PART ONE

Four Biggest Questions

COPYRIGHTED MATERIAL

CHAPTER 1

What Should I Know about Market Cycles?

Million-dollar returns in real estate are realized through equity gains and cash flow over time. Investors can realize faster returns under any market condition if they learn to manage and calculate the time lines that produce equity and cash flow gains.

The rewards from sound real estate investing are tremendous. Real property is the single most significant source for creating individual wealth in the United States. Perhaps one of the most important reasons for this is that investors make their real estate wealth while sleeping; property holders see incremental asset growth in value over time without effort. This is referred to as *appreciation in your asset*, and it is the most compelling reason to invest in real property.

Buyers of real estate often expect both short-term and long-term appreciation without any sound technical or economical guidance. What is amazing is that the majority of investors fail to calculate one of the largest wealth builders—appreciation—before executing a contract to buy a specific property. This, in itself, is not catastrophic since property almost always appreciates over the long run. But during an economical real estate slowdown, many regions may experience years of negligible appreciation and possibly even declines in values. Wouldn't it be useful to project how much time the appreciation will take, and the amount of money you'll make on each property?

Even when putting a bet on a table in Las Vegas, we all have expectations of how much return we will receive if we win. It is the same with any state lottery. Each store posts how much is expected to be distributed to the

c01 JWBK177/Ross April 15, 2008 12:37 Char Count=

winner. There is no guarantee that you will be the winner, but at least you know what to expect if you do win.

Now, let's apply this to purchasing property. You may have already bought your first property. Did you have an exact number for appreciation over the first five years of ownership? Estimating your appreciable real estate returns over the short and long term does not need to be a cumbersome or difficult task. In fact, once you are armed with a few tools, it can be as simple as calculating your lotto returns.

Taking the time to understand the dynamics of current economic conditions and applying the results before making an offer to purchase a property will yield you greater financial returns. All forms of financial investing (e.g., stocks, bonds, time deposits) include a component for estimating the expected gain over time. In real estate, appreciation is called *passive income* (the income you earn over time with or without your involvement). Measuring your expected returns should be a fundamental part of your investing strategy.

How Millionaires Make Their Fortunes from Forecast Appreciation

When you put a hundred dollars in a savings account and it is earning interest annually, you are collecting income on your investment. In real property investing, there are two income sources: first, the appreciation return rate; second, in income-producing rental properties, the cash flow from the renting of the property. Unsurprisingly, most real estate millionaires in the United States have acquired their wealth from appreciation returns.

Making money while sleeping is what most Americans dream of. Statistics prove that investing in real estate not only is a way to reach that goal, it is a reality for most of the self-made millionaires in the United States. The combination of passive investing and forecasting is a sure way to achieve financial goals and meet expectations. To calculate your expected future earnings, it is necessary to forecast future appreciation.

The forecast of real property tends to move more gradually than traditional money investments. Stock investment prices can swing several percentage points in a given hour, while home pricing often takes months or years to accomplish a similar swing. Real property pricing moves slowly because it is not a liquid asset (it is not easily and quickly traded or cashed out);

a property sale can take weeks or months to execute and finalize. Meanwhile, sellers and buyers can change their direction or decision prior to contract closing, which can benefit or impair the investor; liquidating an asset can be difficult in a slow real estate cycle, preventing the investor from using earned appreciation on one investment toward a new investment. Short-term property investing is more challenging during a slow real estate cycle. However, when you account for the slower cycle before your purchase—and this is where the forecast comes in—you are protecting yourself from the slowdown with an investment plan that can be executed during any cyclical period.

A benefit of the slower real estate cycle is that your long-term investment is more secure: history has proven that, over time, equity returns and financial gains will rise. From 1995 to 2000, the vast majority of metropolitan areas appreciated 100 percent to 200 percent (see Table 1.1 for the top 50 list). Purchasers of a home in any one of these metropolitan areas for a price of $250,000 in 1995 would have made a minimum of $375,000 in additional equity over the following 10-year period. What a tremendous way to get rich fast! If you had one residence and two rental homes in 1995 in any one of these metro areas, you would have entered the elite group of American millionaires; it can be that easy.

Despite what all the gurus of get-rich-quick schemes tell you, real estate is a long-term wealth builder. If you are looking for a one-year plan to get rich quick and are a high-risk taker, then liquid assets like stocks will be far more productive. The proof is in the number of millionaires created by wealth building compared with the number who get rich in real estate schemes.

A colleague of mine, who is also an economics professor, did a survey of over 100 millionaires. More than 90 percent of them made their wealth from real estate, and all of them did it in a minimum of 3 years; they achieved financial freedom in about a 7-year period. Real estate is one of the most predictable and stable long-term financial markets out there.

Make Money from a Slowdown

In 2006, the United States entered a cyclical real estate slowdown that will last for many years. As an author and real estate entrepreneur, I am all too familiar with what slowdowns mean to most property owners. Our last

TABLE 1.1 1995 to 2005 Average Mean Price Appreciation for Top 50 Metro Areas

10-Year Appreciation (%)	Metropolitan Statistical Area
287.25	Cape Coral-Fort Myers, FL
277.24	Miami–Miami Beach–Kendall, FL Metropolitan Division
273.16	Fort Lauderdale–Pompano Beach–Deerfield Beach, FL Metropolitan Division
268.32	Miami–Fort Lauderdale–Miami Beach, FL
265.17	Sarasota–Bradenton–Venice, FL
264.91	Naples–Marco Island, FL
258.46	San Diego–Carlsbad–San Marcos, CA
253.73	Vallejo–Fairfield, CA
252.17	Merced, CA
245.47	West Palm Beach–Boca Raton–Boynton Beach, FL Metropolitan Division
235.74	Santa Rosa–Petaluma, CA
234.53	Santa Ana–Anaheim–Irvine, CA Metropolitan Division
232.17	Fresno, CA
231.37	Stockton, CA
229.80	Port St. Lucie–Fort Pierce, FL
221.41	Punta Gorda, FL
215.40	Chico, CA
214.40	Oakland–Fremont–Hayward, CA Metropolitan Division
213.15	Sacramento–Arden–Arcade–Roseville, CA
211.73	Riverside–San Bernardino–Ontario, CA
211.63	Deltona–Daytona Beach–Ormond Beach, FL
207.37	Panama City–Lynn Haven, FL
207.30	Bakersfield, CA
207.18	Los Angeles–Long Beach–Santa Ana, CA
206.37	Washington–Arlington–Alexandria, DC-VA-MD-WV Metropolitan Division
205.87	Nassau–Suffolk, NY Metropolitan Division
201.15	Redding, CA
196.02	Los Angeles–Long Beach–Glendale, CA Metropolitan Division
195.57	Phoenix–Mesa–Scottsdale, AZ
192.50	Orlando–Kissimmee, FL
190.99	Washington–Arlington–Alexandria, DC-VA-MD-WV
189.58	San Francisco–Oakland–Fremont, CA
188.90	Baltimore–Towson, MD
188.82	Las Vegas–Paradise, NV
188.78	Tampa–St. Petersburg–Clearwater, FL
187.75	Visalia–Porterville, CA
186.68	New York–White Plains–Wayne, NY-NJ Metropolitan Division
186.32	Fort Walton Beach–Crestview–Destin, FL

10-Year Appreciation (%)	Metropolitan Statistical Area
185.58	Salinas, CA
185.26	Ocala, FL
180.94	New York–Northern New Jersey–Long Island, NY-NJ-PA
179.69	Santa Barbara–Santa Maria, CA
178.28	Palm Bay–Melbourne–Titusville, FL
176.42	Reno–Sparks, NV
170.02	Napa, CA
167.65	San Francisco–San Mateo–Redwood City, CA Metropolitan Division
166.91	Yuba City, CA
162.44	Boston–Quincy, MA Metropolitan Division
162.14	Edison, NJ Metropolitan Division
161.97	Oxnard–Thousand Oaks–Ventura, CA

Source: U.S. Government.

downturn in the early 1990s forced thousands into bankruptcy or to the brink of bankruptcy, including me. Now, recent news reports indicate foreclosures have already surpassed many of the record highs in the1990s.

The current slowing trend is a grand opportunity to make a lot of money; you actually can grow your fortune at the fastest rate in American history. Why is this? Property appreciation reached historical highs during a very calm inflationary period. Owners of real estate benefited from the largest appreciable equity gains in the past two generations. Many of these same owners are now real estate sellers. Investors can tap into the gains when negotiating a purchase over the next several years, resulting in better pricing and seller concessions.

A declining real estate cycle means the buyer controls the market. The end result is that you can buy property at deflated prices to capitalize on the next upward cycle. Instant equity is achieved with a well-negotiated purchase resulting in incremental equity gains over time. This is exactly what I did. Instead of giving up during the last slowdown, I did just the opposite. While others were fearful of the cyclical slowdown, I was investing in real estate. I had little competition and complete control over my purchases; thus, I achieved my fortune. Often, being a contrarian is the best method of attacking a situation. Now is the ideal time for you to do the same.

Before you start investing, it is important to understand what a real estate cycle is and how it influences your wealth accumulation. During a real estate slowdown, an investor must practice a more detailed approach to buying property therefore avoiding negative financial impacts. The forecast is the primary instrument used. Reading about my experiences during the real estate slowdown in the 1990s will help you gain perspective and will give you an example to work from. I provide concrete examples of wealth creation along with practical applications of similar strategies for any investor who wants to make a fortune in real estate.

Why Using a Forecast Is a Good Idea

During a real estate slowdown, many real estate economic statistics become available to the public. The vast majority of the statistics are used by investors of publicly traded stocks. Other statistics are rarely seen by the public since they lack newsworthiness for stock investors. One statistic that Realtors use but that the public seldom hears about is the tracking of homes that do not sell and go off the market. The number is easy enough to gather, since the National Association of Realtors and local multiple listing services track withdrawn, canceled, and expired listings, all of which are categorized as "not sold" property. A seller may stop marketing a property for unlimited reasons; most of them are tied to personal seller issues. Realtors have no way of quantifying statistical data for subjective off-market reasons, so such information is more difficult to apply toward economic business planning. That being said, I still like to use this statistic because it indicates how many people made the effort to list a property with an agent but failed to sell. A lot of homes end up back on the market with new agents, but most slip from any statistical charts.

The 2007 result for the statistic of property never sold is an overwhelming 70 percent in most major metropolitan areas. This represents millions of homeowners who cannot liquidate a property. The first thing we do when a home is not selling is try to find fault. Real estate agents are the easiest to blame. After all, they represent sellers in finding a prospective buyer for a property. When they fail, the seller fails. But in defense of these professionals, the true blame belongs to cyclical economic forces in the investment market.

Homeowners could be better informed about these cycles—by the government, press, and other expert professionals—but, unfortunately, discussing a slowdown does not help to sell product or services; so by the time you hear on the news that a market is slowing, it is too late for you to act or recover. A little preparation would save property buyers from negative earnings that often result in bankruptcy or foreclosure.

Preparing for and capitalizing on market cycles differentiates successful and unsuccessful investors. A winning investor is prepared for economic cycles and knows how to make money from them. We cannot control the economic forces that influence our real estate market, but we can source our forecast and use it to do sound business planning, thus mitigating our risk and opening avenues for positive financial results.

Why Not Using a Forecast Is a Bad Idea

The thousands of investors who read my previous book, *The Spill Zone* (Tampa, FL: Monarch Group Publishing, 2006), and applied the forecast to their portfolio in 2006 are now reaping the benefits: They could make decisions in advance of a real estate recession and create prosperity from their execution. During the previous slowdown, I did not have an instrument like *Forecasting for Real Estate Wealth* to assist me. This lack proved to be very costly.

In 1988, most people were bullish about real estate investing, making fortunes everywhere. So while working full time in a day job, I decided to spend some of my weekend time investing in fixer-uppers that I could renovate and turn for a profit. I developed a business plan and calculated expected financial returns after all expenses for each investment. My holdings consisted of fewer than a dozen properties, all of which had negative cash flow, and my original plan consisted of three steps: 1. Buy, 2. Renovate, and 3. Sell for a profit. It sounded easy enough, but when I came to Step 3, the economic slowdown in real estate made selling difficult.

I was not completely unaware—there was talk across the news channels that the real estate boom would eventually slow down—but everyone had a different idea of when that would occur. As a flipper of renovated homes, I made sure that all my investments had plenty of equity that I could use to ensure fast liquidation. I set aside cash reserves to permit a few months of investment cushion for the time it would take to sell a property. The plan

appeared to be sensible and conservative. In hindsight, the plan failed to take into account real estate cyclical slowdowns. Sure there were plenty of cash reserves for taking a longer time to sell the property but no one had told me that a real estate slowdown can prevent the sale of a property for months or even years. In addition, I had expected that even if a slowdown made selling difficult, I would have plenty of warning to liquidate before the market affected me. No one told me that by the time I found out about a real estate slowdown, the market would have been in it for many months. This is what is referred to as *lagging economic indicators*. The lag is the time that it takes to gather enough statistical data to share findings with the public.

When I finally realized that the United States had hit a cyclical slowdown, I immediately tried to liquidate (even if the renovations were incomplete), but it was too late. Instead I was caught with negative cash flow properties that would not be liquidated for many years. The only way to bail myself out was to take loans from credit card companies, banks, and the most unpleasant source: friends and family. A forecast can prevent all this.

Integrating a Forecast into a Real Estate Strategy

Each of us has a strategy for making money in real estate. Whether it is written down or just in the back of our minds, we all purchase a property with the aspiration of financial returns. Yours could be as simple as building equity in a principal residence that you could use for your retirement. By integrating the forecast into your strategy and understanding real estate cycles, you are certain to time your transactions for optimum results. As an investor, you can capitalize on the market cycle by integrating the forecast to your type of investing. This will not prevent a cycle from affecting your portfolio, but it does allow you to plan for possible scenarios and leave control in your hands. If you were a house flipper or renovator, as I was in the 1990s, you would want to use the forecast before you purchased a property to plan for cash flow requirements that could arise if selling was difficult. Once you integrated the financial cushion into a forecast-supported strategy, you would have ensured positive cash results.

In the real estate recession of the early 1990s, these tools did not exist for me. Before buying any property, I reviewed the financial numbers without having a forecast. As far as I was concerned, if the numbers appeared to

c01 JWBK177/Ross April 15, 2008 12:37 Char Count=

be sensible, my purchases could not lose. As a young naïve investor, my plan was fairly simple: basically get rich quick from buying, renovating, and selling real estate. After all, almost everyone seemed to be in the business of doing just this and success stories were easy to find. This assurance, along with some sound numbers to back my investments seemed to be enough. I quickly realized that during a down cycle, even the most diligent financial projections could fail me. Sound planning without projecting a forecast can be detrimental to any investor. It was for me.

At the time, all my property investments were a few miles from my residence in Southern California. My business model included a financial cushion that was supposed to help if the market slowed, and each property that I had purchased included a lot of upside equity for liquidation even if the real estate market entered hard times. At the time of purchasing each investment, however, my excitement in making large sums of money overcame my sensible nature, and I did not investigate how dramatic the impact of a real estate cycle might be on my ability to liquidate real estate holdings.

Little did I realize that a slowdown could last many years. By 1989, my local investment market, Southern California, had entered a down cycle of 7 to 10 years. Although you often hear that real estate has up and down cycles—and you do not want to get caught in the down cycle—if you have extra equity in your property, at least some could be used to sell in a down cycle. Right?

Of course, this extra equity would not even be necessary to tap into during a real estate slowdown. My investments at first glance appeared to represent positive financial results no matter what the future held. I took more time then most people by integrating my renovation costs and accounting for a market fall of as much as a 20 percent decline in housing value. I still had ample cushion to support selling a property without having to go below any existing mortgage. I thought that my homework was complete, and a downturn could not affect me. The plan was to turn these few properties over quickly and cash in on profits. So the downturn should be missed. Sounds like my homework was complete and thorough, right? Success should be on the horizon? Again, I was wrong.

The minute I heard of the slowing real estate market, I listed all properties for sale. Months passed, and none sold. I decided that it would be best to finish all the renovations and hope that it would make a difference. After more cash outlay and renovation completions, months passed and none sold. Then I dropped prices to a break-even point to get out of the negative

cash flow situation. Months passed, and once again, not a single property sold. Within a year, all my cash reserves were depleted, and the only way to sell the properties would be to lower the price below the mortgages and write a check to the bank to get out—but there were no more checks to write since all reserves were gone. Banks started to get tough about lending, so getting a loan to help bail me out was not an option.

The negative cash flow became even more difficult to handle when I was forced to take a lower-salary job with a two-and-a-half-hour commute. I could barely afford the negative cash flow from my extra investment properties, so payment to rent a house closer to work was not an option. For several years, I struggled awaiting a better cycle, with no cash and a two-and-a-half-hour daily commute to work.

In hindsight, it is easy to pinpoint my failure: my plan to renovate and flip did not integrate the actual forecast for the nation and specifically for the Southern California marketplace. The strategy would have worked if I had factored the negative cash flow created when properties could not be liquidated. A five-year plan instead of a one-year plan, coupled with the forecast, would have focused my property selection on a longer-term portfolio.

For instance, I should have purchased properties that—at a minimum—produce break-even monthly financial results, with a renter. This alone would have created the insurance policy I so desperately needed; a dual strategy of *renovate-flip* and *passive-rental-cash flow* to accommodate likely change in forecast would have eliminated my burden and saved me from this disaster.

Forecasting to Yield Cash Returns

Being armed with a forecast allows you to create the best strategy for maximizing your cash returns. Some strategies work better in various stages of a market cycle; these are discussed in later chapters. For those people who are already experts at any one given strategy, it might serve you better to stick with what you are good at and integrate the forecast into that specific strategy.

In many instances, your preferred strategy might be more difficult to execute based on a given real estate cycle, but it does not need to stand in your way if you integrate a second investment strategy and marry the two when buying any investment. The way you do this is to understand which strategies yield the highest returns in the market cycle.

The year 2006 proved to be similar to early 1990. The Southern California market was heavily hit by the real estate decline. When I bought my properties in 1989, I saw them all as short-term (one-year) investments with a strategy of renovate-flip. I had to learn new strategies of investing to figure out which strategy could complement and possibly cure my failed existing renovate-flip strategy. That is exactly what I did.

This meant taking educational courses for all types of investing. By 2001, my training had included various seminars and more than 10 books on real estate and real estate investing. I passed the Real Estate Brokers State Licensing exam, which made me an official broker in California.

I personally marketed my properties and failed to sell; then I began using complimentary strategies to help move my real estate. Why not go for the gusto and start integrating the strategies I had learned in my training with my existing property portfolio? I used my new forecast skills to combine a short-term strategy and a long-term positive cash flow strategy.

After reading a lot of material, I learned the art of exchanging properties. I found this strategy useful, but a real estate investor who buys in the correct area with the proper strategy in the first place won't find it necessary; basically, it is an excellent bailout technique.

I was able to locate the owner of a small house who was trying to sell and move to a larger home. Neither of us had had any luck finding buyers. An exchange (Chapter 5) would help both of us by eliminating the negative cash flow problem that existed on my rental, while at the same time providing him with the larger home he was looking for. We struck a deal, and my negative cash flow was immediately reduced by several hundred dollars a month; the beginning of my positive cash flow strategy emerged.

Thanks to the forecast, my strategy of *renovate-flip* was converted to a *passive-rental-cash flow* strategy, and I had positive cash flow in my portfolio. Using special selling techniques along with a new strategy, I turned a dismal cash flow portfolio into a long-term positive cash flow strategy.

Change Your Approach if Necessary

After I learned the value of positive cash flow, finding more of it became an addiction for me. Instead of giving up on the real estate business, it became my second job. Being a property investor during the 1990s had lost its luster for most, but I still decided to go in that direction regardless of what others were saying. So many people had lost their homes and ruined their credit

c01 JWBK177/Ross April 15, 2008 12:37 Char Count=

during the Southern California downturn that little confidence existed in the marketplace. In reality, it was the best time to enter the market; it was a buyer's market. Buyers were in great demand and sellers were desperate to strike deals. With the purchase of additional positive cash flow properties, the extra income would lead to financial freedom.

I altered my original plan of financial freedom. The real estate cycle dictated the best method for achieving wealth. My first business plan would not work in a slowing real estate cycle, but a new, creative model was even easier to execute. All the planning in the world is useless if you do not know how to execute it effectively in a changing marketplace. The key is understanding the forecast and market cycles.

Negative cash flow properties were turned into positive cash flow. Integrating the forecast cycle to my business plan allowed me to beat each year's financial expectation. My plan included several types of property that could be purchased at lower prices with less money down. In a short time, I had constructed a large portfolio of properties that focused on the easier-to-qualify, better-priced purchases such as bank-owned properties, foreclosures, estate sales, and hidden off-market property acquisitions. Eventually, the plan directed me to out-of-state purchases.

In just a few years, during the slowdown of the 1990s, I turned a dying portfolio of investments with negative cash flow and zero equity into a thriving, rich portfolio, worth over $8 million in equity and more than a hundred thousand dollars in annual positive cash flow. Imagine what you could do!