Chapter Three

Why Real Estate is the Fastest and Safest Path to Wealth

We all want to know what is the fastest **AND** safest path to wealth! This topic has been debated, I am sure, for centuries. Everyone has an opinion; but the fact is, real estate is absolutely and positively the fastest and safest path to wealth, and it is essential you know and understand why. Now fast without safe is of no real long-term value; and hopefully, your financial life is something you view as long term.

In this chapter, I am going to demonstrate to you **why** real estate is the fastest and safest path to wealth.

The Secret Sauce to Real Estate! The Utility Value

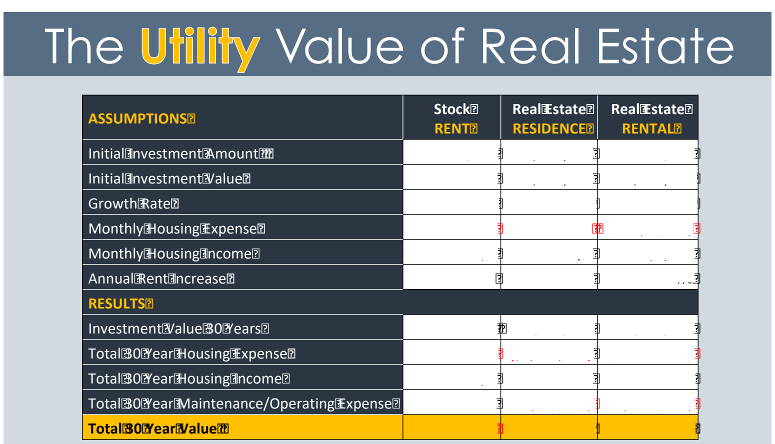
Have you ever watched the TV show Shark Tank?

On the show, you will see an entrepreneur pitch their business model or idea to the Sharks/ Investors. Very often, you will then hear Mark Cuban or one of the Sharks ask, "What is the secret sauce to your business?" Here's what he's really asking: “What is the insurmountable competitive advantage that your business has?”

A patent would be a good example of an insurmountable competitive advantage for a business.

Real estate has an insurmountable advantage over every other asset class that very few people are aware of; and because of this, never discuss. Real estate’s insurmountable competitive edge over every other investment is it’s utility value. When you purchase real estate or property that has a structure on it, whether it be residential or commercial, the structure has the ability to be used. This usage very often has a value, but the amount will vary depending on if it is a residential property for rent, commercial, warehouse, etc.

Now let’s compare this to investing in stocks.



The Utility Value of Real Estate

ASSUMPTIONS	Stock RENT	Real Estate RESIDENCE	Real Estate RENTAL
Initial Investment Amount	[illegible]	[illegible]	[illegible]
Initial Investment Value	[illegible]	[illegible]	[illegible]
Growth Rate	[illegible]	[illegible]	[illegible]
Monthly Housing Expense	[illegible]	[illegible]	[illegible]
Monthly Housing Income	[illegible]	[illegible]	[illegible]
Annual Rent Increase	[illegible]	[illegible]	[illegible]
RESULTS			
Investment Value 30 Years	[illegible]	[illegible]	[illegible]
Total 30 Year Housing Expense	[illegible]	[illegible]	[illegible]
Total 30 Year Housing Income	[illegible]	[illegible]	[illegible]
Total 30 Year Maintenance/Operating Expense	[illegible]	[illegible]	[illegible]
Total 30 Year Value	[illegible]	[illegible]	[illegible]

Let’s start on the top left with investing $120,000 in the stock market. In return for your investment, you will receive $120,000 in stock certificates. What can you use these stock certificates for? Answer, maybe wallpaper!

We will start with analyzing a stock investment and its return on investment. Because stocks do not have the utility value or the ability for you to live in the stock certificates, you must either pay for a place to live or be homeless.

The utility value of real estate is an insurmountable competitive advantage in creating income and wealth growth. Let’s examine exactly how much this utility value difference is worth on a typical residential home investment versus investing in stocks and renting.

Let's say the stock investor is earning a healthy 8% net return on their stocks. Now for you to earn 8% net after management fees means that your gross earnings have to be close to 10% annually, which is extremely unlikely over a 30-year period.

My point is, I'm slanting the deck in favor of the stock market and against real estate.

Consider a monthly housing expense. Let's say you're renting for $3,000 a month. California rents, on average, have appreciated 4.7% for the past 50 years. I'm only using 4%.

In 30 years, your stock portfolio is worth $1.2 million. A financial planner or a stock broker would be very proud of getting you 8% net return over 30 years, or $1.2 million. But because the stocks have no utility, you would have had to pay over $2 million in rent, leaving a financial loss of over $800,000 over that same period, meaning the renter actually went backwards financially without knowing it.

Now let's take that same $120,000 as a 20% down payment on a $600,000 property. We will only use an appreciation rate of 5%, not the 50-year California historical average of 7.3%. You can see the mortgage payment, which includes principal, interest, taxes, and insurance. In 30 years, you have an asset worth $2.5 million. You would have paid $1.1 million for that asset. Next is money allocated for maintenance expenses like carpet and paint. Your net profit is over $1.3 million.

Here's the point—the utility value of real estate (due to the ability to use the land and the structure) versus stocks (which have no utility) is worth over $2 million to you. Do you know how many renters know or consider this when renting? Absolutely none... They don't know.

Do you know how many Realtors know this? Maybe 1%. Now let's go to the third column with a rental property. Let’s say a homeowner turns their home into a rental, using the same financial numbers in 30 years. If they have a $2.5 million asset that has collected $3,000 a month over 30 years, the total value of the utility is $2 million. The total gain is over $3 million for the real estate versus $1.2 million on stocks.

Because of this insurmountable advantage that real estate has over other assets, real estate will on average **triple** the wealth growth over stocks.

Given these facts about the wealth growth of real estate, it is more amazing to learn how few own investment real estate. I want to share with you some startling statistics.

In Los Angeles County, only about 7% of the people own two or more properties. In Orange County, it's about 10%. But guess what percentage have a 401K or an IRA? 32% have a 401K, and 33% have an IRA. Some people have both due to job changes; but when you average it out, approximately 40-50% of the working population have one of these retirement accounts but no investment real estate. How is it possible that the stock market via the 401K or IRA has a market share of 4-5 times GREATER than real estate?

The obvious answer is a lack of knowledge or financial literacy. The majority of residential real estate sales agents are not trained on the financial dynamics of real estate wealth growth! They are trained in two areas:

1- On how to be salespeople, meaning how to market and prospect for clients, and
2- How to sell residential real estate as if they were selling a commodity like an appliance.

WHY Real Estate is the Fastest and Safest Way to Build Wealth!

There are two reasons why real estate is the fastest way to build wealth:

1- The utility value that we have already discussed.
2- The five economic benefits of real estate, which means that you—the property owner—are making money five different ways. There is no other asset that can say this!

Let's review these five different ways:

1- **Appreciation**. Appreciation is the one economic benefit that everyone is aware of. Appreciation is the percentage of the properties increased value. Because many people think appreciation is the only economic benefit, they believe that stocks outperform real estate in wealth growth when in reality real estate, in most parts of the country, will consistently outperform stocks—and it's not even close.

2- **Principal Reduction**. In most cases, borrowers secure a mortgage that is fully amortized over 30 or 15 years. On a 30-year fully-amortized loan, approximately 30% of the mortgage payment is principal reduction. (As interest rates rise, the percentage of principal goes down.) In summary, when the tenant makes a rent payment and you in turn use this money to make the mortgage payment, the principal on the loan is paid down, creating equity in the property (which is the equivalent of money in the bank). Because of the utility value of real estate, real estate is the only asset that you can leverage and get **someone else** to pay off the leverage. If you were going to leverage your stocks, which is extremely risky to begin with, who would pay off your leverage? Answer: no one, because there is no utility to stocks.

3- **Rental Cash Flow**. Rents basically go one way, they go up. It is extremely rare for a property owner to call a tenant and say, “I have good news, I have decided to reduce your rent!” Have you ever received that call?

4- **Tax Benefits**. Real estate has the incredible phantom paper loss of depreciation. Depreciation is the tax deduction allowed by the IRS to expense the building for wear and tear (not the land) of the structure. Residential real estate is depreciated for 27.5 years, and commercial is 39 years. This means that the value of the structure is divided by the IRS allowable depreciable years to arrive at an annual amount that can be deducted from your income on the property. Over the years, this amount can be quite sizable. The most recent tax reform act of 2017 has added an additional tax benefit of 20% tax free income on real estate investments and services. (See your CPA for details on this.)

5- **Leverage**. Leverage refers to making money not only on your money, which is the down payment (assuming you made one; keep in mind—you can often times buy real estate with no money down), but the bank’s money too, or the mortgage that you got when you purchased the property.

Now let’s review what this means in dollars and cents to you, the homeowner or investor. Let’s say you invest $65,000 into the stock market, which then gets you $65,000 worth of stock. You could use this same $65,000 and put a 10% down payment to purchase a $650,000 property. You would then have an asset 10 times the size of a stock investment with the same amount of money.

See the slide below comparing a 5% return on your stock account versus only 4% on real estate. As you can see, it is not close in annual return on investment.

Why Real Estate is the Safest Investment You Can Make!

The whole point to investing in any asset is to not just create wealth but to **also** create non-employment or retirement income. It is this non-employment income that you will eventually rely on for financial security and retirement. The security and stability of this income is critical to you, especially in your senior years. Below is a chart showing California’s 25-year rent history, starting in 1990. The first thing to notice is the stability of the rental income. As you can see, there is a nice steady upward trajectory with little exception. You can research this further by going to UScensus.gov and tracking rental history by state. What you are going to find is rents have had the same consistent inflationary growth dating back to 1940! What other asset can say this? The answer is none.

Second critical point: real estate is the only asset that operates on **two separate** supply and demand components. The first supply and demand component is the supply and demand to purchase real estate.

Example: Let's compare how stocks fared with real estate during the great recession of 2008. Let’s say you had one million dollars in the stock market when the financial meltdown hit and your million-dollar stock portfolio dropped by 50% to $500,000 dollars in asset value.

What do you think happened to your retirement income? Did it go down? Of course it did—dollar for dollar, with 50% of your retirement income now gone. Let’s say you had $5,000 a month of retirement income coming in on that $1 million that you had invested in the stock market. It is now only $2,500. Is that a problem if you are retired? For most people, this is a huge problem.

Now, let's compare that to real estate. Let's say you had $1 million triplex generating the same $5,000 a month in rent, and the economy tanks like it did in 2008, resulting in no one buying real estate. The value of your triplex drops to only $500,000.

Did your rents go down in half?

No they did not! As you can see on the chart, rents actually went up in 2008!

Why?

Even though the demand to purchase real estate declined dramatically in 2008-09 when prices came down by 40-50%, the demand for rents went up. The demand went up because of all the people that were losing their homes. What are the options for someone that is being foreclosed on?

Rent or go homeless?

Not surprisingly, most went out and rented.
The reason real estate is the safest investment you can make is because it is the only asset that you can invest in that operates on **two separate supply and demand components**. The second supply and demand component being the demand to rent real estate.

This is why real estate in high rental demand areas, like California and New York, are the most secure investment when it comes to investment income. What do you think the chances are that you are going to see rents in your community go down? In most of the U.S., people are moving in; and in states like California, people are coming from all over the world!

Do you believe you are going to see this change in your lifetime?
I don’t. This is why real estate is the fastest and safest path to wealth and investment income!