What Every REAL ESTATE INVESTOR NEEDS TO KNOW about ECONOMIC CYCLES

J SCOTT

Copyright © 2018 by ScottBuilt, LLC. All Rights Reserved.

Published by 1-2-3 Flip Press, Ellicott City, MD.

This publication is protected under the U.S. Copyright Act of 1976 and all other applicable international, federal, state and local laws, and all rights are reserved, including resale rights: you are not allowed to reproduce, transmit or sell this book in part or in full without the written permission of the publisher.

Limit of Liability: Please note that much of this publication is based on personal experience and anecdotal evidence. Although the author and publisher have made every reasonable attempt to achieve complete accuracy of the content in this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. Your particular circumstances may not be suited to the examples illustrated in this book; in fact, it's likely that they won't be. You should use the information in this book at your own risk.

Any trademarks, service marks, product names or named features are assumed to be the property of their respective owners, and are used only for reference. There is no implied endorsement if we use one of these terms.

Finally, use your head. Nothing in this book is intended to replace common sense, legal, accounting, or professional advice, and only is meant to inform.

First Edition

Table of Contents

PREFACE **4**

CHAPTER 1: INTRODUCTION **5**

Economies and Markets Work in Cycles 6
Common and Historical Economic Cycles 8
The Business Cycle 9
Don't Fear Change, Embrace It 11

CHAPTER 2: THE ECONOMIC CYCLE **14**

Real Estate Within the Business Cycle 14
Phase 1: Expansion *15*
Phase 2: Peak *15*
Phase 3: Recession *16*
Phase 4: Recovery *16*
Inflection Points 17

CHAPTER 3: WHERE ARE WE IN THE CYCLE? **19**

Tools for Monitoring the Cycle 20
Observation *20*
Timing *21*
Economic Data *22*
Some Final Thoughts on the Economic Cycle 34

CHAPTER 4: STRATEGIES & THE CYCLE **36**

Flipping 36
Wholesaling 37
Single Family Buy-and-Hold 39
Development / New Construction 40
Buying Land 41
Private and Hard Money Lending 42
Note Investing 43
Commercial 44

CHAPTER 5: STRATEGIES FOR TODAY **46**

FINAL THOUGHTS **53**

Preface

I'm writing this introduction near the end of 2018. Over the past twelve to eighteen months, my frequent discussions with real estate investors around the country have transitioned from optimism about a strong housing market to concern that we're approaching another real estate downturn.

I don't know how close we may be to a correction in the real estate market, but as we'll discuss throughout this book, sooner or later it will come. While we'll have no control over it, we can control how we react to it, and how we modify our businesses and investments to take advantage of a changing economic reality and the twists and turns that come with it.

My goal with this book is to teach you what the economic cycle is all about, how it affects the real estate market, and then ultimately how you can modify your investing today to accommodate the changes we're seeing in the market.

NOTE:

I want to provide one very important warning before you continue reading:

Much of the information provided in this book is based purely on my opinion, my experience, and my investing style, as well as on historical trends and even some gross speculation.

Please do NOT rely on any information in this book to make specific investing decisions. Instead, use the information contained herein to better understand the market, the economic cycle, and how best to leverage them to build a solid and low-risk portfolio.

As always, you understand your situation, goals, limitations, priorities and investments better than anyone, so if anything in this book contradicts your beliefs, consider that what I recommend may not be right for you.

Chapter 1: Introduction

In May 2008, my family and I moved to Atlanta, Georgia. Driving through the city and surrounding counties, we couldn't pass three houses without seeing a "For Sale" sign in the yard or a foreclosure notice taped to the front door.

To say Atlanta had been devastated by the 2007 housing crash would be an understatement. It was one of the hardest hit markets in the United States, with housing values in some areas as low as 30% of what they'd been two years earlier. Foreclosure rates in Georgia were up 44% from 2007 and 117% from 2006.

And Georgia wasn't alone.

Nationwide, foreclosure filings increased by more than 81% in 2008, with more than 800,000 families losing their homes. And that trend continued for the next two years. From 2009 through 2010, about 45% of existing home sales in the United States were REOs or short sales.

As we drove through the neighborhoods near our house, we couldn't understand why investors weren't taking advantage of the reduced prices and buying up the distressed properties. I started attending some local real estate meetups to see what was going on. The only information I could get from the two or three investors who attended – down from hundreds just a year earlier – was that they were too scared to buy. They were worried prices would continue to drop, and they wouldn't be able to resell their investments. In other words, these investors were passing up potential deals-of-a-lifetime because they didn't have confidence in their exit strategy.

These investors were waiting for the "perfect" time to jump back into the market. They didn't understand the real estate market works in cycles just like the broader economy – with upswings and downturns – and that there is never a perfect time. Instead, they should have been creating an investment strategy that worked across the full cycle.

This is what we do, and hopefully after reading this book, what you will do as well.

Economies and Markets Work in Cycles

All economies experience ups and downs. They go through periods of expansion where growth is strong and steady, followed by periods of retraction where growth slows, plateaus, and eventually reverses. The individual markets (stock, oil, technology) within the economy experience similar fluctuations.

Do you remember the dot-com boom in the late 1990s or the skyrocketing gas prices in the mid 2000s? These timeframes represented periods of strong growth in the tech and oil markets. But they didn't last forever. Eventually the markets peaked and began to decline. The same thing happens within other markets, as well as the overall economy, perpetuating cycles that repeat themselves over and over again.

Let's look at what drives a typical economic cycle, in the most basic scenario:

When the economy is chugging along well, and businesses are generating strong profits, they'll pass some of these profits onto their employees in the form of increased wages. When employees earn more money, they spend more money. As you can imagine, this cycle of increased business profits, increased employee wages, and increased spending is good for everyone, as businesses hire more workers, unemployment numbers drop, and consumer confidence in the economy increases.

Eventually, things are so good for the average American that consumer demand for products and services starts to outpace the ability of businesses to produce those goods and services. Businesses become desperate to hire more workers to keep up with the demand. And so do their competitors.

Unfortunately, thanks to the low unemployment rate created by the strong economy, there aren't many new workers to hire. Businesses must increase wages to get retired workers back into the work force and to entice workers to leave other jobs and come to them.

This quick and steep increase in wages leads to an increase in the cost for businesses to produce their goods and services, which leads businesses owners to increase prices in order to maintain profits. The

term we use for an increase in the price of goods and services is *inflation*.

Inflation is a sign of a growing economy, but it's also a drag on economic growth. When goods and services cost more, consumers' money doesn't go as far, leading many consumers to spend less or use credit cards to finance their purchases.

The government knows that too much inflation isn't good. When inflation starts to take hold, the Federal Reserve steps in and raises interest rates. Higher interest rates encourage consumers to spend less and save more (remember, higher interest rates means higher returns from savings accounts, CDs, and bonds).

On the negative side, this rise in interest rates also means that consumers can't borrow as much money, and the cost of making payments on their existing credit lines increases, leading to reduced consumer spending.

When people spend less, economic growth starts to slow. Businesses start laying off workers they recently hired and pay their remaining employees less. To avoid losing their jobs altogether, workers are forced to accept lower pay and fewer hours. Now consumers have less money to spend and repaying their existing debts becomes more difficult.

Economic contraction is next. Unemployment increases, consumers default on their mortgage and credit card payments, bankruptcies increase, and businesses are forced to downsize, or worse, close down. Depending on how bad the downturn is, the result may be a recession – which is typically defined as at least two consecutive quarters of economic contraction – or even a depression, which is a much more severe and long-lasting economic spiral.

Eventually, the government steps in again. This time, they decrease interest rates to encourage consumers to stop saving, help businesses borrow more and cheaper money, and stimulate consumer spending. When borrowing and spending increase, the economy begins to grow, and the cycle begins again.

While this is an oversimplification of the way an economy and the markets within it work, it hopefully helps to illustrate why we see

large-scale economic cycles. I'll explain in greater detail what specific factors influence an economy and its markets later. But for now, you just need to know these ups and downs occur, they occur regularly, and they're normal.

Understanding that, as well as some key economic indicators, will help you recognize where we are in the current cycle and when you can expect conditions to change. That, in turn, will allow you to develop an investment strategy that works not just during the upswings but during the downturns as well. I'll explain how as we go through this book.

While you're probably reading this book because you want to learn the ways you can take advantage of all phases within a real estate cycle, keep in mind that the concepts we'll explore extend past real estate to all markets within an economy. In fact, these lessons apply to nearly any type of investment – the stock market, bonds, businesses, commodities, and even precious metals.

Common and Historical Economic Cycles

Economic cycles are not new. Experts have been tracking them for more than a century and a half. Unfortunately, those same experts – even the most well respected ones – disagree over how long a cycle lasts and when we can expect a change in the current one.

Just take a look at the headlines on any given day and you can likely find one expert predicting strong economic growth for the next two to three years, while another one says we're headed for a recession. Another may even contend that we're already in the process of an economic contraction.

Sometimes the experts are right and sometimes they're wrong. But two things you can count on are that no part of a cycle lasts forever, and every cycle will eventually repeat.

Changes to economic policy, tax policy and the way businesses operate may impact the length and magnitude of our economic cycles. However, it's reasonable to assume the markets and broader economy will continue to fluctuate in response to macro- and micro-economic factors just as they have throughout history. In other words,

looking at economic cycles throughout our history should give us a good idea of what to expect in the future.

Before we continue, it's important to point out that the cycles we'll talk about in the rest of this section (and throughout much of the book) are *national* cycles. That's not to say these cycles don't exist independently at the local level as well. They do. But keep in mind that what we discuss in the following paragraphs and chapters may not align perfectly with the cycles you've seen in your local market. Though, for many of you, I bet it will be pretty close.

The Business Cycle

When we talk about economic cycles, what comes to mind for most Americans is what we call the *business cycle*. This is the cyclical expansion (strong economy) and contraction (weak economy) that we see about once a decade or so, and what we typically think of as basic economic fluctuations.

According to the National Bureau of Economic Research (NBER), since 1854 there have been 33 business cycles in the United States. Prior to 1945, the average length of a business cycle was only about 51 months. Since 1945, the average length has grown to about 69 months. Some have been shorter, while others much longer. In fact, the longest expansion (and that's just one part of the cycle) recorded by NBER lasted 120 months, from March 1991 to March 2001, when the tech bubble burst.

Here is a view of every cycle from 1860 through today:

Peak Month	***Trough Month***	***Months Peak to Trough***	***Months Trough to Peak***	***Months Peak to Peak***
Oct 1860	Jun 1861	8	22	40
Apr 1865	Dec 1867	32	46	54
Jun 1869	Dec 1870	18	18	50
Oct 1873	Mar 1879	65	34	52
Mar 1882	May 1885	38	36	101
Mar 1887	Apr 1888	13	22	60
Jul 1890	May 1891	10	27	40
Jan 1893	Jun 1894	17	20	30
Dec 1895	Jun 1897	18	18	35
June 1899	Dec 1900	18	24	42
Sept 1902	Aug 1904	23	21	39
May 1907	Jun 1908	13	33	56
Jan 1910	Jan 1912	24	19	32
Jan 1913	Dec 1914	23	12	36
Aug 1918	Mar 1919	7	44	67
Jan 1920	Jul 1921	18	10	17
May 1923	Jul 1924	14	22	40
Oct 1926	Nov 1927	13	27	41
Aug 1929	Mar 1933	43	21	34
May 1937	Jun 1938	13	50	93
Feb 1945	Oct 1945	8	80	93
Nov 1948	Oct 1949	11	37	45
Jul 1953	May 1954	10	45	56
Aug 1957	Apr 1958	8	39	49
Apr 1960	Feb 1961	10	24	32
Dec 1969	Nov 1970	11	106	116
Nov 1973	Mar 1975	16	36	47
Jan1980	Jul 1980	6	58	74
Jul 1981	Nov 1982	16	12	18
Jul 1990	Mar 1991	8	92	108
Mar 2001	Nov 2001	8	120	128
Dec 2007	Jun 2009	18	73	81

Note that while the lengths of a business cycle may vary, each has one very important factor in common: The expansions are almost always longer than the contractions.

Since 1945, the average expansion has lasted 58 months, while the average contraction lasted only 11 months. And, over time, it appears that this discrepancy between the length of the average contraction and the length of the average expansion is getting more pronounced:

Peak Month	***Trough Month***	***Months Peak to Trough***	***Months Trough to Peak***	***Months Peak to Peak***
AVERAGES:				
1854-2009 (33 cycles)		17.5	38.7	56.4
1854-1919 (16 cycles)		21.6	26.6	48.9
1919-1945 (6 cycles)		18.2	35.0	53.0
1945-2009 (11 cycles)		11.1	58.4	68.5

Don't Fear Change, Embrace It

Change is inevitable. And you can respond to it in one of two ways:

You can embrace it, modify your investment strategy around it, and reap the benefits from the opportunities that present themselves.

Or you can fear it, refuse to adapt, miss out on the opportunities that come your way, watch your profits shrink, and potentially lose money.

Successful investors are flexible. They understand that to succeed they need to be prepared to take advantage of the opportunities that come their way – whether it's during an upswing, a down market, or an inflection point (more on that later). It doesn't matter if you're just getting started or you're a seasoned veteran, there are ways to make money during every phase of the real estate cycle. But to do so, you need to have a strategy to handle changing market conditions, which is what my wife and I have done over the last decade.

When Carol and I started our real estate investment business in 2008, the housing crisis was at its worst, and the foreclosure rate was the highest it had been in modern history. As flippers, that worked to our advantage. To find our next great investment opportunity, pretty much all we had to do was choose a random home from a list of foreclosures available for sale by the banks (also known as REOs). For the first couple of years we were in business, we only bought REOs because there were so many, and nearly all of them were good investments.

But in 2010, Carol started to notice a decline in the number of foreclosures on the market. She realized if we wanted to keep our inventory pipeline full we'd need to start looking for different types of investments by the following year. She'd heard that some real estate agents were focused on short sales, where lenders were giving sellers permission to sell their properties for less than what they owed on their loans. These types of sales were becoming more and more popular, so we decided to start shifting our buying strategy to take advantage of the increasing supply of short sales on the market.

Within a year, REOs dried up in our area, but short sales were taking off. Because we'd started building our short sale pipeline soon after the real estate market began to shift, we were better positioned than most investors to take advantage of this new trend in acquiring investment property.

Fast-forward two years, and Carol again recognized a change in the market. She realized banks were getting more conservative in their approvals of short sales and suggested we find a new strategy for acquiring deals because she didn't believe short sales were going to be a viable option for much longer.

Around that time – 2013 or so – I noticed builders were starting to sell off some of their excess lot inventory. These were empty lots in newly developed subdivisions that weren't as optimal as the rest of the lots and didn't have the same level of profit potential. But these lots were perfect for investors looking to build spec houses, which is something we wanted to pursue.

In addition, as the market started improving, we began to see opportunities to buy older homes on "infill" lots. The existing structures

could be knocked down and replaced with new construction spec homes. For the next several years, building new construction spec houses was our niche. Because we saw the opportunity before many other investors, we were able to capitalize on our ability to change direction quickly and efficiently.

We continue to do so today. Every few years, we alter our strategy to keep pace with the changing market. Our flexibility has allowed us to keep our deal pipeline filled and has given us a head start compared to other investors who aren't as flexible and don't change their strategy as quickly and easily as we've been able to.

With all that in mind, at the time of this writing, we're in the middle of the second longest business cycle expansion in U.S. history. Whether this current expansion will outlast the one we saw during the 1990s tech boom remains to be seen. But history has shown us that it won't last forever. There will come a time when growth will start to decline, and we'll experience a downturn in the economy just like we've experienced thirty-three other times.

The goal of this book is to help you prepare for the changes that are coming and will continue to come throughout the next economic cycle and future cycles. If you're an experienced investor who's been through a full economic cycle, you're probably already familiar with many of the concepts I'm going to discuss.

But if you're experiencing part of the cycle for the first time, understanding and applying the techniques in this book will help you earn more in any part of the real estate cycle. And it will help prevent you from getting blindsided by changes in the market.

Chapter 2: The Economic Cycle

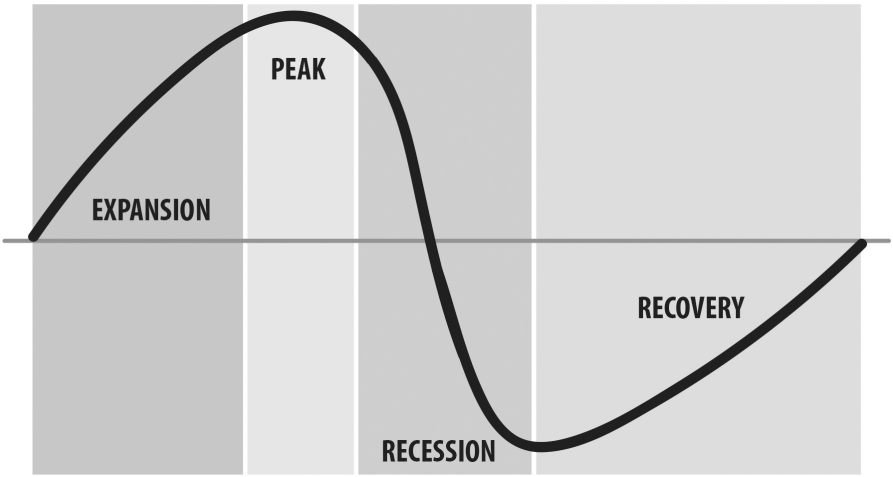
As we discussed in the first chapter, economies and markets move in cycles. Real estate is no different. That said, there's a common misconception among many people – both investors and non-investors alike – that real estate consistently increases in value over time with just some minor corrections along the way.

If you look at the historical data, you'll realize it's not that simple. When you track the fluctuations within the real estate market, a cycle emerges that has upswings and downswings just like the business cycle that we discussed earlier.

Real Estate Within the Business Cycle

While real estate doesn't always perfectly track the business cycle, they are highly correlated. Sometimes the real estate market will react a little more quickly or slowly to economic factors than the broader economy. But overall, when the economy is strong, so is real estate; when the economy is weak, so is real estate.

The graph below illustrates what a typical economic cycle looks like.



The curve represents the economy. It spends several years trending up through a period of economic expansion. It then plateaus during a peak phase, which generally lasts for a few months, but can last for up to a year. It declines during a period of recession and economic turmoil. And finally, as the recession comes to an end, the market starts to recover and again begins its upward trajectory.

As you can see, the phases aren't equal in length; like we discussed in chapter one, the upswings (expansion and recovery) are typically longer than the downswings (recession). However, we never know how long each phase will last in any cycle, as many factors impact the real estate market and those factors can change at any time.

We'll discuss some of them in greater detail later. But before we go any further, let's take a closer look at the characteristics that define each phase of the cycle from the perspective of a real estate investor.

Phase 1: Expansion

In this phase of the cycle, buyer demand for housing increases as other economic factors such as wage and job growth are strong. Occupancy rates continue to increase, and vacancies continue to decrease. Housing inventory is dropping, and new construction begins to meet the increasing demand.

Because demand is outpacing supply, prices increase, and they often increase faster than the rate of inflation. With confidence levels in both real estate and the broader economy high, those with money and those looking to make money turn to real estate.

Deals become scarce, and it's not unusual for investors to overpay for property during this phase of the cycle, thinking they'll be able to make their money back as prices and rents continue to rise. But as we know, what goes up must come down.

Phase 2: Peak

At the peak of the cycle, prices hit a plateau and demand starts to soften. In some geographic locations, there aren't yet signs of a slowdown, but other locations are foreshadowing the economic changes

with higher days-on-market for residential property and fewer new listings and buyers.

New construction continues to boom, as the units coming on the market during this phase have been in the works for months or years at this point. But the strong economy has been driving inflation, and around this time, the government steps in and raises interest rates to help combat that inflation.

Eventually the market reaches a point where the demand that was created during the expansion phase has been met, and the available inventory exceeds the current demand. With excess inventory on the market, rising interest rates, and the first signs that the economy is starting to crack, we start to see real estate prices decline, and the downturn begins.

Phase 3: Recession

During the recession phase, there's general economic turmoil. While every recession is different, some common elements include high unemployment, reduced wages, and tightening of credit.

For investors, this means an increase in the number of foreclosures, higher vacancies, fewer buyers, and reduced property values. As occupancy rates fall below the long-term average, we often see reduced market rents.

New construction quickly stops, and many partially finished projects go unfinished. It's not uncommon to see landlords drastically lower rents to attract new tenants and homeowners drop prices to attract buyers during this phase.

Phase 4: Recovery

This is the phase of the real estate cycle when the previous decline starts to turn around. At the beginning of a recovery, real estate prices may continue to decrease, or they might plateau.

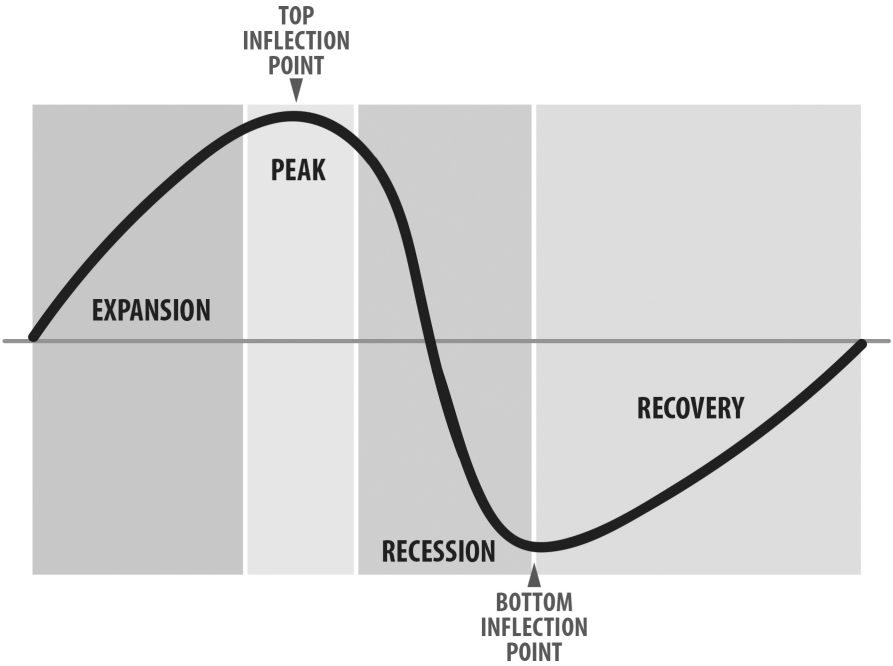
During this phase, it's common for the government to lower interest rates in an attempt to spur economic growth. Once the recovery gains momentum, inventory declines, and many distressed properties get scooped up by investors or savvy homebuyers. Buyer demand

increases and prices may start to rise, but still tend to stay below the inflation rate.

New construction hasn't yet picked up, as financing is still tight and builders are likely still skittish. But builders start to come out of their slumber, begin to line up credit and financing, and look to build their portfolio of land for future development.

Inflection Points

In math, an *inflection point* is the point where a curve changes direction. In an economic cycle, the inflection points are the points at the very top and very bottom of the curve. They occur during the transition from the Expansion phase to the Recession phase (the phase that we call the peak) and the transition from Recession phase to Recovery phase.



At the top inflection point, demand has dropped and supply has increased. They are briefly in balance – prices are not rising or falling – but soon, supply will outpace demand and prices will start to fall.

At the bottom inflection point, just the opposite happens. Supply falls, demand increases, and we hit a balance again. But this time, demand will outstrip supply and prices will start to rise.

In 2007-2008, we saw a very quick and obvious inflection point where the market turned from strong to weak, and the recession came quickly. But inflection points aren't always quick reversals. The market may plateau for months or even years before it turns around, which is what many experts believe is happening or going to happen now, at the end of 2018/beginning of 2019.

You don't typically hear much about these two points in the cycle because they can be hard to identify in real time. In fact, we often don't realize we've reached an inflection point until we're well past it. But they're important because inflection points are the places where lots of money is either made or lost.

In 2007-2008, millions of investors across all industries lost a substantial portion of their net worth – and many went bankrupt – because they weren't prepared for a quick turnaround in the economy. It's not uncommon these days to still hear horror stories from investors about how they lost millions of dollars in equity and assets over the course of just a few months.

On the other side of that coin, those investors who were prepared and well positioned for the bottom inflection point that we saw in 2010-2011 made a killing. The recovery and expansion we've seen over the past eight years is considered to be one of the biggest transfers of wealth in the history of this country, and many investors have profited greatly from that turnaround.

Long story short, understanding these inflection points and preparing yourself for them can mean the difference between great losses and great prosperity.

Chapter 3: Where Are We in the Cycle?

In the last chapter, we said the real estate cycle aligns closely with the business cycle. History tells us that the average business cycle lasts about six to eight years. But as we saw during the tech boom and are seeing now, a business cycle can sometimes last longer – even much longer – than that. Regardless of how long any one business cycle lasts, the real estate market will align closely with it, following a similar pattern of ups and downs.

That's because many of the factors that impact the overall economy such as wage growth, GDP, and unemployment also impact the ability of consumers and developers to buy and sell real estate. When the economy is strong, interest rates are low, and incomes are rising, individuals can afford to make large purchases such as buying a house, and developers are able to build and sell new construction.

But when the economy weakens, interest rates start to rise, and wages stay flat, the opposite happens. That's why you see increased vacancies at the end of the peak phase, during a recession, and at the beginning of a recovery. And it's why you see decreasing vacancies as the recovery gains momentum, during an expansion, and through much of the peak phase.

So how do we use this information to help us become better investors?

The first step to harnessing the power of the economic cycle is to be able to determine what phase of the cycle you're in. That can be difficult to do, especially if you're just looking at real estate as a metric. Because a good bit of real estate performance is localized, different geographic areas can appear to indicate that we're at different points in the economic cycle.

This is especially true around the inflection points, where some parts of the country may seem to be reversing their current trend at the same time other parts of the country appear to be continuing that same trend.

That said, those who track the economy can piece together clues to make an educated guess about where we are in the current cycle. For

example, most experts would agree that right now (again, late 2018/early 2019), we're in the peak phase.

Why? Because since June 2009, the country has been experiencing steady economic growth – a very long time! In addition, interest rates, while still low by historical standards, are starting to creep higher, and there have been indications that the Fed is planning to continue raising rates over the next few quarters.

What most economists don't agree on is *exactly* when we'll hit the inflection point. We don't know if it'll be another two months, two years or somewhere in between. Some say it already happened back in the summer or fall of 2018. However, it's often difficult to know for certain until we're well past that point.

Tools for Monitoring the Cycle

So, if the experts can't always determine where we are in an economic cycle, how are the rest of us supposed to figure it out?

I can't speak for all investors, but I like to use three major analysis tools when I'm considering where we may be in the cycle: observation, timing, and data.

Observation

While this is the least scientific of the ways you can assess where we are in the cycle, just looking at what's going on around you in terms of the economy and the real estate market can give you a reasonable indication of where things may be and where they may be headed. For example, throughout most of the country, for the past several years we've seen a steady increase in real estate values across most asset classes such as real estate, the stock market, and corporate earnings. Based on this information, we can infer that we're currently in an upswing and are more likely approaching the top of the cycle, not the bottom.

Across many areas of the United States, observations of the real estate market, as well as observations of consumer confidence and behavior, indicates things are going very well – perhaps even too well. Many observers believe we're approaching the inflection point, while others claim we have already reached it. Because there's "irrational

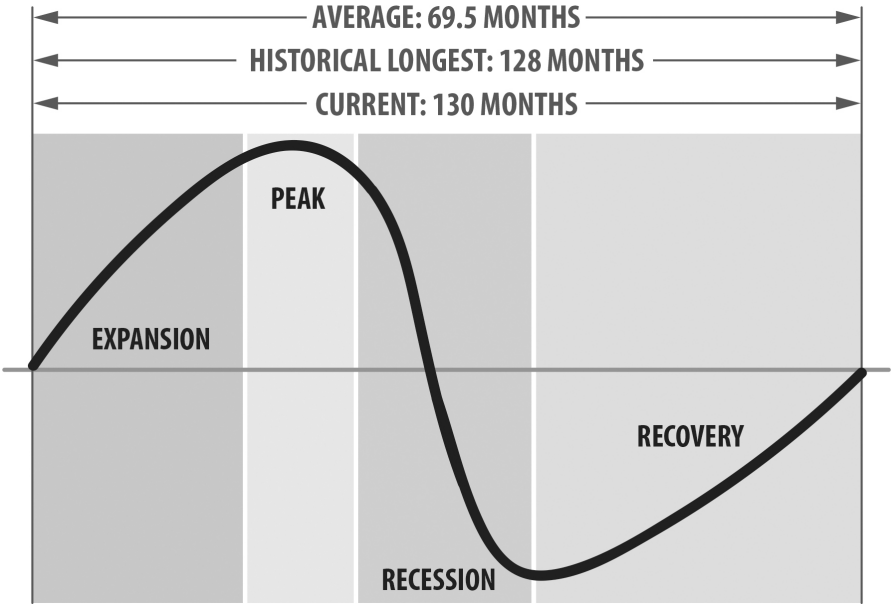
exuberance" in the market and many new investors coming out of the woodwork every day, there is reason to believe the real estate market is hotter than it's been for a long time.

Whether that means a downturn is right around the corner – or still months or years away – remains to be seen. But by observating what's going on at both local and national levels, it's safe to assume that we're closer to the top of the market than we've been in a long while. That means it's time to start considering how we'll change our strategy when signs of a downturn are more pronounced.

Timing

Because business cycles tend to adhere to a rough schedule, we can use that information to determine where we might be in the current cycle. If we look back to the first decade of this century, home values were rising. In fact, the average sale price of a new home in the United States increased by almost 40% from April 2003 ($237,000) to March 2007 ($329,000). Not only were we in an upswing, we were in the middle of the one of the hottest real estate and equity markets in history.

Now if we look at the market in 2009, we see a very different picture. The housing market had crashed, home prices in much of the country had dropped significantly, the stock market had tanked, and we were in a deep recession. That was a decade ago. Given that the typical business cycle only lasts six to eight years, it wouldn't be unreasonable to assume that after ten years we should expect that we're overdue for another downswing, and that it may occur in the very near future. In fact, as of this writing, we are currently in the longest economic expansion in modern history!



Economic Data

There are literally thousands of factors that contribute to the performance of the general economy, as well as the real estate market, in any given area. Some are more influential than others, and some provide greater predictive value about where the market currently is and where it's headed.

While we've discussed using observation techniques and looking at the timing of past economic cycles to determine where we may be in the current cycle, the most reliable indicators of where we are and where we're headed are the data itself. That is how most economists interpret the current situation and direction of the market. If you want to be a successful investor in any industry, you should learn what economic data is important and how to interpret it.

This will be the focus for the rest of this chapter. But before we go any further, there's an important concept we need to discuss —leading vs. trailing indicators.

Leading Versus Trailing Indicators

There are two types of data indicators that can help us determine where we are in the current cycle as well as where we're headed. The first type are *leading indicators*. These factors shift before you see major changes in a specific market or the general economy. Think of them as precursors to change. They can help you predict what's going to happen next. When they shift, it's a sign that market and broader economic changes are coming.

For example, if a large company announces it's moving its headquarters to your city next year, that announcement is a leading indicator of subsequent changes that will occur in your area. Because leading indicators predict what lies ahead, you can adjust your strategy accordingly and take advantage of the opportunities – or hedge against the risks – those changes will bring. That's what my wife and I have been doing for the last decade. Because we've watched these indicators and have adapted our strategy when the market first begins to shift, we've been able to capitalize on opportunities other investors have missed.

On the flip side, *trailing indicators* are the results of shifts in a market or economy. Think of them as successors to change. Unlike leading indicators that warn you so you can adjust your strategy, trailing indicators show up after a change has already occurred. For example, after the large company moves its headquarters to your city, you'll likely see new jobs created, an influx of current employees relocating, increased traffic, and rising home values. These are trailing indicators caused by the company's move.

If you don't want a two-hour commute because of the increased congestion from all the people who are driving to work at the new headquarters, you hopefully moved shortly after the announcement was made. Of course, if you did, you probably had to contend with increasing home prices as the promise of new jobs drove up the value of homes in your area.

But you get the idea. While it's often too late to make changes to your strategy after trailing indicators show up, that doesn't mean they have no value. On the contrary, they can help us learn. They show us

what went well, what didn't, and what we need to change next time to be more successful.

Analyzing both leading and trailing indicators can help you recognize what phase of the economic cycle we're in and how quickly the next phase is approaching. If you use that information to your advantage, you can make changes to your investment strategy before the next cycle begins. But if you miss the indicators, or change too slowly, your business and your profits will likely suffer.

Also, keep in mind that it's important to look at indicators on both the national and local scale. Let's look at some of those now.

National Indicators

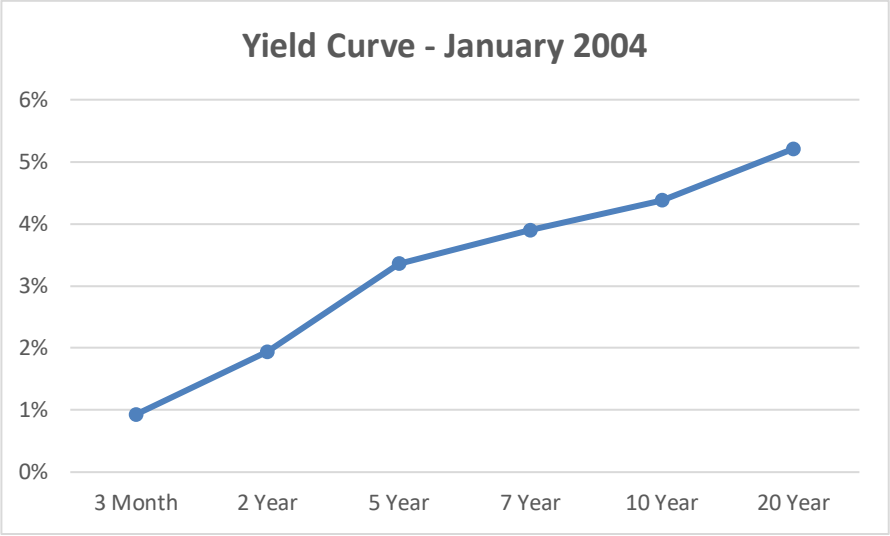
There are many national indicators you can track to help you determine what phase of the real estate cycle you're in and when the next phase might begin. Here are several I follow – and recommend other investors follow – to help make the right investment decisions at the right time.

Yield Curve

The yield curve is an important economic concept that every investor should be familiar with. Said simply, the yield curve represents the change in interest rates for government bonds of different expiration dates. Let me break that down…

When you buy bonds that expire quickly, you should generally expect to get a lower return than if you bought a similar bond with a much longer expiration date. In a healthy economy, there's a vast difference in the return of short term bonds versus the return of long term bonds. The yield curve starts low to the left and ends high to the right.

This is what the yield curve looked like in January 2004, during a strong and vibrant economic expansion:

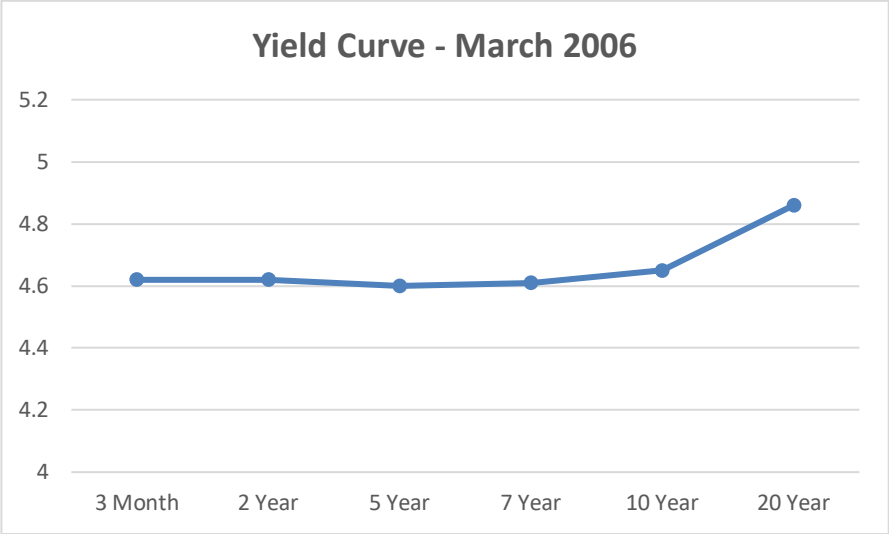


A curve like this makes sense. For those people who are willing to invest their money for longer periods of time, the government provides higher returns.

But the government isn't the only entity controlling the returns on these bonds. The amount of demand from investors also plays a part in bond yields – the more demand there is for a specific bond, the lower the price goes; the lower the demand for a specific bond, the higher the price goes.

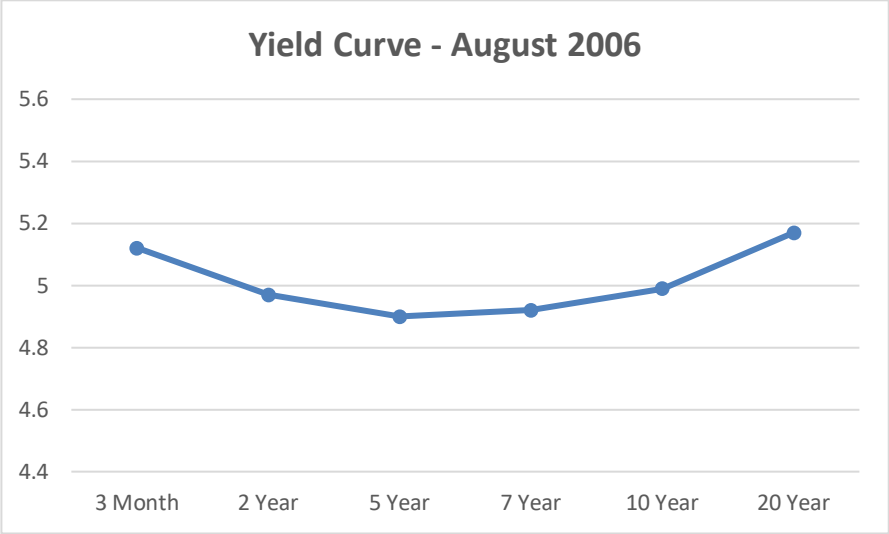
As investors get wary about the economy, they start to move money out of other investments and into longer-term bonds for longer-term security. This increased demand reduces the price of longer-term bonds. At the same time, this desire for longer-term security prompts investors to move money out of short-term bonds. And the lack of demand for short-term bonds increases the return on them.

As investors get more and more concerned about the economy, short-term bond yields increase and long-term bond yields drop – the curve *flattens*. This is what the yield curve looked like in March 2006, about eighteen months before the Great Recession started:



It turns out that the yield curve is one of the best predictors of an impending top inflection point in the economic curve. Right before a recession, we will typically see the yield curve go from flat to *inverted*, with the left and right ends of the curve higher than the middle.

This is what the yield curve looked like just a few months later, in August 2006, about a year before the Great Recession started:



An inverted yield curve has been one of the most reliable predictors of a recession for the past century, and typically occurs between 6 and 18 months before the downturn is evident.

Unemployment

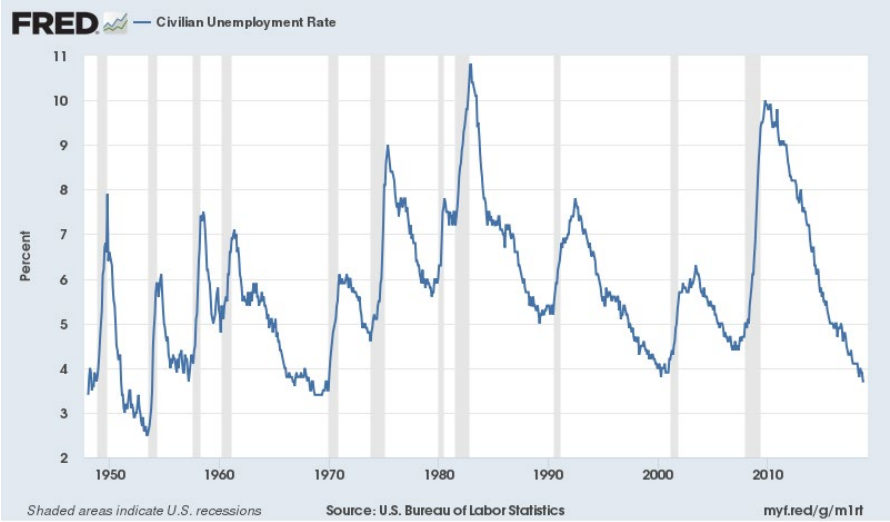
Unemployment statistics measure the percentage of people in the United States who are working versus out of work. There are several measures for this statistic, but the most common is referred to as the U3 unemployment rate. It's considered the *official* unemployment number and measures the percentage of US residents who are out of work but have looked for work within the previous four weeks.

In a healthy economy, we expect the U3 unemployment rate to be in the range of 4 to 5 percent. When unemployment creeps above this mark, it's typically a signal that the economy is weakening. For example, in December 2007 (the beginning of the last recession), the national unemployment rate was 5 percent. But by the end of the recession in June 2009, it had increased to 9.5%, and in October 2009 it peaked at 10%, four months after the recession ended

But, just like an increasing unemployment rate is cause for concern, so is a very low unemployment rate. When the unemployment rate gets down near 4% – and below – we generally consider the nation to be at *full employment*.

Full employment is good short-term because it means many Americans are gainfully employed. However, it's also a precursor to inflation, which will be a drag on the economy. Full employment has historically been a signal that a downturn, or full-fledged recession, is right around the corner.

The following graph maps the unemployment rate over the past 70 years.[1] The grey vertical bars are recessions:



As you can see, full employment is almost always followed by a recession.

Stock Market

Stock prices reflect the predicted future strength of a company. Most companies perform well when the economy is strong and growing. So, if the stock market is performing well, it's likely the economy is too. But just like any market or economy, it can't continue an upward trajectory forever.

If the market has been steadily climbing for a long period of time, it's probably an indication that we're either nearing the end of an expansion phase or in the peak phase. Either way, we know a downturn will be coming at some point. On the flip side, if the stock market's been declining for an extended period of time, that's a sign we're in a recession. The length of the decline may help you identify how close we are to entering the recovery phase.

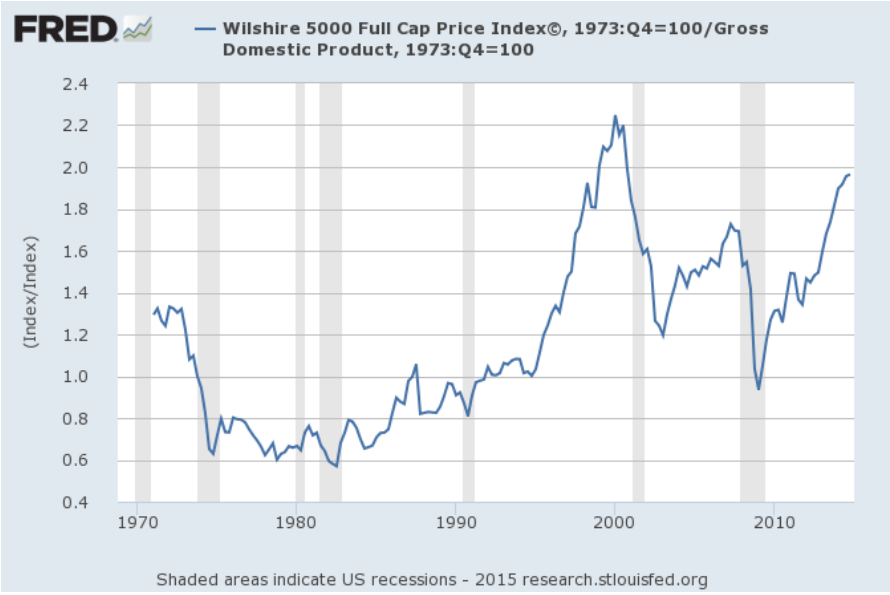
One interesting measure to track with respect to the stock market and the economic cycle is what's often called the "Buffett Indicator," named after famed investor Warren Buffett, who first mentioned this correlation in a 2001 interview. It's the idea that the value of all companies in the United States (which is reflected by the value of the overall stock market) should increase pretty much linearly over time.

Sometimes the stock market price will be above that imaginary increasing line and sometimes it will be below, but over time it will always trend back to that line. If we can determine where that line indicates the correct stock market price should be today, we can see if the market is higher than that – and likely to drop – or lower than that – and likely to rise.

The Buffett Indicator suggests that the total value of the stock market is directly related to the nation's Gross Domestic Product (GDP). We should be able to compare the value of the stock market to the GDP to determine whether the equities market (basically, the stock market) is correctly valued, undervalued, or overvalued.

The general consensus is that if the ratio of these two values is between 75% and 100%, the stock market is fairly valued. Under 75% and the market is undervalued. Over 100% and the market is overvalued.

The following chart maps the Buffet Indicator over the past 50 years.[2] The grey vertical bars are recessions:



By the way, as of the writing of this book (November 2018), the ratio is 147 percent.

Gross Domestic Product (GDP)

GDP is the total value of economic activity within a country and is an indicator of overall economic health. When GDP is increasing, the economy is growing. When GDP is decreasing, the economy is contracting.

Many experts agree the ideal growth rate for the GDP is 3% to 4%. Growth that exceeds this rate is often a sign of above-average inflation, and the government may decide to increase interest rates to slow that inflation. As we'll discuss, increasing interest rates will tend to put the brakes on a growing economy and can lead to reduced GDP or even negative GDP.

In general, if GDP is negative for two or more quarters in a row, the economy is considered to be in a recession.

Interest Rates

Low interest rates make it easier for consumers and investors to borrow money. Rates tend to be low during the recovery and expansion phases of the cycle as the government tries to fuel economic growth.

But when the economy grows too quickly, the government typically responds by raising interest rates to keep inflation in check. Unfortunately, that increase in interest rates means borrowing becomes more expensive and a larger percentage of income is being used to pay interest on credit cards, mortgages, and other types of loans.

The increased borrowing and interest costs to consumers and businesses can put a brake on economic growth. As rates rise, the economy slows, generally leading to a recessionary period.

Wages

When the economy is strong and businesses are growing, businesses often pass some of their increased profits to their employees, and wages increase. But when the economy slows down, profits typically decrease, and wages either stagnate or decrease. Eventually,

companies will start to lay off workers, unemployment increases, consumers can't pay their bills, and a downward economic spiral ensues.

Economists often look at wage growth as an indicator of whether employees and consumers will be spending money – and driving the economy – or scrimping and saving because their paychecks are growing at a slower rate than inflation. When wage growth is lower than inflation, it's a sign that the overall economy is out of whack and economic challenges are looming.

Note that the current economic expansion, which started several years ago, has seen very anemic wage growth. After adjusting for inflation, most employees aren't earning any more these days than they were 10 years ago. This is one of the reasons why a lot of economists believe the current economic expansion isn't as strong as many believe.

National Housing Market

Although real estate markets are localized, and national trends may not represent what's happening in your area, there's value in looking at the national housing market. If housing prices across the country are declining, it's probably an indication that the overall economy is headed for a downturn, which will likely impact your local market. Likewise, if housing prices are increasing, it's probably a sign the economy is strengthening and we're either in the Recovery or Expansion phase.

Local Indicators

In addition to the national economic indicators I discussed above, there are also several local indicators I recommend following, most of which are directly related to housing and the local real estate market.

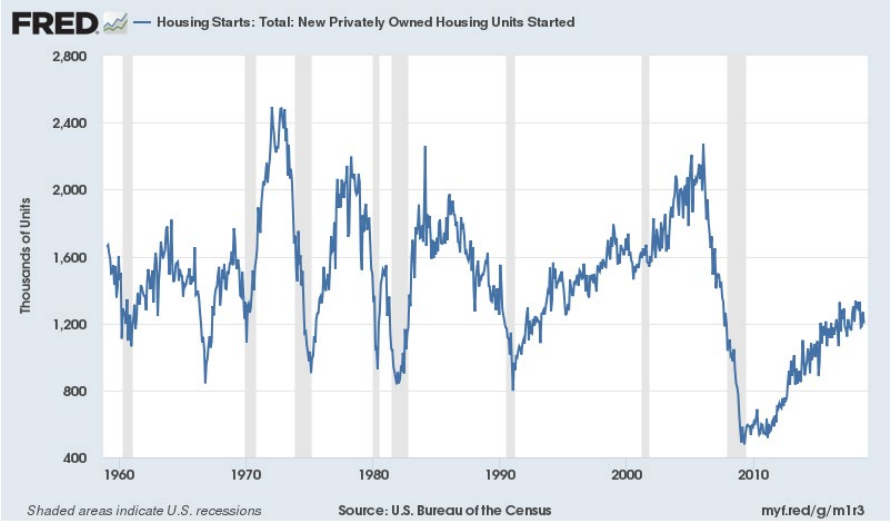
Housing Starts and Building Permits

The number of new residential units developers are starting is an excellent indicator of the amount of housing demand expected in a

location. New construction typically increases during the Expansion and Peak phases when consumers have confidence in the market and plenty of disposable income. On the flip side, new construction usually decreases during the Recession phase as consumer confidence wanes and income growth stagnates. And it tends to stay flat through most of the Recovery phase.

The number of housing starts in an area – or the number of permits that have recently been issued – can provide valuable data about what phase of the real estate cycle your local market is in.

The following graph tracks housing starts over the past 60 years.[3] The grey vertical bars are recessions:



Average Days on Market (DOM)

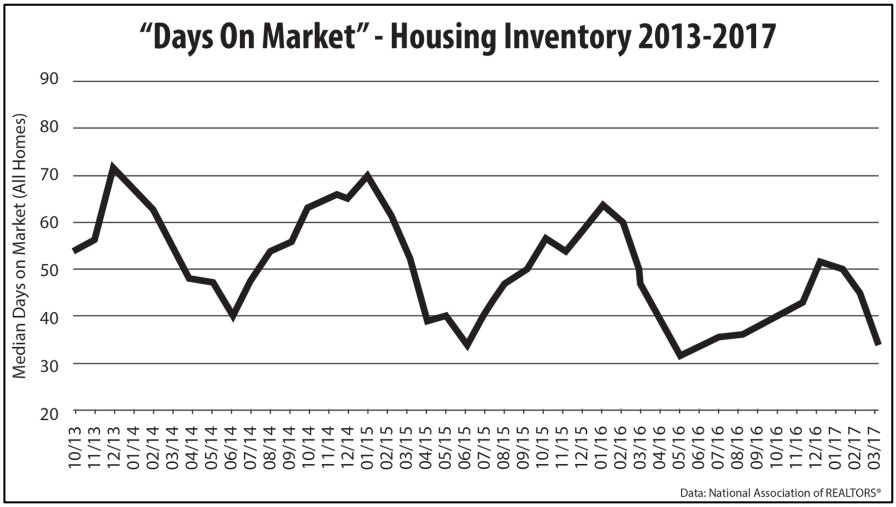
Days on market – also referred to as *inventory* – is an indicator of the amount of demand for residential housing. The more demand, the less time a typical house stays on the market for sale before being put under contract. In other words, DOM is the average amount of time it takes to sell a house.

We'll talk about this more in the next chapter, but on average, DOM across the country is around six months. When DOM drops below

six months, there's more than average housing demand (the market is strong). When DOM increases above six months, there's less than average housing demand (the market is weak).

Throughout the Expansion and Peak phases, DOM is below average, and it's often far below average. But during a recession, DOM is above average. In fact, one of the leading indicators of an impending recession is a sharp increase in DOM.

Here's what the DOM trend has looked like over the past five years. As you can see, DOM has been much lower than average the entire period, and as the current expansion has worn on, housing demand has increased even more.

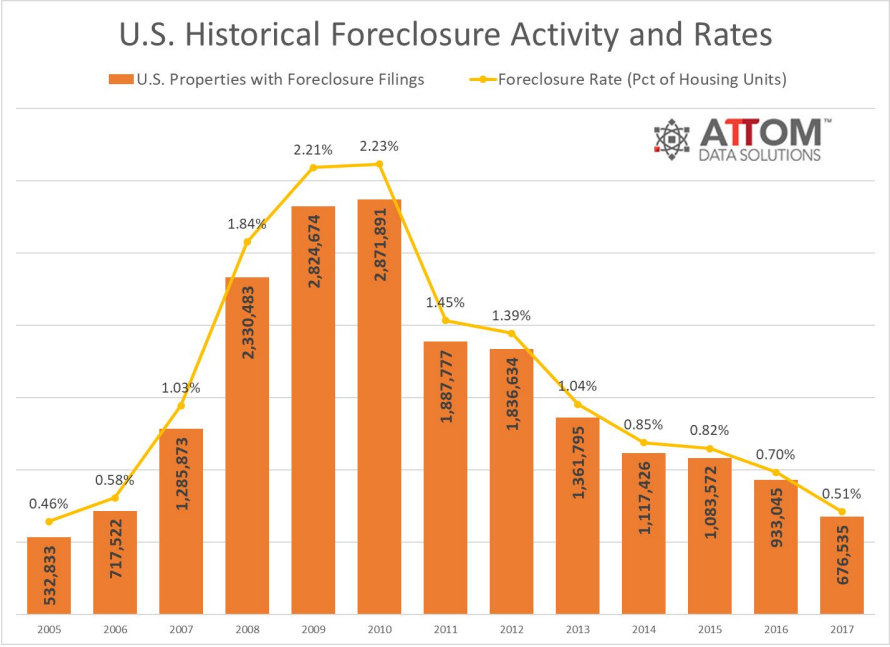


Number of Foreclosures

Foreclosure are a powerful indicator of the strength of the real estate market and where it's headed. During the Recovery and Expansion phases, total foreclosures drop, as consumers have less trouble paying their mortgages and increased home values allow financially stressed homeowners to sell for a profit without defaulting on their mortgages.

But during the Peak phase, as unemployment ticks up and inflation starts to impact how far paychecks will go, foreclosures start increasing. They continue to increase through the Recession phase, where they peak.

The number and percentage of houses in foreclosure is a good indicator of where we are in the economic cycle. The following chart (courtesy ATTOM Data Solutions) tracks foreclosure filings from 2005 through 2017, and is indicative of what we expect to see during a run-up to a recession (2008) and then a recovery and economic expansion (2011 through 2017):



Some Final Thoughts on the Economic Cycle

Remember, even if you're carefully following all the national and local economic indicators, it's not always clear where we are in an economic cycle or when the inflection points will occur. Sometimes, it's even difficult in hindsight!

This is especially true when the transition from one phase to another isn't immediate but takes place over time. Or when the economy stagnates at an inflection point or between two phases.

As you develop and refine your investment strategy for different phases, it's important to remember that all cycles are not equal. For example, the 2007-2011 down market was much worse than normal. On the other hand, the 2001 market correction was shorter – and less impactful long-term.

Every cycle – and every phase of every cycle – will have its unique conditions and circumstances. But if you're prepared for the phase changes, and if you understand the basic concepts around investing during each of the phases, you and your business can thrive, regardless of what the economy throws at you.

One final word before we move to chapter three and examine investing factors in detail. Because the real estate market is local, your area or a certain asset class in your area may be in a different phase of the cycle than other parts of the country. Or you might be in the same phase but experiencing it to a different degree than other areas.

For example, during the downturn a decade ago, virtually every market in the country experienced a drop in real estate prices, but some markets got hit much harder than others. That's why it's important to not only pay attention to what's happening on a national level but also in your own backyard.

1. U.S. Bureau of Labor Statistics, Civilian Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UNRATE, December 3, 2018.

2. Wilshire Associates, Wilshire 5000 Total Market Full Cap Index [WILL5000INDFC], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WILL5000INDFC, December 3, 2018.

3. U.S. Bureau of the Census and U.S. Department of Housing and Urban Development, Housing Starts: Total: New Privately Owned Housing Units Started [HOUST], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/HOUST, December 3, 2018.

Chapter 4: Strategies & The Cycle

To best leverage the phase of the real estate cycle we're in, we must understand and be able to implement a variety of different real estate strategies. While most strategies will work to some degree at any time during the cycle, some are more effective during certain phases than others. To optimize your business at any given time, you need to be flexible and use the strategy that's most effective and profitable – not just one that you happen to like – based on the current market conditions.

If you can only master one strategy because of limited time, knowledge, or capital, there will be times when it will make sense for you to sit on the sidelines and wait for the market to support that particular strategy.

There's nothing wrong with this!

Even if you don't have the resources to change strategies as the market fluctuates, understanding the different strategies, how to use them, and when to use them will give you the knowledge you need to stay out of trouble and to take advantage of a great deal if it comes along at an unexpected time.

Throughout the rest of this chapter, we'll talk about the most common real estate investing strategies and how they are affected by changes in the economic cycle.

Flipping

Flipping is the process of buying property below market value, adding value through renovation and/or repair, and then reselling it for a profit at or above market value. Because flipping requires you to buy low and sell high, the best times to use this strategy are when property values are increasing, which typically occurs during:

- The Recovery phase; and
- The Expansion phase.

If you try to implement a flipping strategy when property values are decreasing, you may find that the dropping values eat through your

profit before you're done with the project, leaving you stuck breaking even or losing money.

Because flipping typically takes several months to complete from purchase to sale, flippers need to be particularly careful at the top inflection point of the cycle. Flipping at this point in the cycle can be very profitable if your projects are completed before the downturn begins, because values are peaking. But if you don't complete projects before the downturn starts, you could be setting yourself up to lose money if values drop quickly.

Too many flippers refuse to lose even a little bit of money on their deals, so when a market correction occurs and they are holding onto property, they often find themselves waiting for the market to recover. They fail to recognize that it can take years for a full recovery, and eventually these investors may find themselves losing either a lot of money, time or both.

If you're a flipper and you find yourself in this situation after the market peak, it's better to cut your losses and accept a small loss than to wait for the market to recover and risk more sizeable losses as the months and even years drag on.

Of all the strategies we'll discuss, flipping is the one that's most affected by the market cycle, which is why it's important for flippers to understand other strategies and either:

1. Transition to another strategy when the market doesn't support flipping;
2. Sit on the sidelines when the market is declining; or
3. Be ultra conservative if you continue to flip near the cycle peak or during the Recession phase.

Wholesaling

Wholesaling is the process of finding and/or negotiating the purchase of property below market value and immediately reselling it or the contract to another investor for a profit. Good wholesalers can negotiate prices that are low enough that they can resell for a profit, while allowing their buyer to generate a profit as well.

Wholesalers must buy low and sell high just like flippers. But wholesaling has some additional requirements that must be met for the strategy to be effective:

- Wholesalers most often sell to flippers. So, wholesaling will be most viable during phases of the cycle when flipping is viable.
- The best opportunities for wholesaling exist when deals are exceptionally difficult to find. Otherwise, flippers and landlords will find their own deals without the need for a wholesaler. If you want to implement wholesaling as a strategy, you have to be good at marketing and acquiring property at great prices.
- Wholesalers need to pay even less for properties than flippers because both the wholesaler and the flipper must be able to mark up the price of the property when re-selling to make a profit. This can be nearly impossible in both an extremely hot market and a declining market. Great negotiation skills are a major asset for wholesalers.

Like any of the strategies we'll discuss, wholesaling is possible during all parts of the cycle. But because of the additional requirements listed above, it'll be most profitable in a subset of the market conditions where flipping works.

Specifically, wholesaling is most effective during:

- The late part of the Recovery phase; and
- The Expansion phase.

If you're going to wholesale during other parts of the cycle, it's crucial that you're opportunistic about the properties you buy. Don't expect high volume. Instead, search out the rare great deals. Luckily, wholesalers can position themselves such that they rarely lose money. But trying to wholesale during inopportune times can cost investors considerable wasted time and energy.

When trying to wholesale during suboptimal parts of the cycle, it's crucial that you have a large network of buyers. Don't just focus on reselling to flippers; also focus on selling to homeowners, landlords, developers, hedge funds, and others, creating additional opportunity during these more difficult times.

Single Family Buy-and-Hold

Buy-and-hold involves purchasing property and renting or leasing it to a tenant who pays for the use of that property. When done properly, the rent paid by the tenant covers all costs associated with holding the property. Plus, hopefully, it generates additional income that becomes the investor's profit.

Like flippers and wholesalers, buy-and-hold investors want to buy low to maximize their earnings, but unlike those other investors, they don't need to sell high. Instead, they want to buy at a price where they can make a profit on the rental income each month, presumably for a long time into the future. So, good buy-and-hold investors are only interested in low purchase prices. For that reason, a buy-and-hold strategy is often best during:

- The Recession phase; and
- The Recovery phase.

During these two phases, prices tend to be low. Often, homeowners (and even investors) want to get rid of their properties and are willing to sell at a discount. Also, during these phases, there's less competition from flippers and wholesalers, who can often pay more than buy-and-hold investors can afford to pay.

In addition, we frequently see reduced interest rates during the Recession and Recovery phases, which means lower financing costs if you get loans on your properties. Unfortunately, these lower financing costs come with the additional complexity of getting loans during these periods. Banks often tighten their lending standards during downturns, but if you can qualify for loans, you can often lock in great long-term rates.

Finally, because market rents tend to be lowest during the Recession and Recovery phases and vacancies tend to be highest, landlords who purchase during these phases will see a bump in profits during other parts of the cycle. Properties that cash flow when purchased during the downturn will generate even greater cash flow when the economy improves, occupancy increases, and rents trend upwards. This is the buy-and-hold equivalent of buying low and selling (generating cash flow) high.

Development / New Construction

Development involves purchasing land, improving it, and either selling it or holding it to generate consistent cash flow. New construction is the process of taking developed land and building on it, or taking a previously developed piece of land, tearing down an existing home, and building on the lot.

Development and new construction can be very lucrative, but these strategies hold the highest risk and are impacted by the market cycle more than other strategies for several reasons:

- Demand for new construction homes is mostly limited to the Expansion phase and the beginning of the Peak phase;
- When the market hits the top inflection point, buyers flee from new construction first, often leaving developers and builders with partially completed inventory;
- The time required to implement development and new construction strategies is long – typically at least six months and often many years. Investors who engage in development and new construction must plan ahead and start building during the Recovery or Expansion phases, so they have inventory to sell during the late Expansion and early Peak phases when demand is at its highest.

The most successful developers work throughout all phases of the cycle. They buy cheap land and distressed property while the economy is in turmoil and prices are down. Then, they hold their land until values increase and builders are ready to build or homeowners are willing to pay for new construction.

Developers must strike early and quickly because development has a longer timeline than some of the other strategies we'll discuss. It's not uncommon for developers to lose money during the Peak phase as demand is met and fewer homeowners are looking to buy new construction. Good developers will have made enough money during the Expansion phase that they can declare success, even if they're still holding undeveloped or partially developed land into the downturn.

When the Expansion phase is longer than average, developers win because demand continues to increase for a long period of time, and they're able to build and sell more of their inventory. But when the

Expansion phase is shorter than average, developers lose because demand decreases sooner than expected, leaving much of their inventory either unsold or having to be sold at a discount.

Buying Land

Buying land involves purchasing undeveloped or partially developed parcels with one of several potential exit strategies, the most common being:

1. Development. The investor buys land, develops it himself, and either holds it long-term or sells it;
2. Land banking. The investor buys land and holds onto it, hoping the value increases, and then sells it for a profit to another investor, a developer, directly to homeowners, or even to the local government to use for a public development project;
3. Land wholesaling. Some land purchasers are simply looking for an opportunity to buy and resell quickly for a profit, no different than the traditional wholesalers we discussed earlier.

If you're buying land to develop it or bank it, the best time to buy is when property values are depressed. When home values are low, land values also tend to be low. This usually happens during the end of the Peak phase, as the market starts declining and during the Recession phase when values are falling and investors are looking to cut their losses.

On the flip side, the best time to sell land – if land banking – is during the Recovery and Expansion phases. Because it takes a long time to develop and build, many developers start to buy land during the Recovery phase, so they can be prepared for the next expansion. If you own large plots of land, the Recovery phase can be a good time to sell. At the same time, if you own single lots and smaller plots of land, you can typically hold a bit longer and sell for top dollar to smaller investors interested in building a few houses during the Expansion phase as demand begins to pick up.

As the Expansion phase wears on, developers and builders are desperate to buy more land to satisfy demand, and so the value of land increases much more quickly than earlier in the expansion. But

holding land towards the end of the Expansion phase and into the Peak phase is not without risk. If a downturn comes suddenly and earlier than expected, that land that was appreciating quickly can lose much of its value overnight.

Smart land bankers will "dollar-cost average" as they're buying land, which means they'll purchase at different points in the cycle to average out their portfolio value. And they'll do the same thing when selling, getting rid of their portfolio over time to capture increasing prices but also avoid a catastrophic loss should the market turn before they've sold off a significant percentage of their inventory.

Private and Hard Money Lending

Private lenders are those who will lend to investors but don't lend money professionally. They may be family members, friends, or wealthy professionals who have extra cash they want to invest; individuals who want to use money from their retirement accounts to invest in something other than the stock market; or real estate investors who want to diversify their investments. Hard-money lenders are typically professional lenders who are securing their loan with the borrower's property and are susceptible to risk should the value of the property – their collateral – drop.

Lending can work in any part of the market cycle, especially for those lenders who can underwrite a wide variety of deals. Many successful lenders will diversify their portfolio and lend to different types of investors such as flippers, builders, buy-and-hold landlords, and commercial investors so they can lend regardless of which strategies are working in the current market. If more investors are focused on buy-and-hold deals, good lenders will adjust their strategy to support these types of loans; if investors are focused on new construction, good lenders will figure out a lending strategy that incorporates new construction loans.

But that doesn't mean the phases of the cycle don't impact lenders' profits and margins. They do. Demand impacts lender profits, and interest rates impact lender margins. When interest rates are high, investor demand for money is high, and the supply of loans is low, lending profits and margins will be higher than when interest rates are low and cheap money is readily available.

During the Recessionary and Recovery phases, when there aren't many professional lenders working and private lenders are scared to deploy their cash, lenders may be able to generate 10% or more above bank rates, plus several "points" upfront, on their loans. But during the Expansion and Peak phases, when lenders are fighting each other to loan money to investors, lenders often have to make loans that rival bank rates, with few fees or points.

Unfortunately, many lenders focus on lending to only one type of investor, such as flippers or buy-and-hold. And when you lend to only one type of investor, lending will only be viable during the phases of the real estate cycle when that type of investor is making money. Because many private lenders lend to house flippers, they're most at risk during the Peak phase. Like flippers, lenders who lend to flippers need to be especially careful at this point in the cycle, so they don't erase the gains they made during the Expansion phase.

Note Investing

A note is simply a promise to repay a loan (the mortgage agreement you sign is a note), and there are many different strategies around buying, selling, and holding notes.

A few of the most common include:

- Selling property using seller financing and collecting cash flow from the note that's created from the loan;
- Buying "non-performing" notes (notes where the borrower isn't paying as promised) for deep discounts and then working to generate profit from the note by negotiating repayment with the borrower or foreclosing on the property;
- Creating or buying a note, and then selling off parts of a note for quick profit or to borrow against the note.

This is far from an exhaustive list of how notes can be used as an investment strategy, but I did want to touch on the subject, as notes are often a great strategy during the economic phases where other strategies are less effective. That said, notes can be a profitable part of an investment portfolio during any part of the economic cycle, with

different strategies providing advantages and disadvantages at different times.

Commercial

Commercial investors invest in various types of real estate other than small residential properties or land (which is sometimes considered commercial investing itself), including:

- Multi-family (apartments)
- Retail space
- Mobile homes
- Office space
- Warehouse space
- Self-storage
- And a whole lot more!

Nearly all commercial investing relies on income from regular lease payments, just like in the buy-and-hold strategy. For that reason, the commercial strategy follows many of the same cycle rules as the buy-and-hold strategy.

But there are a few big differences:

- Commercial properties are often much more expensive than single family buy-and-hold properties, and commercial lending is typically the tightest during the Recession phase of the cycle. While commercial investors can often get the best deals during a recession, it's usually the most difficult for them to get the money they need to buy during this phase. Because of that, it's often better to implement a commercial strategy during the Recovery and Expansion phases, when lending requirements start to loosen up and borrowing becomes easier.
- Many commercial investors rely on private investors to fund part or all of their deals. This is a form of investing called private placement or syndication. Because of the reliance on individual investors, commercial investors are most likely to be able to put together these deals during times when smaller individual

investors have access to cash and a willingness to risk that cash on a real estate deal.

- Commercial investments often focus on areas that are more recession-proof than residential property investing, and some commercial investments actually thrive during recessionary periods. For example, self storage facilities often see a sharp rise in demand during a recession, simply because more families are moving in together or moving into smaller spaces and need a place to store their extra stuff.

I encourage you to think creatively about commercial investments and how some less common investments can provide benefits during times when other commercial investments are less profitable.

Chapter 5: Strategies for Today

As I mentioned earlier, I'm writing this book during the final months of 2018. While I can't know for certain, I strongly suspect we have entered the Peak phase of the market and are approaching the top inflection point. We may be in this phase for many months (or even a year or more) before hitting the top, but I suspect it's coming.

In my opinion, all real estate investors should be modifying their strategies to prepare for Peak phase investing.

While it's possible to make money during any phase of the economic cycle, all cycles are not equal in terms of risk exposure. In the Peak phase, there are still plenty of strategies and opportunities to continue making money, but the risk of losing money increases substantially during this phase.

The biggest risk comes from the market changing direction, which causes once profitable investments to lose value. But there are other risks as well. When interest rates rise, profits on cash flowing assets shrink due to higher borrowing costs. And when your customer base – homeowners, other investors – starts losing their jobs, it's more difficult to sell your properties, lend your capital, and fill your units.

But if you are conservative and employ the right strategies, there are still ways to profit during this part of the market cycle. Here are my recommendations:

- **Flip with caution.** Flipping is still a great strategy, even in this phase. But as you approach the top inflection point, your risk increases significantly. If you're unable to sell your properties before the market starts to decline, you may lose money on your deals. If you're going to flip during the peak phase, here are some rules to follow:
    - **Be certain of your numbers.** While it's important to understand the costs you'll incur and the potential profit you could earn in any market phase, it's especially important in a hot market. Knowing and verifying your rehab budget, after repair value (ARV), and fixed costs (buying costs, holding costs and selling

costs) are crucial when the market could level out – or decline – before your project is complete. This is where a great lender can be invaluable. Crowdfunding providers, hard money lenders, and private lenders can provide a second set of eyes on your numbers to ensure the deal being funded makes sense.

- **Keep projects quick.** There are parts of the market cycle where taking your time on a project can help you increase your profits. When a market is on an upswing, and it appears that trend will continue for at least another year or two, taking your time means your ARV will likely increase from the beginning to the end of the project. But when you're further into an upswing, the opposite can happen. Dragging out a project won't necessarily result in extra gains, and it may ultimately decrease your profit if the market turns before it's complete. For that reason, if you must choose between a long project with greater profit potential and a quicker-but-less-profitable project, going for the faster project isn't necessarily a bad choice at this point in the cycle.
- **Don't take on more projects than you can work on simultaneously.** In this type of market, I don't recommend buying a lot of properties with the intent of rehabbing them in sequential order (one after the other) because there's a good chance you won't be able to complete all of them before the market turns. In some markets, you may find opportunities to buy multiple properties in a short period of time (for example, the winter months in very cold climates), but that often means not having the manpower to rehab them all at once. While that might be okay in other parts of the cycle, it's not okay during the Peak phase. If you have properties sitting for months waiting to be rehabbed, you risk having the market turn before you even get started, let alone finished. If you decide to buy multiple properties and you're unable to rehab them at the

same time, I highly recommend wholesaling the ones you can't get to or partnering with other investors who have extra bandwidth to take on additional projects.

- **Have multiple exit strategies for each project.** While rehabbers hate to think about what they'll do if a property doesn't sell, in this type of market, it's important to have a Plan B – and perhaps a Plan C as well. There are plenty of potential exit strategies for rehabbed properties that ultimately can't be flipped. For example, focusing on flips that you're confident would make decent rentals or lease-option properties if you're unable to resell them for a profit can help protect you from sustaining significant losses. You might also consider selling your current home and moving into the rehabbed property until the market improves. There are plenty of backup strategies for flip properties. Just make sure you have at least one or two options in your back pocket when making a purchase during this phase.
- **Avoid thin deals.** While there are times when real estate markets will see a quick and drastic correction (take 2007-2008, for example), the shift from upswing to downswing is typically more subtle. And often there's a period of time between the upswing and downswing when values stay flat. If you have a deal with returns of 20% built into the numbers, the market can drop and you won't lose money on the deal. But when you take on deals with returns of just 5%, if the market has even a minor correction, you could be facing potential losses. For that reason, I highly recommend focusing only on deals with relatively large profit margins.
- **Avoid large amounts of leverage.** A lot of rehabbers got into trouble back in 2007-2010 because they were getting loans for almost the entire value of the property they were buying (that's what we refer to as large amounts of leverage). That meant if there was

even a small correction, the value of the property was less than what the investor owed the lender. And unless the rehabber could come up with some cash to repay the loan, the lender was likely going to foreclose. Rehabbers lost many properties this way in the last real estate recession. If you need to borrow money to finance your flip deals, focus on keeping your loan-to-value ratio (LTV) at no more than 75%. That way, even if there's a 25% correction in the market, you can still reduce the risk of foreclosure on your properties.

- **Lower your carrying costs.** At this point in the cycle, it's particularly important to keep your costs as low as possible. That way if the market turns before a project is complete, the monthly costs to hold onto it longer-term will be less. You'll also have a better chance of recovering your costs and making a profit. There are two ways to do this. First, if possible, pay cash for your properties instead of financing them. Second, if you must finance them, borrow as little as possible to keep your LTV low and pay down your loan as quickly as you can.
- **Focus on properties that appeal to as many potential buyers as possible.** Every market has a "sweet spot" for rehabs – that combination of value, location, house style, and finishing materials — that appeals to the widest range of buyers. When a market shifts into a downswing, these are the types of deals that are the most likely to sell, as there are more potential buyers who may be interested in buying the property when it's listed for sale. When you're in a situation where the market may turn, avoid very low-end rehabs where potential buyers tend to have a more difficult time qualifying for financing. And stay away from exotic or "taste-specific" rehabs that will appeal only to a small segment of the buyer pool.
- **Stay away from high-priced houses.** Higher priced houses will be the first to stop selling when the

market turns. As the market declines into a recession, interest rates are typically rising, and wage growth stagnates or declines, which makes it more difficult for consumers to buy a home. If you have a high-end house you're trying to sell, you're going to have a tough time because your buyer pool will be almost non-existent.

  - **Avoid speculation unless you're willing to hold long term.** If speculation is part of your investment strategy, be prepared to hold onto your property for longer than usual, and don't buy houses hoping they'll appreciate. Because property values have already been increasing for years at this point in the cycle, you're less likely to be able to turn around, sell a property, and make a profit based on short-term market fluctuations that quickly drive up the property value. It's more likely the value of the property you thought would appreciate either stays flat or declines.

- **Lend with caution**. If you're a professional or private lender, you should be making changes to your lending strategy to mitigate risk and ensure you're well-positioned to make money regardless of when and how severely the market corrects. If you're going to lend during this phase, here are some recommendations:

  - **Increase your interest rates.** If you're lending at this point in the cycle, make sure your rates are high enough to offset the increased risk associated with a potential market correction. Remember, if values drop, the value of any collateral drops as well. If you're holding a note for a $100,000 loan, and the value of the property drops below $100,000, you are now at risk of losing money if the borrower defaults. Because of the desire to keep their money working, many lenders will lend at rates that are probably too low to account for risk at this phase. Don't make that same mistake. Unless your risk threshold is much higher than

mine, it's better to make fewer – but more secure – loans than to make more loans, each with more risk.

  - **Lend to landlords before flippers.** As someone who does some private lending, I like to transition my loans away from flip properties and towards landlords at this point in the cycle. Because flip properties only make money at sale and buy-and-hold properties are cash flowing every month, the risk of lending on flips is significantly higher should the market turn while the loans are still active. When values are dropping, I'd rather have to foreclose on a cash flowing rental than on a partially completed flip.
  - **Be careful of lending in judicial foreclosure states.** If you're a lender, you always face the possibility of having to foreclose and take back a property from a borrower who doesn't pay. In states that require a judicial process in order to foreclose, you can find yourself tied up in the court system for a year or more waiting for a foreclosure to complete, so you can sell the property and recapture your investment. This is a huge risk if values are likely to fall in that timeframe while waiting for your foreclosure judgment.

- **Be cautious with buy-and-hold properties.** At this point in the cycle, demand is high, prices are high, and cap rates and returns are low, making it difficult to find good rental deals. More importantly, any buy-and-hold deals at this stage are probably seeing maximum rental income and minimal vacancy. If you decide to buy to hold during this phase, make sure you plan for the lower rents and higher vacancies that will occur after the market declines, and include those factors in your analysis. While you may still be able to still find decent deals at this stage, there will likely be better and more plentiful opportunities after the market starts to decline.
- **Focus on C-class instead of A- or B-class properties.** When the economy tanks, people move from higher-end rentals to less expensive ones to save money. In addition, the largest

declines in market rent tend to occur at the higher end of the market. Landlords who are holding C-class properties often do better during recessions than those holding A- and B-class properties, as their income and occupancies will be more resilient to the downturn.

- **Avoid short-term borrowing.** Short-term loans for flips or buy-and-hold properties can be extremely attractive, especially during this phase of the cycle, because rates are still low and money is flowing freely. But if the market turns before you've repaid your loan, you may find that the loan comes due prior to your completing your exit strategy (sale or refinance), and if you don't have funds in reserve to satisfy the loan, you put yourself at risk of losing the property. In this phase, I highly recommend trying to negotiate loans with longer terms and loan terms that allow you to extend the term of the loan if you haven't completed your exit strategy by the time the loan comes due.
- **Consider using long-term lease options to rent or sell.** If you're having difficulty renting or selling your properties towards the middle or end of this phase, consider using lease options. Lease options give less qualified buyers – for example, someone who can't yet qualify for a mortgage – the opportunity to get into a property, make payments, and hopefully change their financial situation and eventually purchase the property. Not only will you lock in a high price for the property during this phase but you'll have someone who can help offset your holding costs by paying rent every month.
- **Don't buy land unless you're willing to hold onto it long term.** As I mentioned in the last chapter, the beginning of an expansion is a great time to sell parcels of land to developers who are preparing for the increased demand that typically occurs later in an Expansion phase. But by the peak phase, most developers have already bought all the land they're going to need for the current real estate cycle. The next big opportunity to sell land is likely two to four years off – and prices will drop in that time – so buying land at this point in the cycle is generally going to be suboptimal.

Final Thoughts

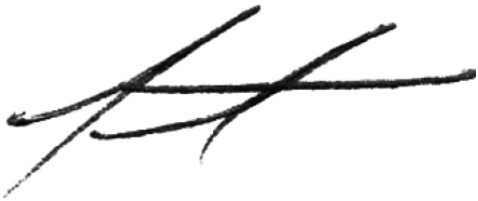
While writing this book, I had discussions with some investors whom I highly respect and admire. One of the recurring themes of those discussions was the idea that great investors should be able to focus on a single strategy throughout the entire market cycle and still be successful.

I don't disagree with this. Those who are world-class at a given investing strategy can use that strategy continuously and are likely to be successful no matter what obstacles the market throws at them. They are so good at the one thing they do they can make money doing it any place, any time, and under any conditions.

But many of us aren't the best in the world at a given strategy. For us, trying to fight the market is an effort in futility; either we don't have the skills to execute on a single strategy at every point in the market cycle or we don't have the desire to try. And for us mere mortals, the idea of bending and flexing to the whims of the market makes a lot more sense than standing up to the market and challenging it to take us down.

Personally, I always prefer the path of least resistance. That mindset, along with the philosophies and strategies I've laid out in the pages of this book, have worked well for me throughout the last business cycle. I hope you'll find they work for you as well.

In the meantime, if you have any additional thoughts, recommendations, or feedback on the information I've provided, don't hesitate to shoot me an email to **J@123FLIP.com**.



Glossary

Appreciation	The increase in the value of an asset over time.
Bonds	Debt (often provided by the government) that pays a fixed interest to the investor.
Business cycle	The cyclical expansion (strong economy) and contraction (weak economy) that we see about once a decade or so, and what we typically think of as basic economic fluctuations.
Buyer's market	Part of the real estate cycle in which there are more houses for sale than people to buy them. A housing market that favors buyers.
Capitalization rate (Cap rate)	The income generated by a property divided by the value of the property. This metric indicates the percentage return an investor could expect by purchasing this property.
Cash-on-cash return (COC)	Percentage return received each year on the amount invested. For example, an investment of $100,000 that generates income of $10,000 would have a 10% COC.
Days on market (DOM)	The amount of time a real estate listing has been on the market. Also used to indicate the average amount of time a property in an area can expect to sit before being getting a contract.
Expansion	Business cycle phase in which buyer demand for housing is increasing as other economic factors such as wage and job growth are strong
Federal Reserve (Fed)	The central bank of the United States. The Fed sets monetary policy for the country, including controlling interest rates by defining the rate at which banks are required to borrow from the government.

Foreclosure	The legal process by which a lender takes back a property from a borrower who isn't paying as promised.
Full employment	Unemployment rate at which most Americans who are looking for work have found jobs. The Federal Reserve considers a base unemployment rate (the U-3 rate) of 5.0 to 5.2 percent as "full employment" in the economy.
GDP	The total annual economic output by a country.
Housing starts	The number of residential housing units that are beginning the process of being permitted and built.
Housing supply	See "Inventory".
Inflation	A general increase in prices for goods and services.
Inflection points	In an economic cycle, points at the very top and very bottom of the curve.
Interest rate	The cost to borrow money or the return on lending money.
Inventory	The number of months it would take to sell all of the housing inventory currently for sale in an area.
Judicial foreclosure	A foreclosure that is required to go through the court system before being legally granted. Judicial foreclosures tend to take much longer than non-judicial foreclosures.
Leading indicators	Economic factors that shift before you see major changes in a specific market or the general economy; precursors to change.
Lease option	A type of purchase contract whereby the owner agrees to allow the buyer to lease a property for a fixed period of time, during which time the buyer has the option to buy the property.

Leverage	The use of borrowed capital to purchase and/or increase the potential return of an investment.
Long-term debt cycle	A longer economic cycle, lasting between 75 and 100 years, where the debt bubble slowly expands and eventually pops.
Non-performing note	A note on which the borrower isn't paying as promised.
Note	A promise to repay a loan; one common example is a mortgage note.
Peak	Business cycle phase in which prices hit a plateau and demand starts to soften.
Performing note	A note on which the borrower is paying as promised.
Points	A percentage of the total loan amount, typically paid as a fee prior to the loan being made. 1 point equals 1% of the loan amount.
Portfolio loans	Loan products with different requirements than offered by government entities. These loans are generally offered by smaller banks to investors, typically in a strong economy when the risk of borrowers defaulting on real estate loans is low.
Private placement	An investing fund created by raising money from smaller, individual investors.
Profit margins	The percentage of the total revenue earned by a business kept as profit.
Recession	Business cycle phase in which there is general economic turmoil; some common elements include high unemployment, reduced wages, and tightening of credit.
Recovery	Business cycle phase where economy starts to recover after hitting bottom.
REO	Another term for a bank-owned foreclosure.

ROI	Return on investment.
Seller financing	Creative financing method by which the seller of a property uses equity in the property to provide a loan to a buyer.
Seller's market	Part of the real estate cycle in which more people want to buy houses than want to sell them. A housing market that favors sellers.
Subject-2	Creative financing method by which the buyer of a property takes over the payments of the seller's loan in return for possession and deed of the house.
Syndication	A form of investing relying on the combined funds of several private investors who have pooled capital to fund part or all of a deal.
Trailing indicators	Economic metrics seen as a result of shifts in a market or economy; successors to change.
Underwrite	The process that a lender uses to assess the creditworthiness or risk of a potential customer and/or loan collateral.
Wrap	Creative financing method by which the seller and buyer create a new loan that requires the buyer to pay the sellers existing loan, plus allows the seller to collect additional payments.
Yield curve	The change in interest rates for government bonds of different expiration dates.