OCTOBER
2022

Peak Possibilities

Your Monthly Guide to Informed Real Estate Decisions

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Why Investing for Income, Instead of Appreciation, is Critical to Success

By Daniel Hart

Growth, also known as appreciation, should always be considered "icing on the cake". What I mean when I say that is: Do not expect it, but be grateful if you receive it. Do not invest for growth only, unless you have a strong and stable high-income career guaranteed for life, and you can afford to pay the bills associated with that speculative gamble for years to come. If you are a doctor, a lawyer, or some other high paid professional, this may be ok, but I would still advise against it. Why hope for income years in the future when you can get guaranteed income now? I would rather know that I have a deal today, than to possibly have a deal tomorrow.

Join ICOR in October for Actionable Real Estate Insights for 2023 with Lon Welsh

Let's say you purchase 123 Sycamore Street for $100,000, because it is in a hot neighborhood (Let's call it a "B-" neighborhood, but it is changing rapidly for the better), and you anticipate in 10 years that it is going to be worth $150,000. We will assume that you rent out Sycamore and that you break even each year, with neither income nor loss. It is usually hard to achieve positive cash flow in hot neighborhoods, since the prices are inflated by owner-occupant buyers and speculators, so a break-even rental property is often the best reality for the speculative investor. In fact, it is all too often that they are losing money every year, even if they think they are breaking even.

Now let's say that in ten years you are correct, and you sell Sycamore for $150,000, earning $50,000. Now, that result is only if you are correct. Over those ten years you will be hoping that you were correct. That is a long time to hope. Wouldn't it be better to be guaranteed that you are correct? Of course it is.

Consider this: Instead of your speculative purchase of Sycamore you purchase a rental property in a "C" quality neighborhood that earns you $5,000 a year after all of your expenses. Not only will you have earned $50,000 after ten years, but you will have received some of your earnings each year, allowing you to reinvest earlier and compound your earnings. When you buy this alternative property, you know it will earn you $50,000 in ten years, so why gamble on a property where you might earn $50,000 in ten years. Plus, the alternative property may experience growth as well, pushing your profit even higher than $50,000.

I have seen many growth investors, also known as speculators, purchase property as an "investment" with their only strategy being to resell it for more when it increases in value. They often give no consideration to the holding cost, because they think the value increase will occur much more rapidly than it actually does, if it does at all. Very often those holding costs cannot cover the mortgage, taxes, and insurance, and eventually they cannot keep up with the payments, causing the speculator to lose the property to foreclosure.

Sometimes the speculator does at least consider the rental income, and they figure it will cover their expenses, but they still often fail to properly calculate the true cost of ownership and an accurate estimate of their net rental income. When they cannot sell the property, which happens a lot, they may be stuck with the property for many years, and it is no fun to own property that produces no income, especially if it loses money each year.

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October @ ICOR

Winning In Today's RE Market With Proven Negotiation Techniques

Are real estate headlines making you crazy? Ignore the news and learn to interpret the metrics yourself. Today's sound byte shouldn't guide tomorrow's investment. Join ICOR in October, when Lon Welsh uses facts and trend history to explore and explain the real estate trends ahead—in all three ICOR markets. The similarities may surprise you.

Learn:
- Why home prices aren't going to fall.
- How to use months of inventory (MOI) as an indicator for the future
- What metrics to watch to spot buying opportunities for investors

Come for the deep dive into trend analysis but stay for Lon's vision of the next 12 months.

Don't miss:
- Why the market will likely resume strength around February 2023
- The truth about housing prices & rents now vs. what will happen in 2023
- The true impact national economic factors will have on real estate

Lon Welsh founded Your Castle in 2006. It is the largest independent brokerage in the Denver metro. He grew sales from $0 in 2006, to $2.8 billion in 2021. In July 2016, Your Castle made the "Inc. Magazine—fastest growing companies in America" for the third year in a row. Your Castle have six offices spanning the Front Range and major resort markets, and over 750 Realtors. Lon sold YCRE to a private equity group in 2021, but remains the CEO.Lon's newest venture is Ironton Capital, a Real Estate Private Equity firm founded in 2019, with the goal of helping passive investors get diversified access to institutional grade real estate.

For full details or to register visit www.icorockies.com/events

Colorado Springs
Tuesday, September 13th
Hyatt Place Colorado Springs
503 Garden of the Gods Rd West
Colorado Springs, CO 80907

Denver
Wednesday, September 14th
PPA Event Center
2105 Decatur St
Denver, CO 80211

Northern Colorado / Fort Collins
Thursday, September 15th
C.B. & Potts
1441 E Horsetooth Rd
Fort Collins, CO 80525

Why Investing for Income, Instead of Appreciation, is Critical to Success

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The reality is that over time there will likely be growth in value, but we cannot count on it. Obviously, market cycles will take place, and the value of the property may go up and down many times, but over the long run it is highly likely that you will see an increase, but it is never guaranteed. At a minimum, you should see growth in the value of your property at the same pace as inflation. Even that level of growth is great, because if you financed your property, you were able to use someone else's money, and maybe just a few thousand dollars (or none!) of your own, to benefit from the growth of the entire value of the property. Plus, that original loan amount, or the remaining balance owed, looks pretty small when you are dealing with tomorrow's inflated (devalued) dollars.

Of course, if the value goes down, you would get all the loss as well, but history tells us that our property values should at least keep pace with inflation over the long term. In fact, owning real estate is one of the greatest hedges against inflation. As the dollar weakens over time, let's say over 20 years, and a Coca-Cola goes from $1, to $5, to $20, our real estate values also go up accordingly. If we had our money in a savings account instead, even if the numeric balance increased over the years, it actually will have gone down in value because its purchasing power will have decreased. Owning real estate will ensure that our wealth is not devalued over time.

Income is my favorite benefit of rental property. Cash flow is king. Say it three times. It is that important. When I denounce speculation, I am actually advocating for a purchase based primarily on the income that a property produces. If you purchase a property, and the total rents exceed the total expenses, you will have positive cash flow. If appreciation occurs, that is great, but if it does not, cash flow will carry you on happily for years to come.

However, most people do not measure all of the expenses, and so they think they have positive cash flow. Most expenses are going to fall into one of these categories: debt service, property taxes, insurance, vacancy, maintenance, and management. Of all these expenses, the easiest to measure is debt service (your mortgage payment), your taxes, and your insurance.

Where investors fail to measure their expenses properly is in the categories of vacancy and maintenance. Most investors severely underestimate these expenses, if they even estimate them at all. Most investors look at their gross rent, perhaps it is $1,000, subtract their mortgage, which usually includes the taxes and insurance, perhaps a total of $800, and they tell people that they earn $200 a month. Guess what? They do not earn $200 a month. In reality, they barely break even and they might even have a loss at the end of each year.

Savvy investors are purchasing properties that produce substantial positive cash flow after all expenses, and that income can be very powerful. It can be used to accelerate the pay down of the debt used to purchase the property, or to invest in more income producing properties, increasing their income exponentially. Rental income comes in every month, and it can come in for the rest of your life, if you purchase properly.

Rental income can set you free. It is wonderful to wholesale a property and collect a big check, and it is nice to renovate a house to sell for a large profit, but those activities require your constant involvement. They are active businesses. Rental income is essentially passive income, and it requires very little time, and if you hire competent property managers it requires about as much time as checking a stock portfolio online. If you want big pay days, you should wholesale or renovate houses for resale. If you want to take back your time, buy income producing rental properties.

October Meetings

ICOR – Colorado Springs	ICOR – Denver	ICOR – Northern Colorado / Fort Collins
In Person Tuesday, October 11th, 6 PM-9 PM (MDT)	**In Person** Wednesday, October 12th, 6 PM-9 PM (MDT)	**In Person** Thursday, October 13th, 6 PM-9 PM (MDT)

Webinars & Workshops

Beginner Investor Subgroup **Webinar** Thursday, October 6th **Foreclosure Webinar Series – Part One: Finding Foreclosure Properties** **Webinar** Wednesday, October 19th	**Succeeding With Contractors – Avoiding The "Gotchas"** **Workshop** Saturday, October 22nd Good contractors can save your investment; bad contractors can cost you your investment. Learn the best ways to work with contractors so you both win.	**Foreclosure Webinar Series – Part Two: Buying Houses That Are Behind In Their Payments But Not Yet In Foreclosure** **Webinar** Wednesday, October 19th

Find out more and register online at www.ICOROCKIES.com/events

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You Have To Start Somewhere

There are many people reporting (breathlessly) that the real estate market is about to crash. The main things that get blamed are rising interest rates, a cooling economy, and prices having risen 'too far too fast', but there's also the impact of inflation, wages, an insufficient supply of homes, crazy zoning policies, rents and demographics to consider. With all of these variables, what's to be done? Let's take a minute and consider two things: first, a bit of context and second, the direction, magnitude, and timing of any decline.

First, a bit of context. Markets move around, and they swung too far in favor of sellers this past spring. Blame seasonality or COVID (or the response) or whatever, but the market strongly favored sellers. Clearly some of the silliness in the spring - like forcing buyers to waive inspections and bidding wars that resulted in a final sales price 20% above asking - is not sustainable, so should we be overly concerned when the market returns to normal? There are still some issues in the market, and not everyone can afford the house they'd like, but really the market is in a much more rational and balanced position now.

Buyers got pretty excited in the spring as well, and we saw some pretty creative justifications for paying higher prices. Buying and rehabbing homes to put into a short-term rental pool, scrapes, short-term holds, etc. were discussed. Now, we are seeing much less of that. David Nielson, head of Boomerang lending, observes: "We are getting a lot more requests now for 'regular' financings. Borrowers that plan on taking a mid-priced older home and updating it and selling it in line with the market. And we are having a much easier time being on the same page with the after-rehab value. Our borrowers have been through the cycles and it's just returning to normal. The good news is they are having an easier time finding projects that pencil now and no more crazy waits for cabinets and cement."

Given that the market was not sustainable at the elevated levels, should we expect some pullback in prices? That certainly seems reasonable. But direction, magnitude and timing still matter. If the direction of house prices is likely lower, how far will they fall? And how fast? The consensus seems to be in the neighborhood of a 10% pullback, which hardly fits the definition of a 'crash'. The last major pullback, which does seem to qualify as a crash, prices declined by over 25%, but that took more than 5 years. And how fast matters. During that last time (on a national level) there were no 6-month periods during which the prices declined by more than 10%. An average developer (our borrowers really add value, not just 'flip') makes about 25% on their investment, which means there will still be profit in the event of the type of declines we saw last time.

It still would be helpful to have a bit more granularity as to direction, magnitude, and timing, and fortunately it is available. The Chicago Mercantile Exchange which trades billions of dollars daily in futures on such investments as the S&P 500, interest rates (bonds) and various commodities, has a way to invest in the housing markets. The S&P Case-Shiller index allows you to look at the 'bets' (or hedges) being placed on the national level of home prices. The way these futures work is that on settlement day, the current price (the 'spot' price) is compared to the price of the contract and the difference is settled (in cash) between the counterparties. The current spot price is 308.18. We can compare that price to the futures price and determine what these investors are figuring will be the price at that point in the future. Here's what that looks like at present:

SPOT:			308.18
Ticker	**Period**	**Price**	**Change**
CUSX2	Nov-22	315	2.2%
CUSG3	Feb-23	299	-3.0%
CUSK3	May-23	293	-4.9%
CUSQ3	Aug-23	301	-2.3%
CUSX3	Nov-23	286	-7.2%
CUSG4	Feb-24	288	-6.5%
CUSG5	Feb-25	299	-3.0%
CUSG6	Feb-26	308	-0.1%
CUSG7	Feb-27	313	1.6%

So people that actually make investments based on housing prices expect a 7.2% decline in prices by next year in November, which is probably quite different from the talk you hear on tv or at the bar. And also, quite supportive of starting new projects. Want to go even more granular? There are also futures on house prices in Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco, and Washington DC.

It should come as no surprise that the Denver market looks to take a bit of a harder hit than the national average, with the futures market expecting a decline of almost 12% by February of 2024. That should come as little surprise given the marginal outperformance of Denver area prices over the last year by just about the same amount of the extra decline (Denver was +19.3 % over the last 12 months vs +18.0% for the National Average).

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SPOT:			332.05
Ticker	**Period**	**price**	**change**
I2X22	Nov-22	321	-3.3%
I2G23	Feb-23	302	-9.0%
I2K23	May-23	307	-7.5%
I2Q23	Aug-23	306	-7.8%
I2X23	Nov-23	298	-10.3%
I2G24	Feb-24	293	-11.8%
I2G25	Feb-25	309	-6.9%
I2G26	Feb-26	327	-1.5%
I2G27	Feb-27	344	3.6%

Markets change and we are through the silly season that was this spring and back to a relatively normal market. Certainly, there are still concerns, but pessimistic prognosticators seem to be quite out of line with people that are actually making investments, in both current and planned future markets. Therefore, we can pretty confidently say, there is a light at the end of the tunnel and it's not an oncoming train.

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The Power of Leverage

I am constantly asked to comment on the age-old comparison: stock market vs. real estate. Historical evidence supports the fact that there is absolutely money to be made by squirreling it away into stocks endorsed by Warren Buffet!

However, I want to suggest an analysis that conveys the importance of the power of leverage in investment. Leverage is a powerful tool that intimidates many people, yet when applied properly can yield a substantially higher amount of money than stock market investments can even begin to yield.

Let us start with what we know. We know that over the last 20 years, the stock market has produced about 7% annual return. So, let's say you had $160,000 and invested every penny into what Warren Buffet suggests. This includes 401(k), IRA, and 529 plans. Now let's say you hold on to your portfolio for 15 years. At the end of that 15-year period—assuming you averaged 7% annual returns—your portfolio will be worth $441,445. That sounds great! Right?

Now, I am not saying that $441,445 is bad. Butttt...we can do better by investing in and leveraging real estate. Let's take that exact same $160,000 and leverage it to buy a $450,000 property. We put 35% down because we are putting it on a 15-year note. If nothing else changes, at the end of 15 years, you will own an asset that is worth $450,000 (in Colorado?) Already that is better than the stock market. However, we accounted for a 7% annual return with the stock market. On our real estate investment, let's assume a conservative 3% appreciation year-over-year. Plus, we can also add the $35,000 rental income you created for the rest of your life. If you combine the 3% appreciation and the $35,000 income, now you are looking at an asset value of $705,000! Simply by leveraging$290,000 over 15 years, you were able to gain $263,555 more than the stock market alone.

This is a very simple and very conservative analysis comparing the two investments. It doesn't even factor in risk, and I have a theory about risk that will change the way you look at risk forever. Stay tuned!

ATLAS REAL ESTATE

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By the Numbers

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10 Average Days Between Residents

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Purchasing Flood Insurance

Often when homeowners or real estate investors are looking to purchase a new property, they often forget to ask, "is the property in a flood zone?" The good news is you have choices, you could purchase flood insurance if your property is in a flood zone or is outside the flood zone. An insurance agent could check with the property address, if the dwelling is in a flood zone. Currently, you could purchase flood insurance through FEMA or through the WYO "Write Your Own" flood program through private insurers.

Flood insurance is available for homeowners, business owners and even renters. There is a difference between how water losses are considered to be a flood loss, vs a covered hazard insurance water loss. Hazard insurance policies would provide coverage for Water Damage that occurs as a sudden and accidental discharge of water. This can often be from a broken pipe, toilet, refrigerator, washing machine, or HVAC system doesn't drain properly, causing a flood. The resulting damage can be severe, depending on the location of the leak and the amount of time it has been leaking. Water damage can often occur on second floors and then can leak to the lower levels and cause extensive and expensive claim damage.

I, regularly, get the question from investors, "is water damage covered that originates from the roof?" This is always reviewed on a case-by-case basis but can be covered if it is related to a covered peril from a storm (hail).

Even though each claim has its own merits, flooding events like surface ground water or flash flood are normally excluded from hazard insurance policies.

Flood damage is damage to the home, personal property, or commercial building as a direct result of a flooding event. There should be significant rain over a short period of time to create a flooding event or flash flood. If the rental property or commercial building is in a high-risk flood zone, the property owner must have a separate flood insurance endorsement or policy to have coverage for a flood caused by weather events. Flood insurance is often required by the mortgage lenders for properties that are in a designed flood zone. The most common flood policy is normally covering the building or home. I always recommend to the investor to include coverage for property inside the building as well as a loss of rents or additional living expense coverage. These additional costs for additional living expenses and contents can sometimes be greater than the damage to the building or home. I review many flood policies and I have found that many policies do not includes these important coverages.

Flood insurance will provide money to repair or even rebuild a home, if it is damaged or destroyed by flood. When a homeowner has to file a claim, they are only responsible for paying the deductible. As a result, the homeowner retains the home, keeps making their mortgage payments, and everyone will be happy.

According to FEMA, a flood insurance policy covers the following:
- The insured building and its foundation
- Electrical and plumbing systems
- Central air conditioning equipment, furnaces, and water heaters
- Refrigerators, stoves, and built-in appliances such as dishwashers
- Permanently installed carpeting over an unfinished floor
- Permanently installed paneling, wallboard, bookcases, and cabinets
- Window blinds
- Detached garages up to 10% of building property coverage (detached buildings other than garages require a separate building property policy)
- Debris removal

If you notice above, what is not covered is the loss of use/additional living expenses and or loss of rents. However, some private carrier could cover it.

In Colorado, purchasing the right flood insurance can be difficult. Before purchasing your new property ask to see if the property is in a high-risk designated flood zone before initiating the property purchase.

Feel free to contact me and I can assist you with the correct flood policy for your investment property.

Sure, you have a roof over your head, but do your investments have the right coverage?

How can I help? Let's set up a time to review your policies!
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Patience and Planning

When did we, as a society, lose our patience? Was it with the invention of the microwave? Fast food chains? The iPhone? When did we forget how long it actually takes to grow something, whether it be a garden, a human, or an investment? Success with a fix-and-flip might be one win, but it's not enough to quit our day job and sit back. The modern lifestyle illusion is that success is, and should be, quick and if we don't like something the first time we try—move on. Unfortunately, this is a mindset many must overcome when learning how to implement the Infinite Banking Concept.

Banking is a necessary function of our lives, especially for real estate investors. Depositing, withdrawing, and borrowing. But we rarely consider what life could look like if we replaced the traditional bank with a pool of money we created ourselves. Why? Because we believe the lie that it takes too long or costs too much.

Think back to the fall of 2012. Where were you? What were you earning? Did you save? Did you live for the day or think long-term? What if, at that time you started slowly reserving a small portion of your earnings in a system that grew with compounding interest so that today you had $200,000 at your disposal? Now imagine using that pool of money today to replace your need to borrow from an external source. How much faster could you move? What if you treated your pool of money with the same respect you do to any other lender- and paid yourself back with interest. What rate would you charge yourself? How would you use the money?

The beauty of starting the Infinite Banking Concept is that you do not need to wait ten years for money to grow. You can use your money the moment it is deployed into the system... much like a bank account. Unlike a bank account, the money, when structured and used properly, will grow as if it never left your account. This is not magic, it's simply math. Utilizing the Infinite Banking Concept is more like taking out a line of credit on a home. You're not actually selling bricks from your house to get capital. You're borrowing against the value of your home. Meanwhile, the home value continues to increase.

The Infinite Banking Concept is not for everyone. It's not for those who want to simply get rich quick. It's not going to solve a chronic debt problem. But it can help. It requires discipline and patience- two words often lost in an insta-society. Those who take the time to learn the concept today, and properly implement the tools with their current strategy, will be miles ahead of their comrades ten years from now. Your conversations will be more around current and future opportunities rather than wishful reflections and regrets.

If you're not familiar with, or have yet to see how, the Infinite Banking Concept will work with your real estate investment goals, don't let another year slip away before you begin your education. Your future self will thank you!

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SATURDAY, NOVEMBER 12TH

Gold in Performing & Non-Performing Real Estate Notes

With Jeff Watson

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SATURDAY, DECEMBER 10TH

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Checkbook Control and the McNulty Case

When I use the term "checkbook control", I'm referring to the arrangement in the self-directed IRA investing world in which an accountholder has set up an IRA-owned entity, typically an LLC, and they are the manager and have checkbook direction over the funds in their IRA that were invested into the LLC. I have been discussing a Tax Court case known as "McNulty" with knowledgeable, educated individuals in the field, and I want to share with you what I believe are the current best practices involving checkbook control and some things that may need to be adjusted in your existing IRA-owned entity to better comply with how the IRS is interpreting the rules.

Let me give you an overview of the facts in the McNulty case. Mr. & Mrs. McNulty formed two separate IRA-owned LLCs and then used those LLCs to make various investments. The Tax Court case focused on investments made by Mrs. McNulty, specifically ones in which her IRA purchased a safe and then gold coins to be stored in the safe. The safe containing the coins was kept in the McNulty's primary residence. The IRS determined that the way in which she handled the money and did these transactions was a violation of the rules governing IRAs and that each time Mrs. McNulty spent money from the IRA to buy coins of which she physically took possession, it constituted a distribution as of January 1st of that year. Essentially, Mrs. McNulty destroyed her entire IRA.

The key language used by the Court was that Mrs. McNulty had "unfettered access and control" over the assets in the IRA, which is really what most people say they want when they are asking for checkbook control. They want to make the day-to-day decisions and sign checks so they can immediately pounce on a deal.

In the years since IRA-owned entities became a thing, there has been an ongoing debate about who should be the manager of an IRA-owned LLC. Certain custodians that I am affiliated with have made the decision that the accountholder should not be the manager of an IRA-owned LLC based upon a careful reading of sections of the Tax Code, specifically 26 U.S.C. 4975. Instead, the manager should be an independent, non-disqualified, disinterested third party.

The manager is the person responsible for the day-to-day operations and actions of the LLC. The manager supervises the LLC's activities, the hiring and termination of the LLC's employees and independent contractors, and ultimately calls all the shots for what happens in the company. This is true whether the LLC is a small, single-member LLC with only a couple of assets in it or if it is a $50 million company. The manager is the person ultimately in charge.

One of the things the manager has the authority to do is deal with the banking institutions with which the LLC has accounts. That means the manager has the ability to go to the bank and deposit and withdraw funds, meaning the manager pretty much has "unfettered access and control" of the LLC assets. That was the problem in the McNulty case. Mrs. McNulty had unfettered access and control of the assets bought with the money in her IRA-owned LLC. That is a huge problem in the eyes of the IRS. The best way to avoid that is for someone other than the accountholder to be the manager of the LLC.

An important practice taught to me early in law school was that when you read a court decision, always look at the legal precedents cited within the case to better understand where the court is coming from and the basis for their opinion. When we do that with the McNulty case, we find an important case cited, Ancira v. Commissioner, which was decided in 2002 (119TC135). This case held that no taxable distribution from an IRA occurred when the IRA accountholder personally received and had possession of a check that he could not negotiate. The check was made payable to the IRA but was in the hands of the accountholder.

This is an important case to think about when looking at what the court meant in McNulty when it talked about "unfettered access and control". It's clear that if you choose to remain the manager of your IRA-owned entity and receive payments, wires, ACH deposits, checks, money orders, etc., that are directly payable to the IRA entity and not to you personally or in your title as manager, then your receipt and possession of those negotiable instruments is not a distribution of the assets. It remains to be seen what arguments may come as to the ability to go to the bank and withdraw cash.

In McNulty, the court further emphasized that point by talking about another case, McGaugh v. Commissioner, and how the accountholder held in his possession a stock certificate issued in the name of the IRA. The court stated that the IRA accountholder could not realize any personal benefits from the possession of that stock certificate and did not have constructive receipt of the IRA asset because the stock certificate, being a financial instrument, was titled in the name of the IRA.

I want to clarify one thing. The McNulty case applies to IRA-owned LLCs. It does not apply to solo 401(k)s. A solo 401(k) is a retirement plan adopted by a self-employed individual or an individual who owns an entity being taxed as a corporation. That individual is required to be the trustee of their 401(k). This is completely different from my warnings about being the trustee of your IRA-owned trust. There is a significant distinction between the two.

For those of you who have solo 401(k)s wherein you handle the checkbook, this McNulty case is not bad information. It is instructive, however, to make sure you are being very diligent and accurate regarding all the

investments you make with your solo 401(k). You must keep track of the amount of contributions that go into any Roth component vs. a traditional component, the amount of the employer match going into the traditional component, and the investment results of the Roth and traditional funds together.

From these cases, we can see that dealing with financial instruments is permissible for an IRA accountholder when their IRA owns an LLC.

Please remember, however, that the facts in each case depend upon the circumstances of each case. Making a decision based upon just this information would be unwise and imprudent. It's important to consult with your own legal counsel when you have a question about IRA-owned entities, how those entities should be operated, and who should be managing them.

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