156: Introduction to Real Estate 2.0

Full Episode Transcript

With Your Host

Bonnie Koo, MD

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Hey everyone. So for the next few episodes we're going to talk about all things real estate. And so you're going to hear from two of my really good friends who are really great at, obviously, doing real estate. And so one from the passive side, one from the active side. And we're also going to talk just a bit about their journeys, how they even got into it, they're both physicians, just to really hear their thoughts about how to think about money and sort of the money mindset and also from a physician perspective.

So what I thought I would do for today's episode is actually give you an overview of real estate in case you're not familiar. And it's actually a replay of one of my first episodes. We're into episode almost 160 at this point, and so this is episode, I don't know, it was like 5, or 6, or 7 or 8, and so it's been a minute.

And so we're actually going to combine both episodes in one because basically I'm giving a great and broad overview of real estate in case you're not familiar and to help you figure out why it might be something that you should do. All right, so here it is. And then next week you'll hear from Dr. Peter Kim of Passive Income MD.

Welcome to *The Wealthy Mom MD Podcast,* a podcast for women physicians who want to learn how to live a wealthy life. In this podcast you will learn how to make money work for you, how you can have more of it, and learn the tools to empower you to live a life on purpose. Get ready to up-level your money and your life. I'm your host, Dr. Bonnie Koo.

Today we're going to talk about real estate. Specifically, today it's going to be high-level. I just want to set the tone and we're going to explore some more specific topics in later episodes because real estate is such a big topic. I mean, there are whole podcasts, books, and businesses devoted to solely real estate. And this is not a real estate podcast. Why am I even talking about it today? Well, I've come to realize that real estate is a great way to build wealth and relatively quickly, so I'd be remiss to not mention it.

Here's an overview of what I'll talk about today. I want to talk about why should someone like you should even consider investing in real estate? I want to go over some of the common objections to investing in real estate. And then I'll talk about the overall benefits. And then I'll start going into how you actually make money in real estate. I find that this is actually one of the most understood details about real estate investing.

Okay, before I start, I want to talk a bit about my real estate history. Like many of you, I knew that many people invested in real estate and that was a thing. But I just wasn't personally interested in it and I had some of the common objections that I'll go into a little bit later. But eventually I decided, "You know what? I need to learn more about this. I need to educate myself. If I could become a physician, I can certainly learn about real estate, right?"

So I started small. I started investing passively through syndications, and you'll learn what that is in a later episode. And up until recently I was avoiding direct real estate, meaning owning my own property. At the time of this recording, we have purchased our first rental property. It's definitely a learning curve and there's lots of stuff happening, but I'm so glad we finally took the leap.

So why should someone like you consider real estate investing? If you recall my earlier episode, Think Beyond Your Clinical Income, I'll be referencing this episode a lot. You'll recall that I talked about a table with legs and that the goal is to create as many legs as possible so that your table of wealth is as stable as possible.

What's great about real estate is there are so many legs within the leg of real estate and you can build this leg relatively quickly versus stock market investing, which just takes a long time and there's absolutely nothing wrong with it. Also, you can have a lot of control over real estate and I'll go into why that's important.

Let's go over the common objections I hear and that I personally had when it came to investing in real estate. So many of us think it's so hard and it's so overwhelming, you don't even know where to start. And that's partially because of the breadth of real estate. And so my goal today is to kind of start breaking down these pieces for you.

Also, many of us have heard horror stories about bad tenants, or fixing toilets, or things that could go wrong. And finally it's a lot of freaking work, right? At least that's what I think, and maybe that's what you think too. I want to say that you know much more about real estate investing than you think you do because take a step back. Where do you live right now? Is it a home? Is it an apartment? Is it a condo? Are you renting it or do you own it?

Whether you rent or buy, most of us have experience renting, so we understand at least part of the puzzle, right? Just remember these types of experiences, when combined with focused reading and education and supportive mentors, can make taking the plunge into real estate relatively easy and you can become successful too.

Okay, let's go over the overall benefits. There are five specific benefits I will go over: speed of growth, control, taxes, familiarity, and tangible assets. So first let's talk about the speed of growth. I've mentioned earlier that you can create wealth relatively quickly through real estate. So what do I mean by relatively quickly? Within a few years. Compare that to stock market investing, which will take decades for compound interest to work.

Second, we have taxes. So a lot of us have what we call retirement accounts and these are sheltered from taxes, right? But at some point you are going to have to pay taxes on it. Whether you pay taxes upfront, like in a Roth IRA, or if you pay taxes later, like a traditional 401k. But there's no getting around the fact that you're going to have to pay taxes at some point on these investments. And many of you are thinking, "Well, but yeah, that's normal. I mean, you're always going to have to pay taxes."

This is where real estate investing really, really hits the mark. And this is what I'm really excited to talk to you guys about. When it comes to real estate there are so many tax benefits to real estate investors. In fact, the tax code was written for real estate investors and this is especially true if you achieve something called real estate professional tax status, also called REPS, R-E-P-S. We'll talk more about that later.

Okay, let's go over the overall benefits of real estate. We're going to talk about the speed of growth or speed of wealth with real estate. We're going to talk about control, taxes, familiarity, and the fact that it's a tangible asset.

So first, let's talk about the speed of growth with real estate. And I think this is one of the biggest benefits of real estate because I hear so often from my women physician colleagues that they understand the basics of stock market investing, but that it takes so long, especially when they start plugging in numbers in a compound interest calculator.

And so if you want to reach financial freedom quicker, or at least get flexibility earlier, then you really should consider real estate because you can create freedom relatively quickly. So what does that mean, relatively quickly? You could do this within three to five years. I would say probably five years. That's way, way less time than waiting decades for the stock market to pay off, right?

Next we have control. This is where some people get a little scared because in some ways, investing in index funds is kind of nice because it's super hands-off, and it's even more hands off if you just invest in a target fund. With real estate, it's a bit more hands on, although there is a range over passive to active. But the more control that you have over real estate, the more benefits you will have and the more wealth you can grow quickly.

Familiarity, remember, most of you guys are already familiar with real estate investing way more than you think because you've been a tenant at some point as a renter or you've owned a home or maybe you're living in that home that you own right now. So those experiences actually make up part of the knowledge of being a real estate investor. And the more types of homes, apartments, et cetera, that you've lived in, that gives you even more experience than you realize.

Finally, real estate is a tangible asset. You can see the property that you own. It's real. And this is so different than investing in the stock market where you just see numbers on a screen and a bunch of letters and yeah, you know that you own 0.45 shares of a company. But what does that really mean? You can't really see it. You definitely can't touch it. And so for many people, the fact that you can actually see and touch your property can actually make you feel a lot more confident.

So let's talk about how you actually make money by investing in real estate. And this is where I find a lot of people actually don't understand how it makes you money. That's partially because if you're a homeowner, you only see one side of how real estate can make money, specifically appreciation. And that is one way to make money in real estate. But that's sort of gambling, right? Because you're kind of hoping that it will appreciate, and generally it does.

Obviously, every real estate market is different. For example, you know, my fiancé had a condo in Brooklyn, New York City. And so the appreciation in New York city is unreal. He was able to sell his condo at almost 400% more than what he actually paid for.

And that brings me to another topic, leverage. Because he didn't actually pay the amount when he bought it. He bought it for, it was in the low one hundreds, let's just say $150,000 for this example. He didn't have to put in $150,000. He made a down payment of $15,000 and was able to sell it for way, way more. So that's called leverage. Basically you're making a down payment, you're leveraging borrowed money to make more money.

This is kind of an out-there topic or concept because a lot of us think that debt is bad, right? Because in real estate you often take on debt to make money in real estate. And that's a concept that many of us are not familiar with or we're not comfortable with because we've been conditioned to think that debt is bad. We'll talk about that in a later episode.

So cash flow is one of the ways you can make money with owning direct real estate. Basically, your tenants pay rent and the rent covers more than your mortgage and other expenses, so you've created a small amount of cash flow.

Now, a lot of people understand this concept and when you look at the actual numbers, you might think, "Well, gee, this is only cash flowing $500 a month or a thousand dollars a month. That's not really going to move the needle for me." But that's just one aspect of how you make money in real estate. The real benefit, in my opinion, are the tax benefits.

And there are such numerous tax benefits that I sort of mentioned earlier. And so it's really the tax benefits combined with all the other things, cash flow, possible appreciation, and leverage, that just grow your money at such a fast pace. Let me give you an example.

So I mentioned before that there's something called real estate professional tax status. This is where you're able to write your real estate losses, which are paper losses, meaning they're not actually real, meaning you're not losing money, but on paper you are losing money. That's not making sense. Don't worry about it now, it's just something you do on your tax return, okay?

If you're able to elect this tax status, real estate professional status, you are able to use these paper losses against your active income. What do I mean exactly? That means that if you are working as a physician or you have a business or some other sort of stream of income where you'd generally pay income taxes, right? Which most of us think is normal and that we all should pay taxes.

Well, if you have real estate professional status, you have the possibility of actually paying zero income taxes. Now, some of you might be thinking, "Well, that's just not right. I mean, I should be paying income taxes." Here's the thing, the government will get its money. Instead of paying income taxes, you’re paying taxes through the real estate because when you own real estate, the real estate generates taxes for the government.

Think about it, property taxes. Do you have tenants living there? Property manager. All the things that go along with real estate investing generate taxes for the government. You’re still paying taxes; it’s just offloaded and basically, someone else is paying the taxes for you.

Think about that. You’ve got your cash flow, which is generally tax free anyway because you can write your paper losses against it. You’ve got leverage because you’re generally not paying the whole – Let’s say you bought a $300,000 property, you’re not putting in $300,000 to buy that property. Generally you’re paying a percentage of it, 25 to 30% let’s say, and the rest is loaned from the bank.

And then if you combine this with tax benefits, like real estate professional status, it can really supercharge how you create wealth. We’ll talk more about real estate professional status later because there are lots of nuances and most physicians initially will not qualify. However, it’s still worth it to invest in real estate because later you may qualify.

So I want to close out this overview of real estate episode by talking about the different types of real estate out there. Now, many of us just think of homes because you probably live in a single family home. That’s what we call it in real estate investing. That’s the most common type of real estate that people think of.

Well, let’s talk about all the other ways you can invest in real estate that you can actually own. It starts with just raw land, like you could just buy land that has nothing on it. Land is valuable or you can develop real estate on top of it. We already mentioned single family homes. This is the traditional home that you probably live in now. Then we have multi-family homes, basically it’s duplexes, triplexes, quads, et cetera.

Then we have our super large apartment complexes, which is where I live now. I'm renting right now. We have mobile homes, we have commercial real estate. We have self-storage, there is senior living. Just look around. You'll start noticing all the different types of real estate that people live in. And those are all available as investments in the future.

You can think of real estate investing in two ways, equity and debt. And by understanding these two ways that you can invest in real estate, you'll be a much more informed investor. Basically, you either own real estate to varying degrees or you're lending money so that someone else can own the real estate.

So equity means that you are owning the property, at least to a varying degree, and we'll talk about that a bit later. This can take on many different forms. For example, in direct ownership you actually own the property and then you rent it out. And this requires, I guess, the most work and you have the most control as well.

Another example is investing in syndications, crowdfunding, or real estate investment trusts, also known as REITs. This is the passive side of real estate investing. And when you do it in this way, you're basically owning a share of real estate, kind of like how index funds are owning a share of a stock.

When you invest in real estate in this passive way, you basically get profit or grow money from the promised interest return, and then again when the share of the profit is sold. There are many similarities or correlations between real estate and the stock market.

Let's talk about debt. If you're familiar with how bonds work, then you can think of debt investing in real estate as something similar to that. This is where you're lending money to another person or entity so that they can buy real estate. As an investor in debt, you will basically typically receive monthly interest or quarterly interest payments.

Now, these interest rates can actually be quite high, especially compared to bonds. And after a period of time, your capital is then returned. These interest rates can be as high as 10%. So the fact that the interest rate can be high and the fact that they're relatively simple and relatively secure, because the debt is secured against an actual property, it can make debt investing actually quite powerful.

Now, I just want you to understand that the money you make from investing in real estate debt is often taxed or is taxed as ordinary income. Meaning that you're going to pay your marginal tax rate on it. Now, you can invest inside of a tax advantage account inside a retirement account. Many of us think that you can only invest in stocks or index funds in retirement accounts, but you actually can invest in real estate, debt funds, syndications, et cetera, inside of a retirement account.

This special type of account is called a self-directed retirement account and they generally come in two flavors. You have self-directed IRAs, or individual retirement accounts, and you have self-directed 401ks. So if you choose to invest in things like real estate debt inside of it, then you'll shelter your taxes.

Now let's introduce the spectrum of passive to active real estate. I want you to think of two competing forces here. Passive means it's relatively passive to you as an investor, which means it's also the least amount of work on your part, the least amount of time. In return, you get the least amount of benefits and control.

And then on the far end of the spectrum, you have active real estate, which means the most work, the most involvement, the most control, and the most benefits, including amazing, amazing tax benefits that are afforded to real estate professional status.

Direct ownership, when you own the home directly, where you buy a rental property, this is the most active type of real estate investing. And this also comes with the most tax benefits because you really have control over real estate.

Now, for some of you that might scare you because you're worried that you might make the wrong move or that you'll make a mistake or you'll have bad tenants, et cetera. I'm not going to sugar coat it, there are challenges and obstacles you will encounter when investing in direct ownership. But if you're up to the challenge, you'll also reap the amazing benefits as well.

I know many of you are interested in what we call passive real estate investing, but you still need to understand some basic terminology and do some education for yourself. The good news is all these terms are the same whether you do passive real estate investing or direct real estate investing. In fact, I'll say starting with passive is a great way to transition to direct ownership.

Many real estate investors that I know own both passive and active real estate. Even within direct ownership, there are ways that make it easier and sort of more done for you as the investor.

So you may have heard the term turnkey real estate, and I think this means different things depending on who you're talking to. But turnkey real estate, at least the form that I'm talking about, is where you still own the property, but someone manages a lot of the work for you. You have a little bit less control, it's more hands-off, but you still own the property.

But if you want to get even more passive then let's talk about syndications. What is a syndication? You may have heard that word a lot because that word is becoming more popular lately and there's a reason why, because a law was passed not too long ago where syndications were allowed to "advertise" to the masses. Before that, they weren't allowed to.

A syndication simply is where investors pool funds together to invest in various real estate projects. Think huge multi-million dollar projects that, on average, a single investor couldn't do themselves. Many of you have heard about crowdfunding and real estate funds, and these are definitely the most passive types of real estate investing. And, like I said, because they are the most passive, they also have the least tax benefits.

Hopefully, I've made real estate a bit more accessible to you and also helped you realize that it's not as hard as you think. And you've got to start somewhere, so why not start now?

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So let's talk a bit more about the types of passive real estate investing. Specifically, I'm going to talk about crowdfunding, syndications, and REITs. I think earlier I said my first foray into real estate was through syndications, but it's actually through REITs and that's because if you own an index fund, chances are, you also own a REIT because they're usually folded inside some of the popular index funds, like VTSAX by Vanguard.

This is where a trust purchases property and rents the space, and then the income that's generated from the rental is returned to the shareholders. So if you are already familiar with how to buy index funds inside of your brokerage account or your retirement account, then while an REIT is very similar and it's super easy in that sense, you can buy an actual fund of REITs or usually it's folded in already inside of some of the larger popular index funds. So you can buy these through Vanguard, Fidelity, et cetera.

Now let's talk about crowdfunding. Many of us are familiar with this concept because we've all heard of things like Kickstarter and so you kind of have an idea of how crowdfunding real estate works. Crowdfunding real estate is fairly new, at least in a formal capacity. However, investors have been pooling funds for centuries.

Crowdfunding is popular now because of the new-ish online platforms that have streamlined the crowdfunding process. In this way, you can bypass the parts of active real estate, meaning working with the agents and brokers and contractors, and just go to a crowdfunding real estate website to invest in a variety of real estate projects. You still want to do your due diligence, however, meaning you need to understand the terms and how to read if it's a good deal or not. And real estate crowdfunding can involve either debt or equity deals.

So let's talk about syndications. Syndications are somewhat similar to crowdfunding, but they are a little different. The same in that they both require pooling together funds from multiple investors. So basically, you're pooling money together to purchase a much larger real estate or project that you normally couldn't invest on your own. Think multi-million dollar deals. Think high-rise apartment buildings, assisted living, self-storage centers, et cetera.

When you pool the money together, the expenses are shared and the risk is split. Oftentimes crowdfunding and syndications are used interchangeably, but they're not exactly the same thing. I think the best way to think about the differences is that crowdfunding is focused more on obtaining large amounts of investors, hence that's why it's an online platform. You rarely talk to anyone high up in the company. You usually talk to a low-level analyst. When I think syndications, I think of sort of a smaller type of shop where it's focused more on the relationships.

So that concludes our two part series on giving you an overview of real estate.