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THE VIEW

"Government looks like it had been poured into Washington and forgot to say when." - ***hat tip to P.G. Wodehouse***

One of the questions we hear repeatedly nowadays is "What do you think about me buying a rental property?" Prices on real estate have dropped so much and rates are so low it is compelling some to consider this alternative. The answer is not an easy one. The best way to determine what is right for your own circumstances is a thorough evaluation of your expectations and the likely resulting reality. There are some key factors to consider that may help you set your expectations:

1) Interest rates have been in a secular decline for over 25 years giving a boost to investment property valuations. Mortgage financing has gone from the mid teens in 1985 to 4% today . This will not happen again over the next 20 years.

2) Demographics have lead to a significant demand over the last ten years for vacation homes and investment properties (fully 25% of sales in the years leading up to housing's collapse). Will this trend continue when housing eventually recovers?

3) Bank reserve requirements have declined from 15% in the 1980's to approximately 5% in the 2000's. This is important because it allowed banks to lend more of their capital, which they did to fuel housing's advance. Bank reserve and capital requirements are going higher.

4) In the years leading up to housing's peak we saw underwriting standards decline appreciably. We saw something similar in the late 80's and early 90's. Underwriting standards are very tight at this time and it may take some time for them to relax.

5) Somewhat bound by #3 and #4 above, the securitization (bundling and sale) of mortgages has almost vanished and is making a very slow reemergence. This speaks to the availability of capital for mortgage

lending. It is not likely to recover to pre-crisis highs anytime in the foreseeable future.

The conclusion that we draw from these factors is several fold. First, the prices paid between 2005 and 2007 were illusory and transitory. Do not use these as a benchmark of a property's true worth. Second, the historical returns over the last 25 years in real estate are not likely to be realized over the next 5 to 8 years (barring some very unique circumstances). No, *you're likely not the one* with very unique circumstances. Real estate investing is an *active* investment not a *passive* one. This means if you have never owned rental property, be prepared to do some work.

Do the math! Consider the property's purchase price and how you will finance it. Consider its rental income, and then deduct its financing cost (if applicable), taxes, HOA dues, maintenance cost, cost of vacancy, etc. The returns are likely in the 4-7% range. Remember, this is an *active* investment. This is an illiquid investment as well. When returns look to approach 9% or better after considering all expenses, then further consideration is warranted. Even so, do not commit an uncomfortably high amount of liquid resources to it. As an investment it should sit comfortably within the allocation structure of your current investments.

[Note: This is *not* to advise real estate professionals or career real estate investors to abandon their disciplines. Rather it is a primer for the non-career investor and how this may fit into an overall investment strategy.]

Lest you think we are biased to stock or other capital market investments, quite the contrary. We have been advising our clients to expect more muted returns in these other categories for some time now. The returns that clients and investors have come to expect over the last three decades will not likely materialize over the next 5 to 8 years. The important aspects of investing, beyond returns, are coming into clearer focus for most investors. Namely, the measure of risk you are taking with each investment (volatility, default, interest rate, etc.), the level of liquidity, and the aggregate risk of all of your investments combined (measures of correlation).

The reason for lower returns lie in the fact that we are in a debt consolidation economy that will take a number of years to work through; the symptoms of which I outlined at the start of this letter not only affect real estate, but almost all other assets as well.

Below is a table that is our best effort as to what to expect from the broad investment categories listed:

Investment	***E Return****	***E* Risk**	**Liquidity**
Cash	1-2%	Inflation	High
U.S Bond Aggregate	3-4%	7-8% *sd*	High
Emerging Markets Bond	7-9%	10-14% *sd*	Medium
U.S Large Co. Stock	4.5-6.5%	17-21% *sd*	High
U.S. Small-Mid Co.	6-8%	22-25% *sd*	High
Developed Markets Stock	5-7%	18-22% *sd*	High
Emerging Markets Stock	8-12%	25-32% *sd*	Medium
Commodities	5-15%	22-35% *sd*	Medium
Real Estate	4-7%	Neg. Carry	Limited

*Annualized over the next 5-8 years *sd*=standard deviation

The Efficient Frontier

This concept in finance aims to achieve the optimum mix of all assets (including those listed above) into a portfolio of risky assets that has the best return for each level of risk taken. In theory it allows an investor to create an optimum portfolio of diverse assets with lower risk and higher return than investing in just one of those assets on its own. This is one of the principle tools we have in modern finance to control risk and invest client portfolios. Unfortunately, the theory (developed by Harry Markowitz in the 1950's) is not infallible and has shown its age in recent years. A number of assumptions that the theory uses have been called in to question over the last decade, namely, that investors are rational, seek to avoid risk, and that correlations between investments remains constant and fixed.

With its many flaws, however, it is still some of the best work we have available to enable the profession to build fairly robust portfolios (as it relates to risk) for our clients. New ideas in *risk budgeting* and using *cash* or a *risk-free asset* (T-Bills) to hedge, are allowing us at Clearview Investment Partners, LLC to improve the overall risk profile for our clients without detracting significantly from returns. To see our view of how a mix of portfolio assets might be

expected to perform over the next 5-10 years read more *here*.

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