



When you think about real estate investing, the first thing that probably comes to mind is your home. Of course, real estate investors have lots of other options when it comes to choosing investments, and they're not all physical properties

Real estate has become a popular investment vehicle over the last 50 years or so. Here's a look at some of the leading options for individual investors, along with the reasons to invest.

KEY TAKEAWAYS

- Real estate is considered to be its own asset class and one that should be at least a part of a well-diversified portfolio.
- One of the key ways investors can make money in real estate is to become a landlord of a rental property.
- Flippers try to buy undervalued real estate, fix it up, and sell it for a profit.
- Real estate investment trusts (REITs) provide indirect real estate exposure without the need to own, operate, or finance properties.

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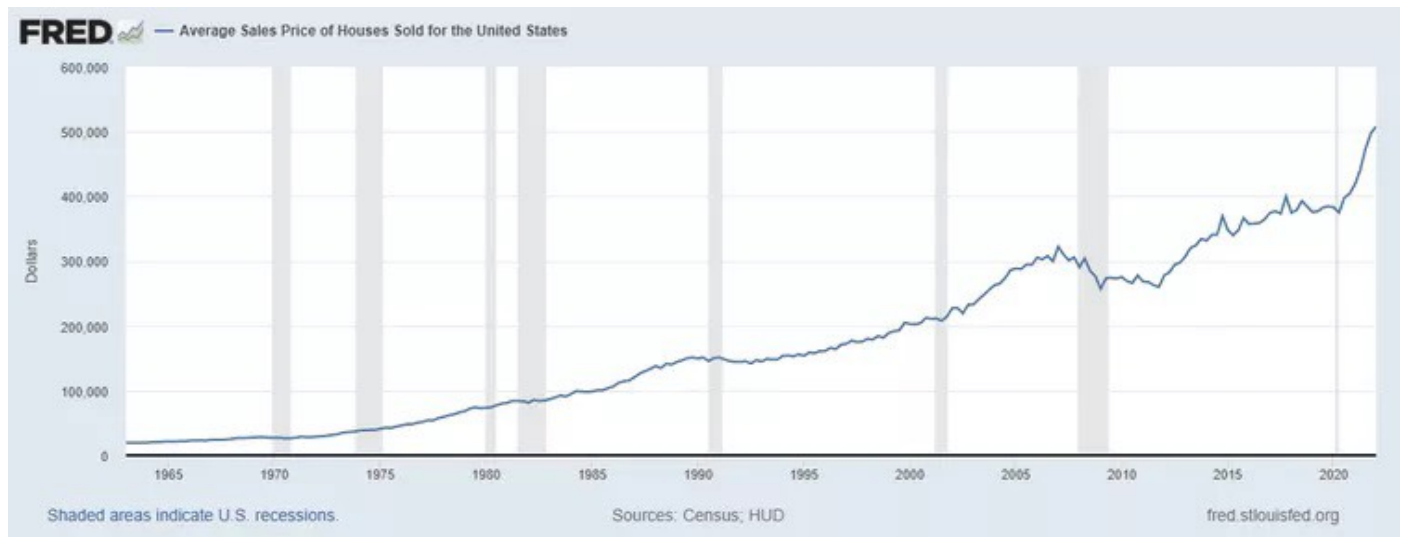
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Historical Prices

Real estate has long been considered a sound investment, and for good reason. Before 2007, historical housing data made it seem like prices could continue to climb indefinitely. With few exceptions, the average sale price of homes in the U.S. increased each year between 1963 and 2007—the start of the Great Recession. Home prices did take a small hit at the onset of the COVID-19 pandemic in the Spring of 2020. However, as vaccines were rolled out and pandemic concerns waned, home prices accelerated to reach all-time highs by 2022.

This chart from the Federal Reserve Bank of St. Louis shows average sales prices between 1963 and Q1 2022 (the most recent data available). The areas that are shaded in light grey indicate U.S. recessions.



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Rental Properties

If you invest in rental properties, you become a landlord—so you need to consider if you'll be comfortable in that role. As the landlord, you'll be responsible for things like paying the mortgage, property taxes, and insurance, maintaining the property, finding tenants, and dealing with any problems.

Unless you hire a property manager to handle the details, being a landlord is a hands-on investment. Depending on your situation, taking care of the property and the tenants can be a 24/7 job—and one that's not always pleasant. If you choose your properties and tenants carefully, however, you can lower the risk of having major problems.

One way landlords make money is by collecting rent. How much rent you can charge depends on where the rental is located. Still, it can be difficult to determine the best rent because if you charge too much you'll chase tenants away, and if you charge too little you'll leave money on the table. A common strategy is to charge enough rent to cover expenses until the mortgage has been paid, at which time the majority of the rent becomes profit.

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The other primary way that landlords make money is through appreciation. If your property appreciates in value, you may be able to sell it at a profit (when the time comes) or borrow against the equity to make your next investment. While real estate does tend to appreciate, there are no guarantees.

This is particularly true during periods of intense volatility in the real estate market, including most recently throughout the duration of the COVID-19 pandemic. From February 2020 to March 2022, median real estate prices in the U.S. rose by an astonishing 38%. The dramatic growth has left many wondering whether prices are due to crash.

Flipping Houses

Like the day traders who are leagues away from buy-and-hold investors, real estate flippers are an entirely different breed from buy-and-rent landlords. Flippers buy properties with the intention of holding them for a short period—often no more than three to four months—and quickly selling them for a profit.

There are two primary approaches to flipping a property:

- Repair and update. With this approach, you buy a property that you think will increase in value with certain repairs and updates. Ideally, you complete the work as quickly as

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quickly as possible and then sell at a price that exceeds your total investment (including the renovations).

- Hold and resell. This type of flipping works differently. Instead of buying a property and fixing it up, you buy in a rapidly rising market, hold for a few months, and then sell at a profit.

With either type of flipping, you run the risk that you won't be able to unload the property at a price that will turn a profit. This can present a challenge because flippers don't generally keep enough ready cash to pay mortgages on properties for the long term. Still, flipping can be a lucrative way to invest in real estate if it's done the right way.

REITs

A real estate investment trust (REIT) is created when a corporation (or trust) is formed to use investors' money to purchase, operate, and sell income-producing properties. REITs are bought and sold on major exchanges, just like stocks and exchange-traded funds (ETFs).

To qualify as a REIT, the entity must pay out 90% of its taxable profits in the form of dividends to shareholders. By doing this, REITs avoid paying corporate income tax, whereas a regular company would be taxed on its profits, thus eating into the returns it could distribute to its shareholders.

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Much like regular dividend-paying stocks, REITs are appropriate for investors who want regular income, though they offer the opportunity for appreciation, too. REITs invest in a variety of properties such as malls (about a quarter of all REITs specialize in these), healthcare facilities, mortgages, and office buildings. In comparison to other types of real estate investments, REITs have the benefit of being highly liquid.

Real Estate Investment Groups

Real estate investment groups (REIGs) are sort of like small mutual funds for rental properties. If you want to own a rental property but don't want the hassle of being a landlord, a real estate investment group may be the solution for you.

A company will buy or build a set of buildings, often apartments, then allow investors to buy them through the company, thus joining the group. A single investor can own one or multiple units of self-contained living space. But the company that operates the investment group manages all the units and takes care of maintenance, advertising, and finding tenants. In exchange for this management, the company takes a percentage of the monthly rent.

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There are several versions of investment groups. In the standard version, the lease is in the investor's name, and all of the units pool a portion of the rent to guard against occasional vacancies. This means you will receive enough to pay the mortgage even if your unit is empty.

The quality of an investment group depends entirely on the company that offers it. In theory, it is a safe way to get into real estate investment, but groups may charge the kind of high fees that haunt the mutual fund industry. As with all investments, research is key.

Real Estate Limited Partnerships

A real estate limited partnership (RELP) is similar to a real estate investment group. It is an entity formed to buy and hold a portfolio of properties, or sometimes just one property. However, RELPs exist for a finite number of years.

An experienced property manager or real estate development firm serves as the general partner. Outside investors are then sought to provide financing for the real estate project, in exchange for a share of ownership as limited partners. The partners may receive periodic distributions from income generated by the RELP's properties, but the real payoff comes when the properties are sold—with luck, at a sizable profit—and the RELP dissolves down the road.

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Real Estate Mutual Funds

Real estate mutual funds invest primarily in REITs and real estate operating companies. They provide the ability to gain diversified exposure to real estate with a relatively small amount of capital. Depending on their strategy and diversification goals, they provide investors with much broader asset selection than can be achieved through buying individual REITs. Like REITs, these funds are pretty liquid.

Another significant advantage to retail investors is the analytical and research information provided by the fund. This can include details on acquired assets and management's perspective on the viability and performance of specific real estate investments and as an asset class. More speculative investors can invest in a family of real estate mutual funds, tactically overweighting certain property types or regions to maximize return.

Why Invest in Real Estate?

Real estate can enhance the risk-and-return profile of an investor's portfolio, offering competitive risk-adjusted returns. In general, the real estate market is one of low volatility, especially compared to equities and bonds.

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Real estate is also attractive when compared with more traditional sources of income return. This asset class typically trades at a yield premium to U.S. Treasuries and is especially attractive in an environment where Treasury rates are low.

Diversification and Protection

Another benefit of investing in real estate is its diversification potential. Real estate has a low and, in some cases, negative, correlation with other major asset classes—meaning, when stocks are down, real estate is often up. This means the addition of real estate to a portfolio can lower its volatility and provide a higher return per unit of risk. The more direct the real estate investment, the better the hedge: Less direct, publicly traded vehicles, such as REITs, are going to reflect the overall stock market's performance.

Because it is backed by brick and mortar, direct real estate also carries less principal-agent conflict, or the extent to which the interest of the investor is dependent on the integrity and competence of managers and debtors. Even the more indirect forms of investment carry some protection. REITs, for example, mandate that a minimum percentage of profits (90%) be paid out as dividends.

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Inflation Hedging

The inflation-hedging capability of real estate stems from the positive relationship between gross domestic product (GDP) growth and demand for real estate. As economies expand, the demand for real estate drives rents higher, and this, in turn, translates into higher capital values. Therefore, real estate tends to maintain the purchasing power of capital by passing some of the inflationary pressure onto tenants and by incorporating some of the inflationary pressure, in the form of capital appreciation.

The Power of Leverage

With the exception of REITs, investing in real estate gives an investor one tool that is not available to stock market investors: leverage. Leverage means to use debt to finance a larger purchase than you have the available cash for. If you want to buy a stock, you have to pay the full value of the stock at the time you place the buy order—unless you are buying on margin. And even then, the percentage you can borrow is still much less than with real estate, thanks to that magical financing method, the mortgage. Most conventional mortgages require a 20% down payment.

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However, depending on where you live, you might find a mortgage that requires as little as 5%. This means that you can control the whole property and the equity it holds by only paying a fraction of the total value. Of course, the size of your mortgage affects the amount of ownership you actually have in the property, but you control it the minute the papers are signed.

This is what emboldens real estate flippers and landlords alike. They can take out a second mortgage on their homes and put down payments on two or three other properties. Whether they rent these out so that tenants pay the mortgage, or they wait for an opportunity to sell for a profit, they control these assets, despite having only paid for a small part of the total value.

How Can I Add Real Estate to My Portfolio?

Aside from buying properties directly, ordinary investors can purchase REITs or funds that invest in REITs. REITs are pooled investments that own and/or manage properties or which own their mortgages.

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Why Is Real Estate Considered to Be an Inflation Hedge?

Home prices tend to rise along with inflation. This is because homebuilders' costs rise with inflation, which must be passed on to buyers of new homes.

Existing homes, too, rise with inflation though. If you hold a fixed-rate mortgage, as inflation rises, your fixed monthly payments become effectively more affordable. Moreover, if you are a landlord, you can increase the rent to keep up with inflation.

Why Are Home Prices Impacted by Interest Rates?

Because real estate is such a large and costly asset, loans must often be taken out to finance their purchase. Because of this, interest rate hikes make mortgage payments more costly for new loans (or on existing adjustable-rate loans like ARMs). This can discourage buyers, who must factor in the cost to carry the property month-to-month.

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The Bottom Line

Real estate can be a sound investment, and one that has the potential to provide a steady income and build wealth. Still, one drawback of investing in real estate is illiquidity: the relative difficulty in converting an asset into cash and cash into an asset.

Unlike a stock or bond transaction, which can be completed in seconds, a real estate transaction can take months to close. Even with the help of a broker, simply finding the right counterparty can be a few weeks of work. Of course, REITs and real estate mutual funds offer better liquidity and market pricing. But they come at the price of higher volatility and lower diversification benefits, as they have a much higher correlation to the overall stock market than direct real estate investments.

As with any investment, keep your expectations realistic, and be sure to do your homework and research before making any decisions.

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