Hark! The Window Is Closing!
(And an Evolutionary Peek at Dumb Investing)

By Mark Morgan Ford

Today's essay is a bit longer than usual. It will take you an extra five to six minutes to read if you are an average reader. However, the return on those five to six minutes will be great. First, you will hear my theory on why most people make dumb investments. (Hint: It's a Darwinian problem.) Second, I will try to persuade you to make the best investment you can make right now. This is something that can make you seriously wealthy. Few other investments can claim to do that.

One of the most surprising things I've learned *about investing* is that it's really hard for most people to do.

It shouldn't be. The logic is simple. Buy good assets when they are cheap. Sell them when they are expensive.

In fact, most people do the opposite. When prices rise beyond reason, investors get greedy. When they drop and become cheap, the same people get scared.

Why would that be?

The answer is in our DNA. Evolutionary biologists tell us that for millions of years, our primate ancestors survived by following the herd. When everyone else in the forest started running away from some unknown trampling, it made good sense to follow.

Likewise, when you noticed a few of your fellow anthropoids wandering toward a wounded gazelle, that usually meant it was dinnertime.

After millennia, these lessons became embedded in our DNA. We "learned" through experience that, generally, it was "smart" to follow the herd.

This instinct resides deep in what some scientists call our "reptilian" and "limbic" brains. These are responsible for our basic instincts and emotional intelligence. But there is a third part of the human brain. It developed later on in our evolutionary history. That is the neocortical brain. It is responsible for rational thought. The neocortical brain gives us the capacity to consider our options, to make plans, to calculate risk and reward, etc.

If our primitive brains allowed us to survive the Stone Age, our neocortical brain allowed us to become rational human beings. That means, in theory, that we can use reason to make sound decisions.

When it comes to investing, however, a Homo sapiens abandons his rational mind. Fear and greed cloud sound thinking. And when the herd stampedes, he blindly follows.

You can't ignore your gut reactions. They are there for good reasons. When they are based on valid experiences, they can signal both opportunity and danger.

The trick is to pay attention to them but not let them govern your behavior.

> *Great newsletter. I appreciate the depth of analysis and the practicality of your approach to building wealth.* —Platinum Level subscriber Eric Wiens

When an investment opportunity presents itself, we generally have feelings about it (excitement, nervousness, etc.), but we also have facts we can consider. We can determine the risk, and we can determine the reward. We can also analyze value.

By tempering the heat of our emotions with the cool water of logic, we can make sensible investment decisions. Sometimes, sensible investors invest alongside the herd, but just as often, they are contrarians.

[A contrarian is a person who takes a stance or view that is the opposite of what the majority thinks. Unpopular or uncommon views won't sway or affect a contrarian's position.]

I don't believe in being a contrarian for the sake of being different. Contrarian pundits tell you that "the herd is always wrong." In reality, the herd is sometimes right.

The problem is that when the herd stampedes, it will not stop, even when the road it is following takes it right over the edge of a cliff.

As I said in the beginning of this essay, I don't believe that it takes genius to invest sensibly. What it takes is common sense, proven strategies, and practical experience.

You have the common sense. We have the experience and the strategies.

In a recent newsletter, I urged those approaching, or already in, retirement to consider investing in rental real estate. Today, I want to tell you—once again—why you should start investing in rental real estate as soon as possible. But I know that many *PBL* readers are afraid to. So I'm going to spend about eight minutes of your time telling you why—in this case—you have to overcome your fear.

Why Most Investors Develop Bad Investment Instincts

The inexperienced investor thinks he can recognize market tops and bottoms. He watches television and reads the print media. From them, he gathers his ideas and even his "experiences."

The ideas usually come from brokers and media pundits. Brokers and pundits are sometimes earnest, but most of the time, they are hawkers peddling their companies' wares.

The experience comes from reading exciting stories about stock market successes and failures. These stories "feel" like real experience, so they affect us deeply. For example, what happens if you hear enough stories about regular people making millions with penny stocks? You will eventually "feel" like penny stocks are the way to go.

What I'm saying is that inexperienced investors make bad decisions. That's because the media feed their instinctive and emotional brains bad information. The reason they get this bad information is that the media survive by distorting the facts.

This May Come As a Shock...

Consider this: The financial news media make their money by having big circulations and selling advertising.

To draw big audiences, they tell big, exciting stories. To sell advertising, they make sure that the ideas they present are similar to the ideas their advertisers are selling.

That's why you never hear radical analysis or advice from the mainstream media. It doesn't work for them financially.

This is why the average, inexperienced investor doesn't stand a chance. Outside sources program his reptilian and limbic brains on a daily basis to follow the herd. And the herd is almost always wrong.

To be a successful investor, you must use your neocortical brain to decide when to buy and when to sell. As I said at the start of this essay, that's not all that hard to do. That is, if you are investing in assets such as real estate, which can be rationally evaluated.

How This Applies to You Today

I recently had a surprising conversation with one of my real estate partners. I was telling him what I'm going to tell you today: The opportunity for buying really well-priced rental real estate in Florida seems to be coming to an end. My best guess is that the window will close sometime in the next 12-18 months.

He assured me that I was wrong. He told me that there was still "lots of time" to invest in real estate. He said he was worried prices would go down. I asked him how he came to that conclusion. He repeated stories he had been reading in the mainstream press for the past five years. "These are real stories that happened to real people," he reminded me. "My gut tells me that things are going to get worse."

I told him that I had no crystal ball at my disposal. And that I had been reading the same stories as he had. But I reminded him that the mainstream press was telling stories about people getting rich in real estate in 2006 and 2007 right before the market crashed. I had also warned him back then that he should stop buying property, because the rational data indicated that it was overpriced.

Curiously, he had no recollection of my warnings, even though I stopped buying real estate with him during that period. In fact, he told me that I was “delusional” and that I had said no such thing.

I could send him copies of the many essays I wrote during those years, but it won’t do any good. His fear of real estate is deep. It is based on the stories he’s been reading and watching since the market crashed in 2008. As long as he gets his advice from the mainstream media, he will always have the wrong instincts.

Readers of my newsletter know that I’ve been touting rental real estate investing since our publication began. If you want proof, you can read the following issues: “How to Make 54% on Your Money in One Year,” “Why the Government Pays Me $1,250 Every Month,” or “How to Add $81,500 to Your Retirement in 10 Hours.”

I was right about the real estate market being overvalued in 2006 and 2007. I was right about how cheap property was in 2010. And I think I will be proven right about what I’m saying today. What I’m telling you today is that the current window of opportunity for rental real estate investing is closing.

There Are Forces at Play Right Now

In 2008, you could have bought a single-family home in my neck of the wood for as cheap as four times yearly rentals. (A house whose rental income was $1,250 per month, or $15,000 per year, could be bought for as little as $60,000.) In 2010, the price of that same house had increased to about $90,000. That equates to six times yearly rentals.

Today, it is very hard to acquire the same kind of property for that multiple. The deals I’m looking at are up to seven times yearly rentals. (In other words, the same house you could have bought for $60,000 in 2008 and $90,000 in 2010 would cost you $105,000 today.)

That’s an increase of about 15% in two years. About five of those percentage points occurred in 2010, and another 10 occurred in 2011.

There’s a good reason for this inflation in housing prices. Smart, sophisticated investors set aside an abundance of cash from 2005-2008 during the housing bubble. They then put this money back into the market after prices had collapsed.

In other words, my partners and I weren’t the only private investors in Florida looking for these deals. There were many smart investors out there fighting for the limited number of homes that were coming to market.

Caveat Emptor

The economics of housing prices aren't very complicated. Like most assets, their prices are affected by supply and demand.

The supply of single-family, three-bedroom, two-bath homes for sale since 2008 has not been overwhelming. That's because banks have been releasing them into the market slowly. Another reason is that many honest homeowners continue to make their mortgage payments, even though they are underwater.

> *I just subscribed a few days ago and already see how practical and useful your info is, so thank you! I am looking forward to implementing many of your suggestions as soon as possible.* — Gold Level subscriber Leslie Feld

This could change. There are still millions of "underwater" properties across the U.S. In theory, banks could release these in droves. That would drive housing prices down. Some of my investment-writer friends who look at the world from a "big picture" perspective worry about this.

I don't think that is going to happen.

Why? Because flooding the market with houses right now would crash the real estate market again. That would be a *major* problem for banks and government officials. These people, effectively, control the spigot. They are going to continue to do what they've been doing for the last four years: letting out these underwater properties gradually.

Three Reasons Prices Should Stay Strong

I admit, this is theoretical comfort. But there is more than theory to my argument. I believe that real estate prices will continue to edge upward this year and next year. This is all because of three actual events taking place right now.

First, I've noticed something with employees of banks, mortgage brokerages, and local municipalities. They are (often illegally) teaming up to purchase the choicest properties in their localities. This makes demand higher for the honest, rational big/small investors. These are people who have been willing to pay increasingly higher multiples, since, at seven times yearly rentals, these investments are still very good.

A second factor that is contributing to higher housing prices is somewhat surprising. Large banks normally don't like to be in the real estate business. But now some are opening up divisions that hold onto the foreclosures and rent them to the dispossessed owners. (They tell the newspapers that they are doing this to "give back" to the community.)

And third, I recently read that at least one major REIT has set up funds to buy single-family homes in bulk. This is astonishing. As far as I know, this is the first time this has ever happened.

[A REIT (real estate investment trust) is a corporate entity that invests in real estate. By law, it is required to distribute 90% of its taxable income to shareholders. Most REITs trade on the stock market, so you can buy and sell them like any stock.]

This is why the competition for rental real estate housing in my area (and many parts of the country) is so strong. This is why prices have been rising.

If this trend continues—and I don't see why it would not—it is possible that in 12-24 months, the house that costs $105,000 today could cost $120,000 or even as much as $135,000.

What does that mean?

Here's the math: At $120,000, you would be getting an eight times multiple on the $15,000 yearly rent. At $135,000, it would be a nine times multiple.

A multiple of eight to nine times rent is not terrible, but it's hardly attractive. It means that after paying for expenses (including a mortgage), you are not likely to get much, if any, positive cash flow from the investment.

When you get no net cash flow from rental real estate, it means you are investing purely for appreciation. Investing for appreciation is not something that I like to do. In my book, it is closer to speculation than to investing. So when house prices get to that point, I'll no longer be an investor. (And I'll be advising you to look elsewhere for your secondary income.)

So the Time to Invest Is Now!

These are the reasons why I believe the real estate window is closing. And that is why I've been pushing my real estate partners to buy everything they can for us.

It's not too late for you. Prices are still relatively cheap. And mortgage rates are at record lows. Because of the Great Recession, the cost of managing properties is down. And property taxes are down, also.

In other words, the economics of investing in rental real estate are still very good. That means that rational investors should calm whatever fears they have and begin to make sensible, conservative investments before there are no more left.

But What If You Lack Knowledge?

Several *PBL* subscribers have told me that they recognize the opportunity for investing in real estate today. But they mention that they don't know much or anything about rental real estate investing. Lacking that knowledge, they fear that they will make costly mistakes.

Now, that is an example of smart feelings. A smart investor will never invest in something about which he knows little or nothing.

To remedy that situation, in the weeks and months ahead, I'm going to be writing a series of essays. I hinted at this in a recent newsletter. We are going to call it "Rental Real Estate Investing 101." This series of essays will spell out the basics for first-time real estate investors.

And while I'm doing that, Tom is commissioning the development of a step-by-step course on rental real estate investing. It will elaborate on the lessons I'll be talking about in my essays. And it will give you an exact blueprint on how to invest in rental real estate.

The combination of my newsletter essay series and this real estate investing course will be a self-learning program that will give any novice the knowledge he needs to invest intelligently. We will cover the big ideas, the medium-sized strategies, and the little tricks that have worked so well for me.

It won't be difficult. I've said this many times, and I'll say it again: The reason I advocate rental real estate investing as a secondary source of income is that it is not complicated. Anyone with common sense can learn the most important ideas and strategies in a few weeks.

I promised you a longish issue, and this has been one. But I hope that you recognize the value in it. The rental real estate market has been a virtual gold mine for the few smart investors who didn't get caught up by the bubble and waited until after 2008 to get back in.

There is still time to participate, but the door is closing. If you think my take on real estate makes any sense, now is the time to move.

Best,

Mark

Editor's Note: If you love Mark Ford's essays, check out Mark's personal website, markford.net. This is where he publishes his non-financial material, including essays about health, business, and writing. You'll also find an archive of the most popular essays he's written over the last 20 years.