Avoiding Zero-Interest Rate Policy Problems with an Apartment Rental Investment

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Vaudeville-era performer and humorist Will Rogers famously quipped that “he was more concerned about the return *of* his money than the return *on* his money.” Fast forward to today’s environment of zero interest and negative interest rate policy (ZIRP and NIRP), and it is hard to imagine Rogers doing anything with his money other than leaving it underneath his mattress.

While modern investors are not literally stuffing money in the mattress, you may sometimes wish you had that option. At the very least, you may be considering alternative ways to invest your money (link to alternative/hedge fund post). One alternative—commercial real estate investment, particularly multi-family homes—can provide benefits that traditional stocks and bonds can’t during times of low interest rates and inflation.

Paying the Bank to Hold Your Money?

In December 2008, the Federal Reserve Bank, in response to the ongoing global financial crisis, lowered its benchmark federal funds rates to 0.25%. Nobody, including former Chairman Ben Bernanke, thought what was considered an emergency rate during a time of extraordinary measures taken by the Fed would remain in place for long.

When near-zero interest rates failed to stimulate the economy, however, Bernanke & Co. introduced quantitative easing (QE)—the direct purchase of longer-term securities by the Federal Reserve in an effort to continue flooding the economy with liquidity (as well as lower long-term interest rates). European and Japanese central banks went a step further by introducing negative interest rates (for member institutions) and raising the prospect that the general public could soon be *paying the bank* interest on deposits.

Perhaps as extraordinary as the actual measures taken is the fact that ZIRP (or near ZIRP) has been in place for such a long time. The new Fed Chairwoman Janet Yellen has gradually introduced an increase in the federal funds rate, but from a historical and policy perspective, we are still in unchartered waters.

While the merits of such policy are debated in academic and policy circles, real world investors and savers face a number of challenges in such an environment. For starters, yields on fixed-income products are paltry. Money market yields are about 0.3% and even the average five-year CD returns are 1.26%. Meanwhile, annual inflation since the bottoming of rates in December 2008 has averaged 1.74%.

Next, while easy money policy has not yet produced significant inflation in terms of consumer prices, it has, by design, propped up stock and bond prices, which brings the element of market price and interest rate risk. With yields so low, there is a small cushion to absorb market price declines for bonds in a rising rate environment.

The last real difficult markets for bonds was 1994, but with federal funds rates in the 5% neighborhood, the shock to total returns was mitigated. Meanwhile, back in November, when 10-year treasury rates jumped from 1.8% to around 2.4%, the Barclay’s U.S. Aggregate Bond index fell about 4%, again with a small yield cushion to absorb the market losses.

Water Behind the Dam

More ominous, perhaps, is the looming threat of a 1970s-style inflation resulting from ZIRP. Like rising water held behind a dam, asset prices inflated by easy money policy have the *potential* to come crashing into consumer prices. Stocks are generally considered to be a good hedge against inflation. From a long-term perspective of historical returns and inflation rates, this may be true, but when inflation spikes, results can be quite different.

Consider that during the 1970s, real returns on stocks were negative for long stretches of time. For the entire decade, the total return of the S&P 500 was 0.9% a year and a $10,000 investment grew to $10,940. Adjusted for inflation, however, that $10,940 was worth only $5,426, more than a 45% decline in real terms from the original investment over a 10-year period.

More specifically, if you look at the eight-year period from 1974 to 1981, when inflation averaged 9.3% a year (highest eight-year rate on record), stocks had a nominal total return of 9.11% (1.1% annualized). In real terms, though, after trailing inflation by more than 8% a year, they declined by nearly 47%.

To be fair, once inflation was tamed, stock returns in the 1980s surged and helped to push the average long-term stock return above the inflation rate, but an investor who is withdrawing funds during such a period will be significantly impacted trying to play catch up when market prices do rebound.

A trait of investing is that a 50% decline in prices requires a subsequent 100% return to get back to even. If a retired investor also took annual withdrawals of 2-3% during such a drawdown, the situation is exacerbated.

Commercial Real Estate and Apartments During Inflationary Times

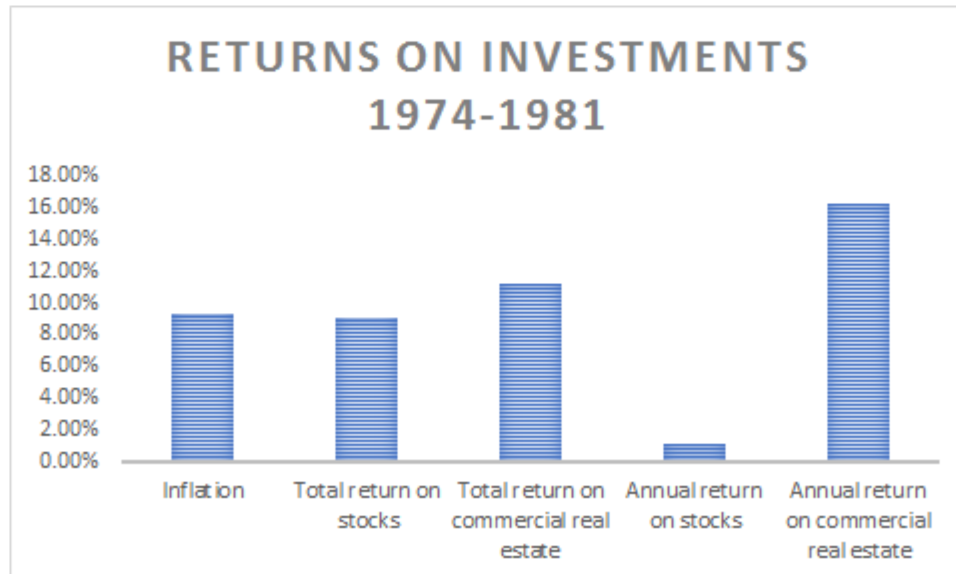
One area that traditional stock and bond buyers may look to in anticipation of inflationary times is commercial real estate investing. Commercial real estate, especially apartments (multi-family housing), have the potential to benefit in conditions that existed during the 1970s.

Real estate returns are based largely on yield or income. A public company (stock) must deal with an ongoing increase in labor and material costs, which may erode margins. In real estate, capital costs (whether purchased or developed) are paid for on the front end of an investment and while there are maintenance costs to contend with, they are typically a much lower percentage than "costs of goods sold."

Compared to other sectors of commercial real estate, multi-family housing uses shorter lease terms that are better suited to keep pace with inflation via annual rate increases. Typical lease terms in other commercial real estate run from three to sometimes even 10 years.

While rents and costs are rising, interest expense on debt used to finance real estate is often fixed. To the extent that interest is variable, the value of the underlying property is not affected the same way a bond would be from a rising interest rate. If rental income is greater than the interest expense (and other costs) the property remains profitable.

Returning to the eight-year period of 1974 to 1981 that saw record inflation, real estate, as measured by commercial real estate investment trusts, had a positive real return, gaining 11.2% per year in income and 16.3% on a total return basis. Meanwhile, inflation was averaging 9.3%. To reiterate, stock returns during this period *lagged* inflation by 8% a year.



In addition, private investment in commercial real estate and apartment housing comes with significant tax advantages. A large portion of rental income can be written off or sheltered with the use of depreciation. Though depreciation is subject to recapture tax when the property is sold, the use of a 1031 like-kind exchange (if a new property is purchased) can defer any capital gains taxes (as well as recapture). The 1031 exchange can be used repeatedly to the point that if used throughout an investor's life, it may become an effective estate planning tool (link to estate planning post).

As difficult as investing in an environment of low interest rates is, the real challenges may be yet to come in the form of consumer inflation. In the spirit of *past performance is no guarantee of future results*, there are no promises that such an inflationary period will develop, or that if it does, how apartment and commercial real estate investments will fare. Wise investors, however, make a practice of looking around the corner to anticipate future threats and opportunities and plan accordingly.