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Money Matter$

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Should you own rental real estate? Probably.

by Adam Sommers

As part of our fiduciary duty as investment advisors, we must always make recommendations that are in the best of interests of our clients, even if it is not in our own interest. That is what sets us apart from the typical "financial advisor" you meet on the street. **We are different**. If your financial advisor isn't always acting as your fiduciary, you should find a new advisor.

In the spirit of what's not in SFM's best interest, we are going to suggest you **consider the idea of investing in rental real estate**—from which we do not collect an advisory fee; and which may take a down payment from funds currently under our management.

With the Federal Reserve Bank effectively printing $85 billion a month, and setting interest rates at zero, investors are being "forced into risk assets" like stocks & real estate. Don't believe me? Check your local bank for CD rates on $100,000 for five years. Yep; 1.5%—if you're lucky.

There are three ways that your household finances can be improved by investing in rental real estate:

1. **Rental income**. If you find an "investment property" that works, the rent you charge will cover the mortgage, maintenance, HOA due, property management fees, taxes & insurance, all while providing you a small monthly cash in-flow. Our recent purchase in Arizona provides us with over $300 cash each month, if no maintenance costs are incurred. And our renters build our equity with the portion of our mortgage that is applied toward principal.
2. **Appreciation potential**. With national real estate prices appearing to have bottomed, what better time to invest than at the outset of an upswing? There are markets that are up 10% in value over the past 12 months, according to the National Association of Realtors. 10% is a

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3-Year Returns

Dow Jones Industrial 30 Average:	11.4 %
S&P 500 Large Company Index:	11.4 %
NASDAQ Composite Index:	12.1 %
Russell 2000 Small Co. Index:	13.4 %
SFM's 'MODEL 25' PORTFOLIO:	10.0 %
SFM's 'NAKED ALPHA' FUND:	19.4 %

(see back page for current stock holdings in the Model Portfolio)

ETF Extra — SPDR Barclays Short-Term High Yield Bond ETF (SJNK)

The SPDR® Barclays Short Term High Yield Bond ETF seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Barclays US High Yield Index. The index includes short-term publicly issued high yield corporate bonds (commonly referred to as "junk" bonds). The Index includes publicly issued U.S. dollar denominated, non-investment-grade, fixed rate, taxable corporate bonds that have a remaining maturity of less than 5 years, and are rated high-yield.

SJNK's Notable Statistics

Average Yield-to-worst:	4.48 %
Average Maturity:	3.46 years
ROR Year-to-date (2/28/13):	1.68 %
ROR Last 12 months (2/28/13):	8.12 %
Total Assets in the Fund:	$ 1.1 Bil.
Expense Ratio:	0.40 %

SFM's ORIGINAL "Model 25" STOCK Only Portfolio

Company Name	Value Grade	Cash Flow	Risk Grade	Market Cap
Apple, Inc.	A-	A-	B	Mega
Abbott Laboratories	A-	B-	B	Large
CF Industries	B-	A	C	Mid
Chevron	B-	C	B+	Mega
China XD Plastics	A+	A-	D	Micro
Interactive Brokers	A-	A+	D	Small
IBM	C	C	A+	Mega
Intel	A+	D	B	Large
JP Morgan Chase	B-	A+	B	Mega
KLA Tencor	C	A-	B	Mid
MasterCard	D	A-	A	Large
Mosaic	C	A-	B+	Large
Marathon Petroleum	A+	B+	D	Large
Microsoft	C	C	A-	Mega
Oracle	D	A-	A+	Mega
Qualcomm	D	A-	A	Large
Southern Copper	C	A-	A-	Large
Siemens	A+	B-	C	Large
Seagate Technology	B+	A-	C	Mid
TJ Maxx	C	B-	A+	Large
Terra Nitrogen	B-	A+	A-	Small
Tata Motors	D	A+	A+	Large
Western Union	A-	C	C	Mid
Exxon Mobil	A-	B-	A-	Mega
YUM Brands	C	A-	A-	Large

SFM ORIGINAL Model "25" Portfolio vs. A Relevant Benchmark

	SFM Model 25	S&P 500 Index
3 Month Return:	4.9 %	10.0 %
12 Month Return:	4.5 %	11.4 %
3 Year Average Annual:	10.0 %	11.4 %
5 Year Average Annual:	5.8 %	3.7 %
Since Inception (6/1/2003):	17.4 %	6.3 %

Should you be a real estate investor?

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solid return on investment by itself; though we know appreciation is only a "potential" source of return. Let's not rewind to 2005 when "investors" were buying houses with negative cash flow (paying more than they received in rents), hoping to sell it later to the "greater fool" for a higher price than they paid. We've seen the wreckage of that strategy over the past four years. But median home prices are now more aligned with median incomes, which makes for a solid foundation on which to invest.

3. **Tax benefits**. I don't want to give away the farm here (in case the IRS is reading…), but there are many tax advantages when it comes to investment property. There are the deductions for all costs that directly offset the rental income: interest, property management, maintenance, taxes and insurance. You also get to depreciate the cost of the structure over 27.5 years. So that's basically an income tax deduction of 3.6% of the value...or a $3,600/year deduction on a $100,000 building. Rental income is not subject to self-employment tax, so the self-employed will appreciate that rental income has at least a 10% lower tax rate than 'earned' income. And if you're like me, maybe you'll buy in a sunny clime (Vegas, anyone?); and you can likely deduct the cost of your trips to inspect the property and meet with tenants and property managers. And if you hold the investment property longer than a year, when you sell it, you are taxed at the lower capital gains rate. Lastly, if you want to trade properties, the 1031 exchange allows you to defer taxes on your gains indefinitely.

Here are the qualifications I look for when suggesting rental real estate to clients:

- Enough funds outside of retirement accounts to put 20% down, and also have some reserves for vacancy & maintenance.
- Paying federal income taxes in at least the 25% tax bracket. That's an annual income of at least $36,000 for single filers, and $72,500 for married couples.

Another point I stress with clients is that **it only takes one rental property to get most of the tax benefits**; you may actually have diminishing returns (but still better than CDs!) from owning more properties. Many of the unspoken tax advantages come with the first property (need a tool to work on the rental? Deduction.); and many self-employed clients already utilize the initial tax advantages 'of which I do not speak'. I may even suggest to clients that do not own a first home that it would be wise to consider investing in rental real estate before a personal residence. **How's that for different?**