The Tortoise and the Hare in Real Estate Investing

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In over twenty years of working with real estate investors, and being personally involved in real estate investing for even longer, I have had the opportunity to weigh the advantages and disadvantages of different types of real estate investing. That review has led me to the almost perfect analogy to the old fable of the Tortoise and the Hare.

For those too young to remember the old fables, the hare challenged the tortoise to a race believing it was a sure thing the hare would win. The hare sprinted from the gate at great speed, recognized that he was immediately far ahead of the tortoise, who carried his home on his back as he steadily advanced on the race course. The hare became comfortable with the size of the lead and stopped to pursue other interests. The tortoise remained on track steadily moving towards his objective. In the end, the tortoise crossed the finish line first, much to the surprise of the hare.

I see the almost perfect analogy to real estate investors who focus on flipping or quick turn properties as the hares, and investors who focus on long term holding of rental property as the tortoises. Flipping properties requires a burst of energy and commitment at the beginning and, indeed, for each project thereafter, and returns in a relatively short period of time between the purchase and the sale, a profit, directly measuring the success of the investment.

In contrast, while buying and renovating long term investment properties requires a similar upfront commitment and energy, the reward for that activity is not quickly realized. The long term investor does not realize the entire value of the improved real estate by cashing out quickly after the improvements are made. Rather, the investor retains the asset and simply gets a return on the value of that asset, much of which is diverted to paying down the investor's mortgage on the property. The investor's monthly increase in available cash is only a small fraction of the cash realized by the flipping, wholesaling or quick turn real estate investor.

However, the long term investor realizes a large number of benefits from his or her investment activities over the entire time he or she holds the property. First, there is of course the increase in cash flow from the rent

received from the property. Second, there is the increase in net worth which accrues each month in the amount of the principal paid down on the financing of the property. Third, there is any appreciation of the value of the property during the period in which the property is held by the investor. Fourth, there is the availability of depreciation to offset and defer tax liability on other income of the investor. Fifth, there is the increase in cash flow which comes from the increase in the rental value of the property, roughly keeping up with inflation. Of course, once the mortgage is paid off, there is a dramatic increase in cash flow and value which I call the "retirement plan effect" of long term holdings.

For younger investors, this can be accomplished even with financing extending over twenty years or more. For older investors, a shorter mortgage term is required to reach more quickly the dramatic increase in value and cash flow. Often, current cash flow can be sacrificed to shorten the mortgage term and increase retirement age cash flow.

Finally, with the mortgage paid off the property is an asset which appreciates roughly to keep pace with inflation and provides a ready source of capital through refinancing or sale to cover more substantial financial needs later in life. Upon the investor's demise, the remaining equity value in his or her properties becomes available to heirs as part of the investor's estate. Substantial assets can obviate the need for life insurance to pay obligations and can provide a supplemental retirement income for a spouse or can be available to cover the cost of long term health care. Unless our tax structure changes, a long term capital gain, including the recapture of any depreciation, can be realized on the sale of the investment property, subject to advantageous capital gains tax rates rather than the highest marginal tax rate of the investor. Further, if depreciated property is passed to heirs in the real estate investor's estate plan, the heirs receive a step up in basis to the date-of-death value of the property, and do not pay capital gain tax based upon the depreciated basis held by the deceased.

As you can see, none of the myriad of benefits which accrue to the long term real estate investor are available to the flipping, quick turn or wholesaling real estate investor. Flipping properties is a "sexier" investment with a quicker return, but the value of that investment is simply limited to a one-time return.

As I write this article, I have in mind two ACRE members who have been real estate investors for over twenty-five years. One has remained an active flipping and wholesaling investor, quit his "day job" years ago and has

enjoyed a life style which he has been able to achieve from those transactions. His income has ebbed and flowed in direct relation to the ease of credit available to his back end buyers, and over the years he has shifted from doing most of the construction work himself on his flips to hiring others and supervising their work as age has limited his physical stamina.

The other investor used front end flips, lived in properties during renovation to cut costs, and borrowed money from a wide range of sources to begin to grow a long term portfolio of real estate. That investor lived a tight financial existence for the early years of his career, but became more and more financially secure and comfortable as time went by. His many rental units paid for themselves, he built his equity, and for years now, he has enjoyed the financial benefits of a long term investing strategy. He has a large number of possessions including Florida real estate, high end vehicles and jewelry and pays other people well to maintain and manage his various investment properties, while he himself works fewer hours and significantly less physically than the first investor. The second investor's most pressing problems are minimizing his income taxes and maximizing the benefit of his estate plan, while providing for several generations of his family a comfortable living.

The second investor doesn't have to worry about where he will find his next good deal on a flip, or about who will be available to do the renovations or to buy the property when it is fully renovated. He doesn't have to worry about carrying life insurance or long term care insurance because his assets are more than sufficient to cover those concerns and still provide a comfortable inheritance for his family.

To return to the fable of the Tortoise and the Hare, I believe the second investor, the tortoise, has already won the race. Don't you agree?

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