational trends and locational economic-base analyses can be developed to estimate variations in the demand for real estate within a given area. Changes in location, as well as changes in living patterns, determine where there will be growth in demand for real property and what this demand will require in terms of housing and related real estate developments.

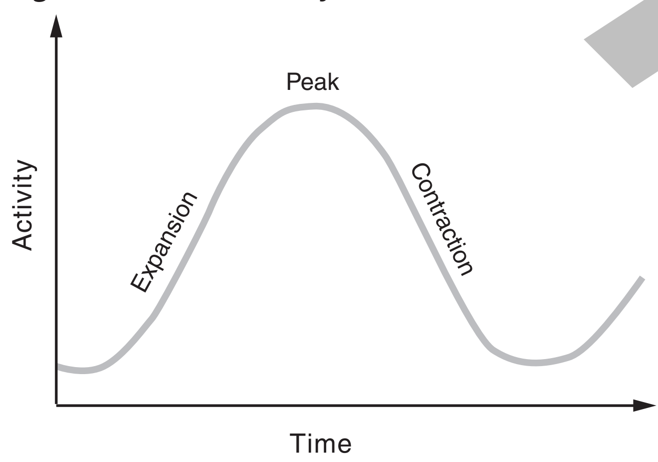
Another component of demand is interest rates. A **tight money** market occurs when interest rates are high and loans are difficult to find. An **easy money** market reflects low interest rates and lots of money available for real estate loans. When loan money is easy and cheap, demand increases.

Supply is usually related to demand. As demand increases relative to the current inventory of properties, prices go up. As prices go up, more people are attracted to developing new properties and redeveloping older ones. The supply continues to increase until there are more properties than the demand can absorb. Prices go down as investors compete to get rid of inventory. Demand increases as the prices go down, until the current inventory is close to being exhausted and things start all over again. Smart investors study these cycles so they know when to buy or sell.

Real estate cycles

Keeping in mind the cause-and-effect relationship between supply and demand, we can now examine the cyclical nature of the real estate market. A real estate cycle (see Figure 1.2) is frequently described as either a **buyer's market** or a **seller's market**. A buyer's market indicates a surplus of supply and a downward price trend, favoring the buyer. In a seller's market, supply is short and demand is high; prices are forced upward by the competitive market situation.

Figure 1.2: Real Estate Cycles



Because the term *cycle* implies repetitive, ongoing fluctuations in price, the buyer's and seller's markets are equal and opposite partners in the cycle. Thus, we can begin at any stage of a real estate cycle to examine the total cycle's fluctuation. If we enter a cycle somewhere near its peak, we can observe a shortage of supply, high prices as a result of competitive bidding, and, logically, high concurrent profits for sellers. Such high profits act to attract new investors who wish to capitalize on the opportunities, and it is reasonable to assume that new construction will take place, regardless of costs. With new buildings available as additional inventory to satisfy demand, the market cycle will level temporarily and then start to fall until supply

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