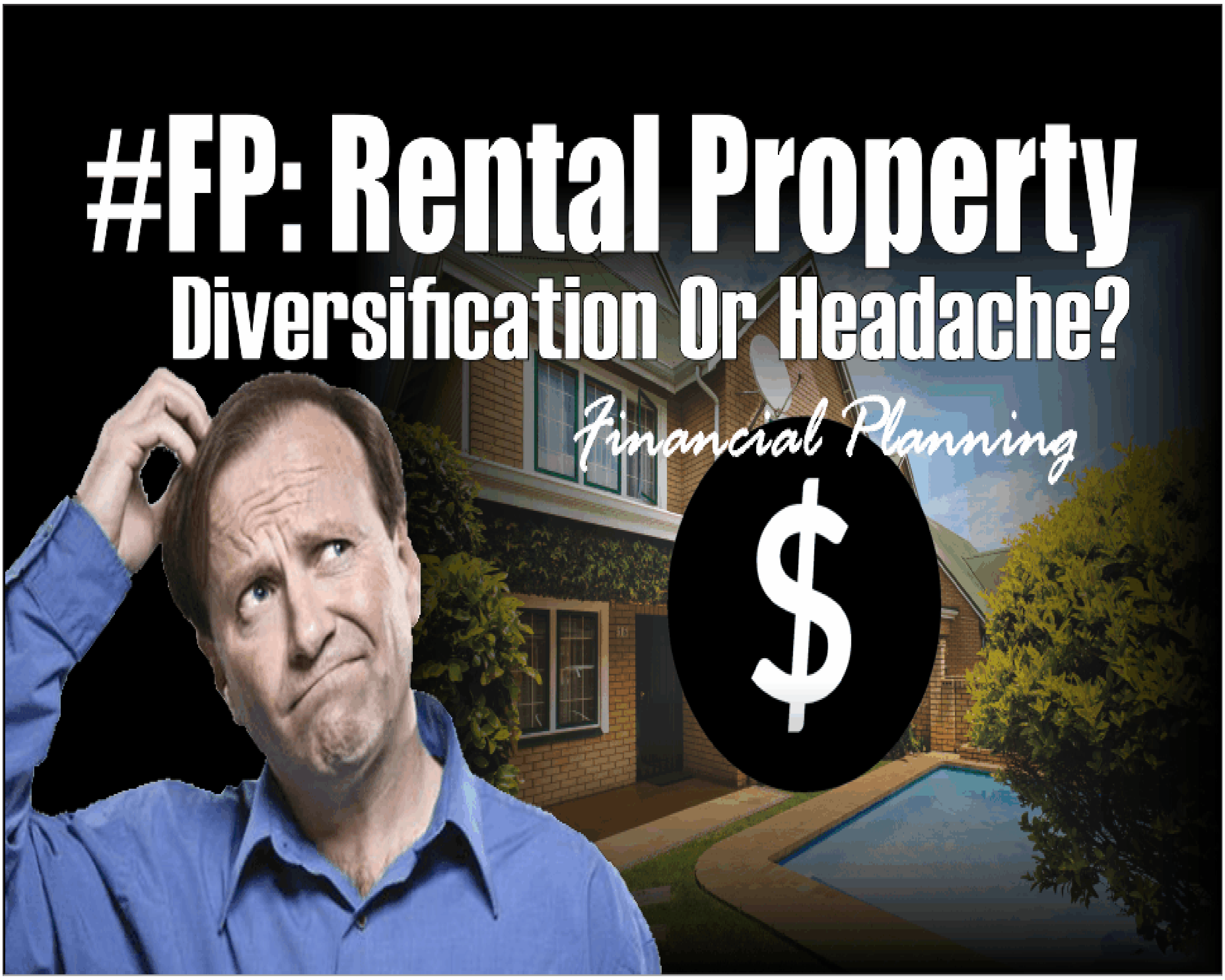

At Real Investment Advice, we have revised the staid definition of diversification so that investors will not be caught off guard by what the financial industry preaches. Read: [Never Look At Diversification The Same Way Again](). Ownership of rental property could be considered a true diversifier and complement to an overall investment portfolio strategy. **Unlike publicly-traded real estate investment trusts or ?REITS,? which experience cycles of positive correlation or connection to the moves in the broader stock market like the S&P 500, real property purchased to generate a supplementary stream of income, especially throughout the early phases of retirement, generally is a unique asset class which doesn?t connect at all to gyrations of the stock market.** However, residential rental property isn?t for every investor. For some, it?s a romantic notion, sounds good in theory, until they experience how much time and effort it takes to select the right property, deal with renters, have a plan for upkeep, and understand that unlike more traditional, liquid investments such as stocks, that it?s tough to unwind from mistakes. Here are 5 things to consider before prospective investors move forward.

1) A primary residence turned into rental property could be an emotional price that?s not worth the additional cash flow.

I lived this one - that?s why I?m sharing the experience. Close to a couple of years back, I regrettably broke through one of the financial guardrails (#3), I now preach to others. Read: [Financial Guardrails: Financial Planning Rules Of The Road.] I purchased a home for an expected life change, as I was planning to remarry. I allowed another person to cross my financial boundaries. I didn?t say *"no."* She lied about a *"yes."* And it cost me six figures, not chump change. Ostensibly, the idea was to turn my former primary residence *(which I should have never left),* into a rental and purchase a new place closer to her employment along with amenities I knew she?d enjoy. **One problem was my ongoing emotional attachment to the old homestead.** Oh, the renters were fiscally responsible, the money always came in on time; however, the young couple with children didn?t have the commitment to maintain the property like I did. The landscaping eventually succumbed to Texas heat and deteriorated to resemble an abandoned property, post-apocalypse. I?d stress constantly over how a house I lived in and cared for was not being maintained; eventually, I spent thousands of dollars getting it back to presentable (*and more)*, which wiped out most of the positive cash flow I received. It kept me up at night wondering how the interior was being sustained. I realized it wasn?t worth the stress and made a decision to move back into my property once the two-year lease concluded which meant I needed to stress over this oh, for another year and a half. I was thankful when the renters broke the lease a year early to move out of state. **You see, when it comes to investments, you must remain unemotional. We preach this sentiment consistently at RIA.** Once your primary residence is re-classified as a rental property in your overall financial-life portfolio, make certain there are no mental obstacles to tackle, first. I learned this lesson after the fact. If you believe that a former residence can be a rental, there are plenty of resources available to help qualify renters, be the go-between on maintenance items, collect rent and hold security deposits, provide tax documentation, leasing agreements and overall management of the property. Fees are usually a first month or two?s rent along with a nominal monthly fee.

2) Know your potential market inside and out.

Professional residential real estate investors don?t rush into investment decisions. As a matter of fact, I?ve witnessed the most successful of this group undertake a couple of years of thorough due diligence. They live and breathe the cluster or neighborhood they?re interested in. They live close, within 15 miles of the area of interest. **Serious buyers drive every neighborhood and document observations about the quality of structural upkeep and how it changes from street to street.** Potential investors study the quality of the school districts, the number of rentals, how long properties remain on the market, property tax history, work with tenured real estate agents, tax advisors who guide them on possible benefits like depreciation and mortgage specialists to understand the interest rate environment. Lending rates on investment real estate tend to be higher, less attractive than what?s available for primary residences *(in which **you** plan to occupy).* If you can?t put in the hours of homework because of your current schedule and family commitments, it?s best to wait and include real estate investing in your overall plan as time permits.

3) Real Investment Advice?s rental real estate down payment and debt management rules.

Do you possess adequate liquidity (savings) to purchase real estate for investment purposes? Can your household balance sheet handle the purchase, maintenance and taxes, especially if properties are empty for extended periods between renters? **Real estate investing where you?re seeking ownership of one or several homes, should only occur once your finances have reached a level where you?re successfully funding retirement goals.** In our experience, we see disciplined savers, mid-forties to early sixties in age, who are in prime savings and earnings years consider primary rental real estate. Interested parties tend to maximize funding to retirement plans first, possibly ?over? fund permanent life insurance (yes, permanent life insurance can supplement retirement income), long-term care policies and have accumulated more than one year?s worth of living expenses in a cash reserve. Many are seeking (after formal retirement planning), a venture to keep them busy throughout retirement and additional household cash flow outside of conventional liquid avenues. ***To determine if you qualify to purchase rental real estate, RIA suggests you consider the following guardrails:***

- *Make certain to have at least a three-year track record of maximizing funding to all retirement accounts, health savings accounts and hold at least one year?s worth of living expenses in an emergency reserve vehicle like a savings account or money market.*
- *Have the ability to limit the use of leverage (or mortgage), to no greater than 50% of the purchase price of a rental property.*
- *You have taken action to mitigate financial and mortality risk with adequate life, disability and long-term care insurance coverage (which may be determined by meeting with a Certified Financial Planner or qualified insurance agent).*
- *Create a rule to take into account management, vacancy and maintenance fees and still generate positive cash flow or rental income that exceeds expenses. Generally, 25% of your rental income should be allocated to expenses.*
- *Stick to a two-year cash buildup period where positive rental income proceeds are allocated to a savings reserve to build what I call, a ?rental property contingency fund.?*

4) Be prepared for the worst.

A working investor couple I counsel lost a renter, required a roof and a new HVAC system. *All at the same time*. Since they followed the guardrails, there was adequate cash set aside to pay for half of these items out of pocket. You see, they?ve been putting aside two years of positive cash flow in a savings account which helped them weather unfortunate circumstances and wait for a qualified renter *(it took 3 months),* without experiencing household financial distress.

5) Never lose sight of the market that interests you.

Like any investment, savvy real estate investors have an exit strategy even if it?s decades down the road. There?s a point where the liquidity from sold properties may be required to fund burdening healthcare, long-term care and senior housing choices. Active retirees eventually grow less active and not able nor willing to keep up with the ongoing responsibilities of rental real estate. Investors maintain meticulous track of all improvements that affect cost basis as selling a property could eventually result in long-term capital gains. I?ve learned from those who hold rental real estate for at least 10 years that they never stop monitoring market trends in property taxes, gentrification, school quality, rentals, foreclosures and sales. They gather intelligence by maintaining long-term relationships with experienced realtors who with ?boots on the ground,? can provide qualitative information not reflected in the numbers. Primary rental real estate can provide true diversification, unlike stocks and other liquid investments. **Unfortunately, it can be an illiquid nightmare if rules aren?t followed, especially if markets sour.** Like anything else, real estate cycles. Experienced real estate owners prepare upfront as they know and expect, over the lifetime of an investment, that the cycle will turn on them. The successful ones are able to weather the downturns and not place their entire financial picture in jeopardy.