PASSIVE REAL ESTATE INVESTING

101

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Passive Real Estate Investing:

REA CAPITAL MANAGMENT

101

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INTRODUCTION

This is the first part in our Real Estate Private Equity Educational Series.

The goal of this eBook is to introduce you, the reader, to the world of Passive Real Estate investing. In the following pages, I will discuss some of the basic differences between investing in equities and investing in real estate. What the pros and cons of each are, and then dig deeper into what a real estate syndication is, and what makes it a very powerful investment vehicle.

After learning what can make real estate syndications a great tool to:

- Create generational wealth
- Provide cash flow
- Provide capital appreciation
- Provide tax savings.

I will explore in more detail the Critical SAFETY RULES that must be followed to ensure your investment success.

I began my career as a financial planner after graduating from Villanova University. During that time, I was extensively trained in investing in stocks/equities as the cornerstone for building wealth and creating a lasting financial legacy. While I still contribute to our equity portfolio on a monthly basis and believe in the long-term value of equities, my favorite asset class by far is real estate.

My interest in real estate was sparked by my brother-in-law, the CFO of a large pharmaceutical company, whose financial expertise I deeply respect. He began purchasing vacation properties and renting them out, which piqued my curiosity. I dove into the world of real estate investing, reading everything I could find—from books on wholesaling and fix-and-flips to strategies like BRRRR (Buy, Rehab, Rent, Refinance, Repeat).

I was captivated by the idea of owning tangible assets that generate cash flow and offer significant tax advantages, such as depreciation and 1031 exchanges. (A 1031 exchange, also known as a like-kind exchange, allows investors to defer capital gains taxes by reinvesting proceeds from a property sale into another qualifying property.)

Soon, my wife and I began buying, renovating, and renting properties—and we loved it. Watching our properties appreciate while generating positive cash flow, with tenants effectively paying down our mortgages, was incredibly rewarding. As our portfolio grew, however, so did the challenges—tenant issues, maintenance headaches, and the complexities of managing property managers. Over time, these frustrations began to wear on my wife.

Then, another door opened. When my youngest sister got married, her husband introduced me to the world of real estate syndications. As a partner in a real estate investment firm, he explained how multiple investors could pool their capital to acquire large-scale properties, completely passively. Investors received monthly cash flow and shared in the appreciation when the property was sold, all without the day-to-day responsibilities of ownership. I was hooked.

With my experience in managing a rental portfolio and my transition into passive real estate investing, **I came to a powerful realization: when done right, real estate can be one of the most reliable, straightforward, and profitable ways to build wealth.**

With that in mind, I invite you to read on and discover what I believe is one of the best ways to invest your capital. I'll also share the Critical SAFETY RULES—a set of principles designed to help you avoid 99% of investment pitfalls and make wise, informed decisions.

THE PASSIVE WAY TO REAL ESTATE

When most people think of investing in real estate, they think of fix-and-flips or buy-and-hold single-family rentals.

Many potential real estate investors, like you, have money and want to invest in real estate, but do not want to chase properties, tenants, and toilets. Or even if you did, you do not have the time. The great news is that you can invest in real estate completely passively!

What is a Real Estate Syndication?

A real estate syndication is a structure or relationship between a company, called a "Sponsor / Operating Partner," and multiple investors who pool their money to invest in real estate. The investors are passive, and the sponsor oversees the buying, operating, and ultimately selling of the property. That company and its key principles are also responsible for other things, such as accounting, tax returns, and making distributions to the investors. Bottom line … you invest your money and a real estate expert does all the work.

Unfortunately, there are many people out there who would love to take your investment money, and many of them are unqualified or unprepared for the responsibility, or simply do the job poorly.

But if done properly, investing in private real estate offerings can be a safe way to invest and diversify your portfolio.

My goal in creating this eBook is to show you how to evaluate both the real estate you will be investing in and the sponsors you will be investing with.

Investors often choose an investment opportunity because it promises the highest returns, the lowest fees, the highest profit split, or a large capital investment by the offering's Operating Partner. These are all numerical quantities that you can measure, and they are just like icebergs. You see the tops of them, and you think you are seeing the important part. But you likely are unaware of the enormous mass under the surface, and that is where the danger is. Making smart investment choices involves seeing under the surface, seeing the entire iceberg, and doing an analysis that matters. This book will start the process of showing you how.

The Passive Way to Real Estate

I started my career as a financial planner, and in my experience, I saw that most clients are checking their equity portfolios often to see if they are Rich or Poor that day.

This is exactly why I love real estate: I don't have to wake up every morning and wonder whether I'm rich or poor. Real estate just moves too slowly to require a daily health checkup. If you study markets properly, buy the right properties at the right price, and operate them correctly, you can achieve consistent and somewhat predictable results. This doesn't mean that things always go your way, but if stocks and commodities turn like a fighter jet, real estate turns like ship.

This is part of the reason the old-school 60/40 stock-bond portfolio is outdated. Modern portfolio theory emphasizes portfolio diversification, maximizing risk-return profiles, and attempting to flatten portfolio volatility. Real estate adds a non-correlated asset class to your investment portfolio to help you achieve all those things.

What are the Benefits of Real Estate as an Asset Class? [1]

1. **Diversification**
   If you agree that diversification is a motivating reason to add real estate to your portfolio, I have even better news. Real estate offers diversification not only from stocks, bonds, and commodities but from other real estate as well.

You can buy different types of properties. You can buy properties in different cities and even different states. But doesn't that add a lot of risk? Haven't you always heard that you should only buy property that you can drive to in less than an hour? What if you know absolutely nothing about apartment complexes or hotels? How can real estate that you know nothing about be a positive addition to your portfolio? What if you don't want to deal with tenants, toilets, and trash? Or you don't have the time to spend countless hours searching for properties? Or you just prefer not to spend your time that way? Those are just a few of the many challenges that investing in real estate presents.

How much of your investment portfolio should you dedicate to real estate? Diversifying into real estate isn't diversification at all if you allocate all your capital to real estate or if you allocate all your real estate capital to one single investment. Consider limiting your real estate exposure to 20 percent of your net worth if you are conservative or 50 percent if you are more aggressive. The bottom line is that the right answer for you is a personal decision and may depend on a lot of factors, so do what feels right, but don't go all in too fast. No opportunity will be the last one you'll ever see!

2. **It's less correlated to the public markets.**
   This simply means that if stocks go down, real estate doesn't automatically follow, unlike stocks or mutual funds that are tied to stock indexes.

3. **You can use leverage.**
   This means you can use debt to amplify gains. By way of a simple example, if you purchase a property and borrow 75 percent of the property's cost, and the property value goes up 25 percent, you've doubled your money.

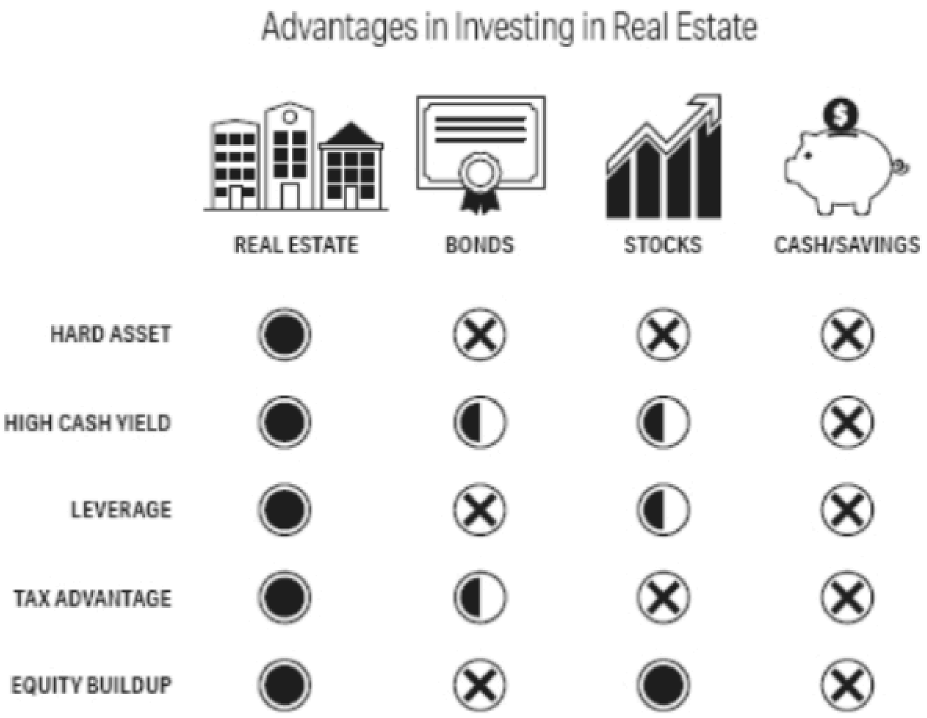
4. **Real estate is resistant to inflation.**
   In an inflationary environment, rents tend to go up. Increasing rents mean increased income. Expenses go up, too, so don't be fooled into thinking it's a one-way street, but it's very likely that rents will go up more than the higher expenses will offset. Inflation can also cause home prices to appreciate. Increasing home prices can make homeownership unaffordable, forcing more people into the rental market. Increasing demand from renters puts upward pressure on rents.

5. **Real estate is a hard asset.**
   There will always be some value in the land and buildings. While stocks can go to zero, real estate does not.

6. **Real estate tends to appreciate.**
   If you are looking to grow your capital (most people are), you're in a position of advantage with real estate. But you don't have to rely just on the market to increase its value. You can make repairs and upgrades, improve management, and reduce expenses to force the income and value higher. Try doing that with equities! The

concept of “forced appreciation” is one of the most important elements of investing in real estate.

7. **Real estate is a TAX-ADVANTAGED asset class.**
   Even though real estate tends to appreciate in value, tax laws recognize that buildings and improvements on real estate don’t last forever. The law allows real estate owners to depreciate the structures and improvements over specific periods of time. This means that it’s possible, and perhaps even likely, that you can receive positive cash flow while recognizing a tax loss.



What are the Downside’s of Real Estate as an Asset Class?

With all these factors in mind, it’s easy to see why real estate is such a desirable investment. So why isn’t everyone investing in it?

The main reason is that owning real estate can be a pain. It’s not like a stock that you buy in your brokerage account and forget about for a few weeks, a few years, or a few decades. For the most part, real estate requires active management.

Real estate is also somewhat cyclical. You probably saw the huge rout that took place in the mid-2000s. Deep depressions are rare, possibly even once-in-a-lifetime events, but real estate is not immune from ups and downs, and you might have to weather a storm or two. Many people don’t know how to “read” the market or just don’t want to. Professional real estate investors who are active in the market not only consistently study the related economics, but they also buy, sell, and rent properties continuously, which provides instant, up-to-the-minute feedback on the market. Casual investors are often intimidated by the market and choose to avoid investing in real estate altogether.

Real estate is also expensive. If you want to own real estate but don't want to be involved in the day-to-day drudgery that comes with it, you can hire a property manager. The quality of management increases as the size of the property increases. Generally speaking, the management system overseeing a $20 million apartment complex is going to be more sophisticated than the one overseeing a $30,000 single-family home. Not everyone can afford to go out and buy a $20 million apartment complex, so they either buy smaller properties, even though they might struggle with management challenges, or skip real estate investing entirely.

Fortunately, there is a better way, one where you can have it all: the ability to own very large assets without having to invest millions of dollars or deal with any of the hassles of owning property.

What is a Syndication?

A syndication, as mentioned earlier, is the structure or relationship between an Operating Partner / Sponsor and multiple investors who pool their money to fund a real estate acquisition or other venture. Investing in a real estate syndication means investing passively, alongside multiple other passive investors, with one person or company overseeing the acquisition, operation, and eventual sale of the property. That person or company is also responsible for various other tasks, including accounting, tax returns, and distributing funds to investors. In essence, you invest your money, and a real estate expert does all the work.

As you will see if we decide to work together, my team and I operate in a corporate culture based on an unwavering dedication to trust and integrity, and these business principles are applied every time we engage with clients.

However, there are stories around of unscrupulous investment sponsors leaving with the money and disappearing. Not only do these crooks victimize investors, they also victimize honest investment sponsors who must now explain to prospective investors why they aren't crooks. There are a lot of very honest sponsors in this business, and I'm sure each has the task of convincing investors they are honest. It's a constant fight, and investors are right to be careful, because at the end of the day, the moral character of the sponsor can be the most critical variable—and the most difficult to measure.

Additionally, more common than fraud and theft is incompetence: Operating Partners who get in over their heads, take improper risks, have insufficient analytical tools, or don't manage assets properly. Any of these can result in getting into a bad deal or totally screwing up a perfectly good one.

This information highlights the importance of thoroughly vetting the investment sponsors you will entrust with your valuable capital. Many people who invest in syndications don't know what questions to ask, how to recognize a properly underwritten acquisition, or how to properly compare one opportunity to another. My goal with this eBook is to help fix that.

Why Invest in a Syndication?

Real estate is a low-barrier-to-entry investment. If you have the down payment and can get the financing, you can buy real estate. So why would anyone invest in a syndication instead of just buying property directly? Let's run through the most common reasons.

Tenants, toilets, and trash. Dealing with tenants can be challenging and time-consuming, and everyone has heard landlord horror stories of 2 a.m. clogged toilet calls or rogue tenants who trash the place. There are ways to mitigate these annoyances, but many people avoid real estate due to these issues alone.

Time. If you have the cash to invest in real estate, you probably earned it by doing something you're really good at, and whatever that is, it probably takes up a lot of your time. Or maybe you have enough wealth that you don't need to work. Instead, you choose to spend your time traveling, golfing, sailing—whatever makes you happy. Trekking around looking at real estate isn't how you would choose to spend your time, or perhaps you have no extra time to do it, even if you wanted to. Let's not forget that looking at property is only the beginning. Getting financing takes time. Managing properties, or managing your property manager, takes time. Refinancing, reading management reports, responding to maintenance decisions, filing insurance claims, and selling the property—all these things take time.

Lack of local investments. My office is based in the Princeton, NJ Area, and some of my investors are also in the area, where a starter home can easily cost close to $1 million. I talk to a lot of investors who say, "I have $200,000 available for a real estate investment, but that isn't enough for a 25 percent down payment plus closing costs where I live." That's true, and it doesn't even address the fact that the returns on a $1 million rental home almost always are not sufficient. Another option is to look for properties two to three hours away, where the numbers are more favorable, but many people in this situation don't have the time to hunt for and manage such properties. Expensive markets aren't the only ones presenting problems. What if you live in a stagnant market, where homes are cheap but don't appreciate much? If houses in your area sell for $50,000 and you have that same $200,000 for a real estate investment, you'll have to buy several houses, increasing the management burden, which, if you lack time, could be an issue. You could buy a larger property, such as a small apartment complex, but you'd be doing so in a stagnant market, remember? Perhaps that's not the best choice, especially if you could invest in a syndication that gives economies of scale on a larger property located in an emerging or strong market.

Diversification. This is one of the most common motivations from investors in private offerings. There are a couple of subcategories of diversification that syndications can help you accomplish. Portfolio diversification means that you are just looking to add real estate to your investment portfolio, and are doing it through syndications in large part due to one or more of the reasons listed above. Geographic and asset class diversification are major reasons for investing in syndications, since you can invest smaller amounts of money in several assets in different areas and in different property types, versus investing a large sum in one single property that you own directly. Sponsor diversification means that you can invest with several different sponsors, which helps to mitigate sponsor risk by not over-allocating to any one group.

Liability. Let's be clear, wealthy people are targets for lawsuits. If you have substantial assets, making money is not as important to you as not losing what you have. Let's say the resident manager at your twenty-unit property is driving to the office supply store to buy supplies and hits a kid in the crosswalk. The grieving family is going to sue you, and your insurance company will defend you until they call one day and say that you forgot to purchase non-owned auto coverage, so this loss isn't covered by your policy. You're on your own. The multimillion-dollar judgment that comes next wipes you out—or at the very least, it hurts a lot. That's a risk you don't incur when investing in stocks, bonds, and mutual funds. Likewise, your investments in syndications don't present this same risk profile. Your risk is generally limited to the amount that you invested in the offering. If you invested $250,000 in an offering, in the above scenario, even with a multimillion-dollar judgment, you can only lose up to $250,000.

Cash. This reason to invest in Syndications goes two ways. Some people don't have enough money, others have too much. "Not enough money" could mean a variety of things, such as simply not having enough to invest in your specific market (like the one with million-dollar starter homes). Or perhaps you have enough to invest in a single-family home, duplex, fourplex, or even a fifty-unit apartment building, but you don't want to invest in a small property. You want the economy of scale offered by a 200-unit apartment complex, but you don't have enough money (or experience) to buy one on your own. You can invest in a syndicated 200-unit apartment building alongside other investors and reap the rewards of scale without having to come up with all the money yourself.

High-net-worth investors definitely need larger scale. Imagine buying tens of thousands of homes! There are some investors who won't write checks for less than $20 million. In many cases, they invest with operating partners so they don't have to get into the real estate business themselves. Then there are the folks in between, people who have a few million to allocate to real estate but don't want to invest in one or two properties. They would rather spread their money across various markets, in a range of property types, with multiple sponsors. This gives them ultimate diversification.

Lack of desire. Some people just don't want to be in the real estate business. They have the money, they have the time, they have local investment options available to them, but they would rather just invest in a syndication and go on with their daily lives. They have no desire to travel around hunting for properties to buy, nor to be involved in the day-to-day operation or management of property.

Inability to find a deal. I talk to many people who have spent countless hours searching for a property and come up empty-handed. They get outbid, the brokers don't return their phone calls, they don't hear about the good deals, or maybe they don't really know how to properly underwrite an income property. They give up on the do-it-yourself route and opt to invest in a sponsor's syndicated offering instead.

Syndications Solve These Problems

I am happy to report that if any of the above obstacles (or other reasons that aren't on this list) apply to you, syndicated real estate offerings can provide a path for you to invest in real estate. Syndications can solve other problems as well. One is what I call the **"professional advantage."**

For example, let's say you have an issue with your property. You feel you are "Handy" so you go to fix the issue. Problem solved, right? Several days later, and the problem still exists ... then more trips to the hardware store, more trial, more error, and you just can't fix it. You finally call a contractor, and in 15 minutes, the problem is fixed. The lesson here is that sometimes the professional just outperforms the DIY approach.

This is the case with real estate. As a professional real estate investor, I have been able to buy properties at big discounts to market value. At the same time, amateur would-be home flippers were making offers and coming up dry. One of the most common questions I got asked was, "How come I don't get good deals like that?" The answer is pretty simple: I do this for a living. I had a team of people reviewing nearly a thousand houses per week, and we were bidding on dozens of properties each week. There is just no way the casual investor who looks at one bank-owned property and submits an offer on it is going to strike oil. It takes persistence, consistency, elbow grease, and systems.

The situation just described is the same case in the world of commercial real estate. Brokers want to sell to investors they know, buyers they are sure will perform. The casual investor is at an immediate disadvantage. The only way the one-off buyer beats the pro is if their offer is so ridiculously high that the seller would be a fool to ignore it. Investors often fear that they are giving something up by investing in a syndication versus buying property directly because sponsors earn their living by charging fees and splitting the profits. If you buy properties on your own, you save those fees and splits, or so the theory goes. But if you aren't a professional investor, you're passing up dollars to chase coins.

A great real estate Operating Partner / Sponsor can get:

1. **Better deals than the casual investor**
2. **Buy larger deals than many casual investors,**
3. **Operate the property and execute the business plan better than an inexperienced investor.**

All those advantages squeeze more profit from the investment, so it's certainly possible that a good syndicator can produce a net return to the investor (after splits and fees) that is equivalent to, and possibly even more than, the amount the casual investor would achieve on their own through direct real estate ownership. Plus, that all happens while you are spending your time and energy on other things that you actually want to spend time doing.

This is what Financial Freedom is About.

Leverage is what you get with Syndications

The most important word when investing in syndications is LEVERAGE.

In real estate, we think of leverage as debt, which amplifies return on the invested capital. But in the context of syndications, leverage takes on a whole different meaning.

Leverage in this sense means the passive investor can:

1. **Leverage the sponsor's knowledge** to find the right investment and implement the right strategy, in the right place, at the right time

2. **Leverage the sponsor's experience, contacts, and systems** to source deals that you could not source on your own

3. **Leverage the sponsor's access to deal flow** located by their full-time staff who are dedicated to finding investment opportunities

4. **Leverage the sponsor's financial strength** to obtain the best financing terms

5. **Leverage the sponsor's team** to professionally manage the asset

6. **Leverage the sponsor's market research and skill** to execute the business plan by making decisions that maximize return and minimize downside

7. **Leverage the sponsor's time to find the right properties** and execute a complicated business plan so the investor can do other things

8. **Leverage the sponsor's network to find the right properties,** the right financing, and the right insurance; form the right legal structure; and handle construction and remodeling

9. **Leverage the capital of other investors** so that, as a group, the investors can invest in deals larger than they could or would invest in on their own

What is the primary responsibility of a syndication sponsor?

To Add Value!

I do not mean add value to the real estate (although this is an expectation as well). I mean that should add value to the relationship, to their client, the passive investor.

Sure, you can invest in real estate without an operating partner. **But if syndicators add value and help you accomplish your goals, they satisfy a need for you.** Every sponsor should strive to add value at every stage of the investment process, and every passive investor should seek sponsors who do just that.

Are Syndications a Fit for You??

People invest in syndications for a variety of reasons. They're a great tool for solving a lot of problems or creating a better path to add real estate to your portfolio, but they aren't for everyone. Suitability is an important and often overlooked factor in the syndication world.

Accredited Investors
One common gauge for suitability is the concept of the accredited investor (See appendix). There is no specific class, test, or certification required for accreditation, so the term is somewhat misleading. An accredited investor is someone who meets the definition set forth in the securities code.

At the time I wrote this ... anyone whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million (excluding the value of their primary residence) automatically qualifies as an accredited investor.

Another way to qualify is income. Any person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year qualifies as an accredited investor regardless of net worth.

Other Qualifying Factors
Suitability comes down to a variety of factors far beyond the investor's net worth and income. Most importantly, are you familiar enough with real estate investments and syndications to properly evaluate the opportunity and understand the risks? After reading this book, I hope that the answer to this is yes! Is your capital a match for the business plan? In other words, you don't want to invest short-term capital in long-term projects. Conversely, investing long-term capital in short-term projects might not be the best idea, either.

Limited Liquidity and Risk Tolerance
Most real estate investments have a lack of liquidity, meaning you can't get your money back whenever you want it. Investing in a project with a business plan to purchase a home, renovate it, and immediately resell it has a fairly high liquidity component because the home is likely to be owned for a relatively short period, such as a few months. But purchasing a stabilized, cash-flowing multifamily property or Hotel could have a five- or even a ten-year business plan, or a five-year plan that turns into ten if the market isn't cooperating at the time of the intended sale. In either event, your capital could be tied up in that property for the entire hold period with no way to get any of it out, except for selling your ownership interest to someone else. But unlike conventional stocks, there is no secondary market for you to sell your interests. They are very difficult,

if not impossible, to sell, unless you have a friend or family member who wants it, or perhaps a well-capitalized sponsor who would buy you out. My point is that if you might need your capital in a short period, a longer-term business plan may not be suitable for you.

There is also the issue of your risk tolerance versus the investment's risk profile. If you are risk-averse, a ground-up development deal might not be suitable for you, despite your overall goal of capital growth and your lack of need for current cash flow.

The Start

Investment Fund Managers or Sponsors should be taking the time to get to know you and set up a phone call with you. During that call, they should ask about your goals and objectives, your risk tolerance, and your priorities as they relate to cash flow and capital growth. In addition to learning about you during the introductory phone call, the fund manager should clearly explain what they do, without using a lot of jargon. They should take the time to answer every question you have. If they don't have the answer, they shouldn't make it up; they should research it and get back to you promptly.

The reason for this conversation is to establish a relationship with you and to learn which offerings might or might not be suitable for you. Be skeptical of sponsors who don't seem to care if you are a suitable investor. This likely means they don't care if their other investors are suitable either. That might not seem like your problem, but it is if unsuitable investors are investing in the same offering as you. Their problems can turn into your problems when the going gets tough.

[1] Brian Burke, *The Hands-Off Investor (BiggerPockets Publishing), 10-29.*

Introducing the Critical SAFETY RULES for investing in Syndications

These 11 rules are straightforward to follow and do not require extensive research or prior experience to learn them. In fact, I am sharing them with you for free, just to show you how simple it is to protect yourself when investing in real estate. Here's the truth: anyone can become a savvy real estate investor; all it takes is patience, education, and action.

Rule #1 – Never Invest Based On Projected Appreciation

Rule #2 – Always Invest Based On Cash Flow

Rule #3 – See Each Of Your Investments

Rule #4 – Expect Things to Go Wrong

Rule #5 – Get It In Writing!

Rule #6 – Never Rely Solely On a Contract

Rule #7 – Live Where You Want To Live, Invest Where It Makes Sense

Rule #8 – Never Let Leverage Eat Your Cash Flow

Rule #9 – Be Careful When Selecting Your Property Manager

Rule #10 – Make Sure Your Property Is Properly Insured

Rule #11 – Separate Your Assets!

As you may have already recognized, the investment strategies outlined in this eBook are not designed for those seeking thrills when investing in real estate. They are catered to investors who focus on a slow-and-steady approach to building financial freedom.

Now, before you ask, I'll tell you the answer: YES, there is a rule that can help to eliminate the last 1% of real estate investment problems. If you take the time to finish this E-book, I will share with you the one rule that should effectively make your real estate portfolio 100% problem-free.

Rule # 1: Never Invest Based On Projected Appreciation

By far, this is the most important rule of investing in real estate; in fact, almost half of all real estate tragedies occur because someone failed to follow this simple yet crucial guideline. Unfortunately, many believe that because there is only so much land, real estate prices will always go up. This belief leads people to invest in markets that are "desirable" and therefore have a greater chance of appreciating more quickly. This philosophy causes problems when investors start to buy properties based on aesthetic values rather than the ability to produce income.The problem is that when there is no quantifiable way to appraise a property's value, all objectivity goes out the window. Flipper after flipper will attempt to squeeze every last penny of profit out of a property. These investors are essentially playing hot potato with their capital, hoping they will sell their property before the bubble bursts.

Remember: You cannot control or predict the fluctuations of the retail market.

You may think you have an upper hand, but so did the rest of the real investors that went belly-up during the 2008 crash. The retail market is fickle and can change on a dime. Don't get caught up in the excitement of a real estate agent projecting 25% annual appreciation for the next five years. This not a reliable way to invest, and you will certainly regret basing your investments on this projection alone.

Most of these appreciation-based investment nightmares come from investments in states where the prices are notoriously the most volatile in the country. California, Florida, Nevada, and Arizona, to name a few, are responsible for many of the great losses of the real estate "gurus" of the 2000s. Those four states alone make up almost 50% of all the foreclosed properties and defaulted mortgage debt in the nation since the 2008 bubble burst.

Do not end up like those investors.

As part of your due diligence process, review past price fluctuations and future projections. It's important to only invest in markets that have a proven track record of price stability, rather than volatility. Structure your investments so that you will be happy with the return, even if the property never increases in value. This will keep your capital well protected and give you peace of mind.

Just like the general economy, real estate is cyclical, following a series of price appreciation and depreciation. Don't get caught in the wrong part of the cycle. If you focus on income production, rather than future appreciation, you will be able to weather a downturn in the market if need be.

Rule # 2: Always Invest Based On Cash Flow

Did you know that during the real estate bust, property values depreciated by more than 30%, while property rents only decreased by 3%? That is ten times less volatility. That alone should show you why I am so drawn to cash flow focused investing.

Because rent rates are so much more stable than property values, I determine each property's value based on its ability to produce income. This way, I am able to acquire a much more reliable appraisal of the property without worrying about the aesthetic elements of the property.

If you are not extremely familiar with the market in which you're looking to invest, here is a link to a website where you will find a good starting point for estimating rent in the area. www.rentometer.com

If you are intrigued by the projected rents you see from RentOMeter.com, call up property management companies in the area in order to get some hands-on feedback from those in the field. Some rental prices vary street-by-street, so make sure the property management company you contact has extensive knowledge of your property's location.

Once you have a solid understanding of your market's rent rates and purchase prices, you have enough information to begin estimating your cash flow expectations.

Calculating CAP Rate

The most fundamental cash flow calculation metric in real estate is the

Capitalization Rate (CAP Rate). The CAP Rate formula encompasses the property's rental income, expenses, purchasing price, and vacancy, and therefore can give you a reasonably good idea of the profitability of an investment.

Remember, the CAP rate is only an estimate to determine what rate of return a rental property will produce if it is purchased all-cash. The CAP rate is only one of many factors you will consider when making the decision on whether or not to invest.

Let's take an example property and calculate its CAP Rate:

Purchase Price: $80,000
Monthly Rent: $1,000

Gross Potential Income (Annual Rent): $12,000
(8%) Vacancy: $960
Annual Expenses: $4,968

Now that we have the breakdown of income and expenses, we can find the first element of the CAP Rate, which is the Net Operating Income (NOI).

Net Operating Income (NOI) is a property's income after operating expenses and vacancy are deducted.

NOI = (Gross Potential Income) $12,000 - (Expenses) $4,968 - (Vacancy) $960

NOI = $6,072

A **CAP Rate** is a rate of return on a real estate investment property based on the

expected income that the property will generate if purchased in all cash.

CAP Rate = Net Operating Income / Purchase Price

CAP Rate = $6,072 / $80,000

CAP Rate = 7.6%

There are two assumptions in the CAP rate formula that can cause a great discrepancy between projections and performance: Vacancy Rate and Expenses. Remember, if the property is vacant, it will not produce any positive cash flow, so estimating the CAP Rate is useless unless you have validated a strong rental demand for your property. Additionally, expense projections can vary significantly based on neighborhood, property value, and tenant demographics. I will discuss later in this book how to conservatively estimate both vacancy rates and expenses, so that your projections will set you up for success.

In all of my investment markets, I am able to attain **at least a 1.2% rent-to-price ratio**. This means that a property that rents for $1,000 per month will sell to an investor for $80,000. Usually, an investment property with a 1.2% rent-to-price ratio will produce a 7.6% CAP Rate.

The bottom line is that if you are in the market for a property that is renting for $1,500 a month and another buyer is willing to pay $250,000 because he likes the view, let them have it. Move on! **As real estate investors, we cannot get attached to a property for any reason other than its ability to produce cash flow.**

It is also essential that you understand the difference between current cash flow and projected cash flow. Think of it like this: **Investing in a property based on a projected 25% increase in cash flow is the same as investing in speculative appreciation.** I want quantifiable returns based on actual current figures — NOT aggressive future projections.

Rule # 3: See Each of Your Investments

Though I live in the city of Princeton, all of my investments are outside the state of New Jersey. Even though most of my investments are far from where I live, I have managed to see 100% of them by either visiting them myself or by having someone I trust conduct property walks with photos and videos. While personally visiting your markets may not make sense to you, it is crucial that you get eyes on all of your investments. Although it's a simple step, very few novice investors follow through with it, leaving them vulnerable to property misrepresentation.

Step One: Google Maps

As basic as it sounds, a great first step when gauging interest in a property is to check Google Maps, which can give insight into the neighborhood and property itself. Google the address and zoom into the street view of the property, giving you a detailed depiction of the exterior of the home and the surrounding area. From here, take note of the neighborhood. Notice the level of pride of ownership in the area. Are the neighbors' houses nicely kept, or do you see cars without tires parked on the lawns? Are there broken windows in the surrounding houses? Is there graffiti or vandalism in the area? Take the time to fully observe before taking your next steps.

If you notice several signs that the neighborhood lacks pride of ownership, simply move on. Don't be fooled by the high rents and low purchase prices of these areas. These properties may look good on paper, but they will never perform as projected. It doesn't matter what the property rents for if you are constantly evicting tenants for leaving trash in the streets and broken-down cars in the yard.

Step Two: Get an Agent Involved

Remember that Google Maps is not updated on a daily basis, but it's a good place to start. If you like what you see to get started. If you like what you see from Google, call an agent and tell them you are thinking about buying the property. Explain that you would appreciate it if they would walk the property and take photos to give you a ballpark figure of what the property is worth, as well as any repairs he or she think the property needs. Most agents will do this for free because they want you to list the property with them if you decide to buy or sell it. You can also order a Broker's Price Opinion (BPO) at a very reasonable price. A BPO is basically a drive-by appraisal conducted by a real estate agent that provides a 2-3-page report summarizing the property's external condition and lists several comparable sales in the area. This report will give you a reasonable estimate of the property's value without the time and cost of an appraisal. I have found both real estate agents and BPOs to be pretty conservative in their pricing, and they are excellent tools for initial due diligence.

Step Three: Verify Your Assumptions With a Third Party

Even if the property is out of state, just a few phone calls can verify the property's condition and save you a world of financial trouble.

Matt Faircloth, one of the most well-known cash flow investors in the U.S., taught me this rule through a brutal investment that I'm sure he had nightmares about. He summarized a deal he closed with a note broker, where he invested $250,000 in a pool of notes with an unbelievable projected yield. Just a couple of days later, he got a horrifying phone call explaining that the broker with whom he had closed that deal was being sued for fraud. He rushed to the area where the properties were located, went to the specific address...and what did he find? A huge interstate running right through where the properties used to be.

Learn from this veteran's mistake. All he had to do was send a real estate agent out the property's location, and he would have avoided this financial tragedy.

Rule # 4: Expect Things to Go Wrong

Never blindly trust a projected pro forma without first running your own **conservative** numbers to ensure that the property will perform under **less-than-optimal circumstances.**

When reviewing pro formas, the first thing to determine is whether the projections are setting the investor up to expect more than they will actually receive. When it comes to financial planning, it's best to set up scenarios that **under-promise and over-deliver** on expectations. Obviously, over-promising and under-delivering is not an option.

The first metrics to look at in a pro forma are the projected vacancy rates. If the property only generates a strong return at 98% occupancy, you will need to reconsider your investment. **Projecting an 8% vacancy rate is the industry standard**, implying that every year, the property is vacant for one month. Most tenants sign one-year leases, and there is usually some lag time for clean-up before a new tenant moves in. To be safe, run the numbers again and see if the deal still makes sense at 12% and 15% vacancy rates. Anticipating potential higher-than-expected vacancy rates can be crucial in setting your expectations before making a final decision.

Just to let you know, operators and agents often try to sneak other misleading figures into pro formas to inflate the returns. For instance, I have seen many projections where there is an expected substantial decrease in **operating expenses** the second you take control of the building. If the building is operating at a 48% operating expense ratio prior to you closing, there better be a damn good explanation if that number is projected to decrease to 34% within the first year of your purchase.

The **expense ratio** of a property is the percentage of a property's income that will go towards expenses.

Expense Ratio: Expenses / (Gross Potential Income – Vacancy)

Typically, a 50% operating expense ratio is a good, conservative rule of thumb to base your numbers on initially; however, it is crucial to review the previous 2-3 years of financial statements to make accurate future projections. If they don't want to give you the necessary docs, just walk!

Safeguarding Your Investment Through Economic Diversification

One way to safeguard your investment is to invest in an area that is inherently diversified across all sectors of its economy, particularly in employment. There are many markets where the economy can be bolstered by a single industry or even a single company. I always steer clear of these markets because I don't want to have my investment relying heavily on one facet of the economy. I look for a good mix of employment opportunities in manufacturing, healthcare, education, transportation, and technology when selecting a location to invest in.

One way to limit many of these one-sector cities from your portfolio is to exclusively focus on large cities. **I only invest in areas where the population of the major metropolitan area exceeds 500,000**. This way, if one company moves out, I am not worried about the area's economy going down the drain.

Rule #5: Get It in Writing!

One of the big mistakes novice investors make is not specifying their expectations in writing **prior to investing**.

"I **assumed** the seller was paying for the roofing prior to closing; I would have never agreed to this price if I had known I would be footing the bill for that!"

I have heard some variation of this story many, many times. Do not attempt to negotiate after you have closed. Remember, reading through legal clauses thoroughly may not be the most riveting experience of your investing career, but it could help you stay out of the courtroom!

Here are some examples of the most crucial clauses you will want to discuss:

A) Finance Terms

Most real estate transactions require the creation or transfer of a mortgage in order to close the deal. Make sure you, the seller, and the lender are on the same page as far as interest rates, down payment, default procedure, assignment of the deed, and whether or not the loan is assumable. Once you have specified the terms, get it in writing, and make sure you record any liens on the property immediately upon closing.

B) Specify Who Pays Specific Closing Costs

Your agreement should specify whether the buyer or the seller pays for each of the standard fees associated with a purchase of a home. Make sure an itemized chart of escrow fees, title search fees, title insurance, notary fees, recording fees, transfer tax, and so on is all agreed upon.

C) Home Inspection

Always get your property's home inspected prior to purchase. The most critical aspects of the inspection process include environmental hazards, roofing, plumbing, and electrical systems. In your contract, be sure to include a clause that allows you to walk away from the deal in the event that there are unforeseen, significant flaws in the property’s condition. It is important to remember that this clause does not force you to walk away, just that it gives you the option to, depending on the situation.

D) Fixtures and Appliances

Specify any fixtures and appliances that are to be included in the purchase. Don’t assume that because there was a refrigerator in the kitchen when you walked the property, it will be there after closing. Be sure to note if there is an HVAC system, its age, and the system's operational condition.

E) Closing Date

Allow yourself **plenty** of time when scheduling your closing date. Standard time frames for closing are 30, 45, and 60 days. Be conservative. Especially when obtaining institutional, FHA, or government financing, it is crucial to act quickly to close your deals. Appraisals can come in low; the title can be cloudy; the home inspection can reveal major defects; the financing can fall through; or the property can prove uninsurable. Ensure you have allocated sufficient time and mental preparation to address these problems, as they are reasonably common.

F) Clear Title

Please always stipulate in the contract that you are only obligated to close if the property is given to you with a clear title. Unreleased mortgages, incorrect liens, third-party mortgages, lawsuits, personal credit issues, and zoning issues all can cause massive headaches. This is precisely why you put in a “Clear Title Clause” in **every single contract**. Again, it is not mandatory that you exercise your right to drop the deal—it simply gives you the right to walk or re-open negotiations.

G) Specify If the Offer Is Contingent Upon the Sale of Another Property

Many real estate transactions involve someone selling one property to purchase another. If this is the case in your transaction, make sure you specify this in your contract. This way, if you are unable to close the sale of your asset, you are not contractually obligated to go through with the deal. Be sure to explain your situation to the person you are completing this transaction with, and give yourself a conservative window in between closings.

I think you should work out the contract between the buyer and you before using the attorneys. Once you come to a general understanding, it is essential to have an attorney review all of your documents. Make sure that your attorney is practicing in the state in which the transaction is taking place and that the contract follows any state-specific laws. I attended a seminar once where the speaker was a well-known real estate investor in the Los Angeles area. Five minutes into his speech about funding for hard money loans, I realized the strategy he was explaining was actually a felony in the state of California. He explained that interest points do not count towards interest if they are paid after the loan is due. In California, usury laws do not allow rates to exceed 10%, unless they are conducted through a broker – this actually includes points! Making an error like this cannot only postpone your closing date, but you could do jail time!

Many of these legal clauses, **especially financing clauses**, can be state-specific, so be very diligent to stay within your state's guidelines.

Rule #6: Never Rely Solely On A Contract

Even though it is crucial that you get everything in writing, never rely solely on a contract if you need a person to deliver. When looking at investments, especially passive investments where you rely on a manager of some kind, it is critical that you remember this important point: you are making a bet on a person, not on a piece of paper.

When I am looking at new investments, I make a point to routinely acknowledge my "gut instinct" when evaluating an operator's approach to their business and projections.

Are they putting themselves in a position to over-promise and under-deliver? Or are they being conservative in their projections, so that you can rely on them to perform as expected?

- Are they underestimating the vacancy rate?
- Are they overestimating or emphasizing the property's projected appreciation?
- Are they excluding marketing and closing costs in your profit and loss projections?

If the answer is "yes" to any of these questions, you need to find out why.

One of the very tricky things some operators do when attempting to pad the numbers is to increase rent rates at a greater rate than they increase operating expenses.

For example, some operators project a 5% annual rent appreciation, while the operating expenses increase by only 2%, or sometimes not at all. This creates a widening gap in projected operating expenses and rental income, which can significantly exaggerate the cash flow over the long term. In fact, the impact is exponential (literally).

When operators implement tricks like this, I usually walk away from the opportunity. I do not rely on contracts or properties to protect me from operators that are just trying to squeeze the numbers any which way to make the deal look more attractive.

The Importance of Background Checks

I asked Matt Faircloth, a well-known full-time passive cash flow investor, to share some of his thoughts regarding the due diligence process when it comes to finding out the track record of the person with whom you are doing business:

"**One crucial part** of the process involves running background checks on all of the managers involved in your business deal to ensure that none of them has a shady history, including the possibility of committing fraud. In fact, whenever I speak with another investor and learn that one of their investments went bad, the first question I always ask is this: "Out of curiosity, did you perform a background check on the managers?" Sadly, over the course of many years, I have yet to hear as a response that someone actually performed a background check. And I know for a fact that these checks have saved me multiple times. **Background checks** may be the single most overlooked aspect of due diligence among investors. Don't take the risk—be sure to perform background checks!

If anything unusual shows up in a background check, I never take the risk of investing with someone, as it's just not worth it. There are plenty of good opportunities and good managers out there. If a background check reveals multiple lawsuits against that person in the past, then that alone is a clear sign to pass and move on to the next opportunity. I once performed a background check on someone with whom I was considering investing and who had recently moved to my state. To my surprise, this person had over 40 separate lawsuits against him across 2 states. It was clear that he would move to a state, defraud investors, and then move on to another state. It was my state's turn, and thanks to the relatively inexpensive background check I performed, I'm quite sure I saved myself from losing my entire investment."

Matt has a great point when you consider that there are so many good operators to work with and no reason to risk working with someone with a questionable background. At the end of the day, lawsuits are expensive. The only time a contract is really going to protect you is in court. Depending on the investment size, this might not be a feasible option. Because of this, it is better to base your investment on the person's ability to deliver rather than on a contract. This way, you'll avoid going through a stressful and costly legal process.

Rule #7: Live Where You Want To Live, Invest Where It Makes Sense

One of the age-old causes of real estate horror stories is investors who want to invest as close to where they live as possible, as that is the area with which they feel the most comfortable. This strategy only works if you happen to be living in one of the nation's best cash flow markets, which more often than not isn't the case.

Most of these volatile markets are speculative places to invest, as market timing becomes extremely crucial yet simultaneously difficult to predict and impossible to control. There are several markets that do not experience significant fluctuations and inherent risks.

As I have mentioned before, I live in the sunny city of Los Angeles, CA, one of the areas with the worst cash flow in the country. Yet, I remain a strictly cash flow-focused investor. Granted, there are different risks associated with out-of-state investing, but if you live in a market where the cash flow doesn't make sense, don't be afraid to look across state lines.

If you live in an area that suffers from value volatility, low cash flow, frequent natural disasters, or is going through an economic downturn, you should definitely consider investing in another area.

Take a market like Jackson, Mississippi, for example. During the most recent boom-bust cycle, the city experienced only two quarters where rents decreased. During these two quarters, rent prices decreased by a total of -8%. **This loss was recovered within a 12-**

month period! If you were investing there for cash flow, you had nothing to worry about!

One of the mantras to remember when considering a real estate investment is that real estate is local, not national. No matter what the media says, there are markets out there that are screaming for cash flow investors. In some cases, economic downturns can even create rare opportunities for cash flow as investors provide financing for stable investments that would otherwise not be available.

Rule #8: Never Let Leverage Eat Your Cash Flow

Leverage is a double-edged sword. While leverage is one of the great benefits of investing in real estate, it can also lead to foreclosures and bankruptcies. You may have heard that real estate has created more millionaires than any other asset class; what you might not have heard is that real estate has also caused more bankruptcies as well! The reason for this is leverage.

So, what is the main difference between good leverage and bad leverage?

Cash Flow!

Let's say, for instance, that there is a property you are considering purchasing. The property is located in Memphis, a strong cash flow market, and has a purchase price of $90,000, a monthly rent of $1,000 and a 40% operating expense ratio.

Purchase Price of a Property:	$90,000
Monthly Rent:	$1,000
Operative Expenses:	$400
Net Income:	**$600**

Based on these initial numbers, this property has the potential to generate a quality cash flow.

However, let's see what happens if you close this deal with 0% down ...

Loan:	$90,000
Interest Rate:	7.25%
Amortization:	30 years
Payment:	**$613.96**

(Net Income) $600 – (Debt Payment) $613.96 = (Cash Flow) –$13.96

As you can see from this example, the use of the 0% down loan can result in the cash flow going **NEGATIVE**, even though the property itself looks like it could produce some good returns.

If you invest in a deal like this, you will be paying down the mortgage and **relying on the market's appreciation, instead of cash flow**, to dictate your financial future. If the only way you will end up making money is based on the property's value, you are setting yourself up for failure.

- What happens if the property **value decreases** and you owe more than it's worth
- What happens if your property goes **vacant** for a month?
- What happens if you need some **maintenance** on the property?

If you are forcing yourself to go out of pocket every month, even while the property is occupied, you are **really** going to be hurting if things start to go wrong!

Now let's look at what would happen if you put 35% down and were, therefore, able to attain a lower interest rate and monthly payment.

Down payment:	$31,500
Loan:	$58,500
Interest Rate:	6%
Payment:	**$350.74**

(Net Income) $600 – (Debt Payment) $350.74 = (Cash Flow) $249.26

Now we're making money! This is what a solid cash flow investment looks like.

If you put 35% down, you have the previous month's cash flow to pay for repairs or unexpected expenses.

Most people start investing in real estate with the goal of achieving financial independence and retirement. Are you going to begin building your retirement portfolio with a -$13.96 a month liability?

A good rule of thumb is to make sure your **Debt Coverage Ratio (DCR)** is conservative enough so that there will be room for things to go wrong. A property's debt coverage ratio is calculated by dividing a property's monthly income by its loan payment.

For Example, there is a property that produces $1,000 a month after expenses, and the monthly loan payment is $700. $1000/ $700 = **1.43 DCR**

The industry standard is a ratio of 1.3-1.5; therefore, ensure you stay within this range when determining how much debt your property can sustain.

Remember: If your debt coverage ratio is below 1.0, you will have a negative monthly cash flow and need to consider making a larger down payment. **When cash flow goes negative, there is a paradigm shift in everything that you are doing.**

When the way you are looking at an opportunity goes from "Let me get as many as I can find!" to "I can only afford so many investments like these!" you might be headed in the wrong direction.

Negative cash flow is not the way you want to build your real estate portfolio. The key to building your financial future is allowing for buffers and planning for potential setbacks. This way, when they do, you are prepared.

Rule #9: Be Careful When Selecting Your Property Manager

Any seasoned real estate investor will tell you, property management is probably the most critical part about protecting your investment. Especially if you are investing out of state, property management needs to be one of your top priorities. Here's a tip: Only work with in-house property management companies so that the same people selling you the asset are also responsible for its performance and management. When the asset team and the property management team are under the same roof, you know everyone's incentives are aligned for long-term, mutually beneficial business relationships. This may exclude a lot of companies from your portfolio, but trust me, the amount of transparency that you will achieve with in-house property management is unachievable in any other way.

It is also crucial that you get references from people whom you trust. If you are new to real estate investing, start by calling and asking real estate agents and asset teams who the best property managers are in the area. Most real estate markets are very tightly knit, and the good asset teams are familiar with all of the main players in their market.

Additionally, ensure that your property manager is well-versed in the specific needs of your neighborhood. For example, some specific neighborhoods are likely to be rented by HUD (Section-8) tenants, who have some or all of their rent subsidized by the government. If your property is going to be leased to HUD renters, make sure your property manager has an extensive track record dealing with these tenants. Some of the best cash flow opportunities in the U.S. have some HUD components, and the returns can be strong as long as your property manager understands the nuances of this market.

When I meet with property managers, I look for a couple of key signs when discussing their strategies:

- How do they go about tenant selection?
- How do they build a sense of partnership between themselves and the tenants?
- How do they go out of their way to encourage pride of ownership in their tenants' properties?

One of the key tricks of property management is to encourage tenants to treat the property as if they own it. If the tenant maintains this mindset, not only will they take care of the place, but they may also sometimes reach into their own pockets to address maintenance issues.

On the other hand, if the property manager doesn't take the time to make sure spray-paint or trash is removed from the surrounding areas of the property, the tenant will not show this pride of ownership in their home. This will result in little or no upkeep from the tenant, as well as establish a sour relationship between the tenant and the property manager.

One thing that I have found when comparing property managers is that the good managers will always mention the success of their tenant referral program. The truth is obvious: good tenants know good tenants. Make sure your manager has a strong track record of encouraging good tenants' friends to move in to another one of their properties. Some property managers give a free month of rent, some give out cash every time their tenant refers another tenant. Either way, it is essential that they are doing something that works.

Ensure your property manager is already utilizing Automatic Clearing House (ACH) payments, which are automatically deducted from the tenants' bank accounts each month. This will avoid most late payments, the age-old "it's in the mail" excuse, and it will save your manager valuable time from having to visit each property to collect rent money. I have all of my properties and mortgage notes set up for ACH payments, which makes things run very smoothly.

It is also essential that you align your incentives with those of your property manager. He should not get paid in full unless the property is occupied. Don't fall victim to large upfront fees that only serve the property manager's short-term interests. Ensure that the property manager receives payment based on rental income; this will motivate them financially to keep the place rented. I have seen several management agreements where a property will rent for $750 per month, and a proposed management agreement will be written as follows: "Owner will pay the property manager 10% of rental income or $75 a month, whichever is more."

If your management agreement is structured like this, your property manager has no incentive to get out there and rent the property because he is getting paid no matter what happens.

If you are negotiating with a management team, consider increasing the percentage of monthly rental income in exchange for them eliminating the minimum monthly payment for unoccupied properties.

Rule #10: Make Sure You Are Properly Insured

When it comes to insurance, some markets have special needs. Be diligent in understanding the risks associated with your particular market. **Tornadoes, floods, fires, and hurricanes** can all cause massive amounts of damage to your real estate investment, but if you are insured, chances are you'll recover in the long run.It is also advisable to deal with an insurance company that specializes in investment real estate.

Depending on the market, you might want to get insurance for rent loss, small maintenance problems, and even damage from **vandalism** by tenants. Your plan should be tailored to the specific costs and risks associated with your particular market.

Important Note: Hurricanes are in a league of their own. Virtually no common act of nature has the ability to destroy such a massive amount of property over a large geographic location. For instance, tornadoes can wreak tremendous havoc on properties, but the damage is limited to the small, condensed area of the tornado's path. Historically, insurance companies and government agencies have a well-defined plan of action and are quick to act in such circumstances. Conversely, hurricanes have caused damage in the past that has never been repaired, even if the properties are insured. Due to the sheer scale of the damage caused by hurricanes, insurance companies can become overwhelmed and unable to rebuild all affected properties. Because of this, **I stay away from hurricane hot spots.**

Also, make sure that if you are the owner of a mortgage note and using property as collateral for a loan, **you are listed as the loss payee on the insurance policy.** If you hold a note when a flood hits your property and the property owner defaults, you can foreclose on the property and then **accept money from the insurance company**. Therefore, make sure that the insurance policy is **"assignable to the lender."**

As a general rule, always opt for an insurance plan that can cover up to $1 million in damages. This has become the industry standard, and in the event of a catastrophe, you want to be well-protected. The difference between a $500,000 plan and a $1,000,000 plan might only be $5 a month, but it will be well worth it in a worst-case scenario. Usually, if something as serious as a death takes place on your property, the first thing prosecution attorneys will do is review your insurance plan. If the policy covers $1,000,000 or more of damages, they will oftentimes just settle for the insurance claim. This way, they can satisfy their clients without having to go to court. Of course, if you haven't properly separated your business and personal assets, they might pursue you for everything you have!

Rule #11: Separate Your Assets!

Have you ever heard the phrase "It's not what you make, its what you keep?"

When it comes to asset protection, this is the name of the game. There are thousands of "ambulance chasers" out there, waiting for someone to slip on a wet floor in a property that you own, in order to take a bite out of your personal asset column.

Do not let it happen!

You should never, under any circumstances, own investment real estate under your own name. When considering an investment property, always use a business entity to keep your assets separate and contain your losses.

There are many entities that can be used when investing in real estate: Land Trusts, Trust, S-Corps, General Partnerships, Tenants in Common, etc. However, over the last twenty years, the LLC has become by far the most popular entity for holding investment property due to several unique benefits it provides.

Most importantly, LLCs provide **limited liability** for all members, including managers. Unlike limited partnerships, where managers have personal liability for the company's business debts, in an LLC, all liabilities are held by the entity. This means members do not stand to lose their personal assets to cover business debts. Therefore, if there is an accident on your property that warrants a lawsuit, the only assets that are vulnerable are the assets inside the LLC that owns the property. This means that you could technically hold each property in its own LLC and keep your losses confined to that property alone.

However, owning each property in its own LLC might not make sense from a functional cost perspective. For instance, if you are investing in several properties valued at $50,000 each, the costs of creating individual LLCs for each property might negate too much of your cash flow to be profitable. Many investors will hold two to four $50,000 properties in one LLC to keep costs affordable while still appropriately limiting their liability.

On the other hand, if you are investing in more valuable assets and have several $1,000,000 properties, you should consider holding just one property in each LLC. Again, these decisions should be made jointly based on your investment and your comfort level.

LLCs are very inexpensive to establish and operate, but offer premium protection and extreme flexibility. In many states, a couple of hundred dollars is enough to shield you against personal liability.

Remember, once you have set up your entities, keep your assets separate. Do not use your business credit card for personal expenses, and always follow the formal guidelines that your state requires. **If you commingle your funds, a judge may find that your LLC is no longer valid and "pierce the corporate veil."** When this happens, any and all LLC affiliates can be held personally liable for company debts. This means creditors could potentially seize any assets indirectly associated with the LLC to satisfy corporate debt. Yes – this renders members' homes, bank accounts, and personal investments all vulnerable.

For most real estate investors, this is their worst nightmare. Make sure to schedule an annual meeting with your attorney and your tax advisor to ensure that your strategy will keep you well protected if the rubber meets the road.

Real Life Panic Story

The panic story that replays in my mind, and the reason that I wrote this book, comes from a relative of mine. Years ago, my uncle explained to me the dangers of investing in real estate, having experienced a tragic investment gone wrong himself. Soon after the conversation began, I realized why he was so averse to real estate investing. The opportunity he described to me was a vacant lot in South Florida. He purchased it with a sizeable loan at the peak of a real estate bubble. He didn't realize it at the time, but this investment strategy is akin to playing Russian Roulette with your finances.

My uncle bought this property in 1988, at the peak of the Florida housing boom, just before the savings and loan crisis ripped the bottom out of the market, and prices plummeted into the abyss. In 1988, the purchase price for this vacant lot was $325,000, with a 20% down payment. Less than two years later, the property was valued at less than $70,000. The mortgage on the property was close to $2,300 a month, and he paid this for more than two years, with no incoming cash flow. As prices started to race towards the bottom, he was forced to bite the bullet and accept that the foreclosure process was his only way out.

First of all, the property was located in South Florida, one of the most volatile and speculative markets in the United States. Second, the property was vacant, meaning there was no cash flow. Due to the lack of cash flow, the success of this investment relied heavily on projected appreciation. Thirdly, my uncle utilized leverage to attain this property, meaning he would be cash flow negative every month in order to pay the mortgage or risk foreclosure. It really doesn't get much worse than that.

Due to his limited understanding of these concepts and the market in which he was investing, he lost his $70,000 down payment, as well as nearly $55,200 in mortgage payments he had made before defaulting. He also severely damaged his credit and had a foreclosure on his record for the next seven years...What a nightmare!

It Doesn't Have To Be This Way!

Yes, of course, bad things can always happen. You can do as much as you can to mitigate the risks, but every now and then, something comes along that you won't be able to control. However, as long as you follow my 11 rules, you will be protected, prepared, and will have every chance to recover unscathed.

Insurance Flip: Matthew's Story

A fellow investor and mentor of mine, Mathew Toms, was involved in an opportunity that exemplifies what happens when you are properly prepared for things to go wrong. Mathew's close friend Andrew, who had invested in stocks all his life, decided to enter the great world of cash flow investments. They decided to close on his friend's first real estate property investment: a joint venture opportunity with a home in Nashville, TN.

Nashville is one of the nation's most stable and best cash flow markets. The rent-to-price ratio is greater than 1% and the quality of tenant is usually much higher than other areas that have similar rent-to-price ratios.

After thorough market research, they decided to invest in an $80,000 property in a good neighborhood. The property was newly rehabbed, and the current tenant was paying $1,000 a month in rent. After a successful property walk and a positive inspection report, they closed on the property.

Within two days, a strong windstorm hit Nashville. A tree fell on their investment property and smashed through the front of the house, essentially destroying their newly rehabbed property.

Being that it was Mathew's friend's first real estate investment, I am sure he was horrified. This is exactly the kind of nightmare that drives people to stay away from real estate and just park their money in a mutual fund.

However, due to the insurance coverage they had utilized, within a few short months, the insurance company paid out more than $125,000 for the property. Talk about a good flip!

As you can see, when you take the proper steps to mitigate your risk, you can secure your investment by limiting your exposure to uncontrollable forces. The bottom line is that I want control of my financial future, as opposed to having speculative gambles dictate my retirement. Because of this, I go through great lengths to make sure that I invest in properties where I can accurately predict the return the property will generate, as well as protect myself from downside risk.

Review the 11 Rules

Remember: There are only a few steps to follow to secure your investments:

- **Rule #1** – Never Invest Based On Projected Appreciation
- **Rule #2** – Always Invest Based On Cash Flow
- **Rule #3** – See Each Of Your Investments
- **Rule #4** – Expect For Things to Go Wrong
- **Rule #5** – Get It In Writing!
- **Rule #6** – Never Rely Solely On a Contract
- **Rule #7** – Live Where You Want to Live, Invest Where It Makes Sense
- **Rule #8** – Never Let Leverage Eat Your Cash Flow
- **Rule #9** – Be Careful When Selecting Your Property Manager
- **Rule #10** – Make Sure Your Property Is Properly Insured
- **Rule #11** – Separate Your Assets!

But wait!

Now, as promised, I am going to share with you the one rule that can eliminate that last 1% of problems that the previous 11 rules cannot. **This rule will protect you from anything from common natural disasters to attacks by alien invaders.**

BONUS RULE - DIVERSIFY

Diversification is a crucial element in building a fully protected portfolio. As soon as you start your investment process, you should always be looking to be as diversified as possible. This strategy will protect your portfolio from suffering massive damage when rare circumstances take place. The point is—when things do go wrong, they can't go that wrong if you are highly diversified.

When I am building a client's portfolio, I use several key metrics as a rule of thumb to ensure my client is not overexposed.

Remember: I am **not** a financial advisor. I have created a system that works for me and the majority of my clients. **Always** consult your personal financial advisor before making investment decisions.

01 Maximum Percentage Per Asset Class: 70%

(Residential Real Estate, Commercial Real Estate, Small Businesses, Stocks, Bonds,

Commodities, Currencies, etc.)

This is the broadest category of diversification, but it is crucial to consider when building a portfolio. Generally speaking, residential and commercial real estate are very highly correlated with one another. While they can both be incredible investments, you would still have your eggs in the same basket if 100% of your portfolio were invested in these two asset classes.

If your goal is to be as diversified as possible, consider looking at asset classes that are either inversely correlated with the majority of your portfolio or have no correlation at all. The most obvious example of this is through ownership of precious metals or currencies, but many other asset classes are available that can provide significant diversification from uncontrollable economic events.

02 Maximum Percentage Per Asset Team: 30%

Finding a good asset team is like finding a needle in a haystack, but do not be so mystified by a good partnership that you forget to diversify. Even if you find what you consider to be a diamond in the rough, don't make the mistake of being overallocated to one asset team. Trust me, there are more out there. I recommend constantly networking to meet new teams, even within specific geographic markets. This is the crucial element many Madoff investors ignored when they thought they had found the investment opportunity of a lifetime.

03 Maximum Percentage Per Market: 40%

Even though I am extremely picky about the markets in which I invest, I never blindly trust one geographic region with my whole portfolio. Why risk it? Even if you think one city can give you 1-2 points better of a return, what happens if there is an unexpected natural disaster in that area? I sleep well at night knowing that I am never overexposed to one particular geographic region. Plus, visiting new markets and meeting new teams is not only fun—it's a tax write off!

04 Maximum Percentage Per Investment: 10%

When I am considering an investment for a client of mine or myself, it is ideal to never invest more than 10% of a portfolio's value in one investment. Just from a cash flow perspective, it is nice to know that if an investment goes sideways for a couple of months, you aren't going to need a second job to keep the electricity on.

Depending on what stage of your investment career you are in, this may not be feasible for you right now. Don't worry! Keep in mind that your goal is to build a diverse portfolio, and remember this rule when considering your second, third, and fourth investments. By the time you have built your real estate portfolio, you will have created a **diverse cash flow machine.**

NEXT STEPS

Where do you go from here? Are you interested in expanding your portfolio with this asset class? Interested in Cash Flow, Capital Appreciation, and Tax Savings? Have some further questions?

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