



Real Estate Diversification, Overcoming Concentrated Risk
A White Paper
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REAL ESTATE DIVERSIFICATION

Going the Extra Mile

As investment professionals, it is incumbent for us to go the extra mile to understand the

components of real estate diversification in order to better serve our clients. Educating the real estate investor is vitally important to ensure his or her chances of getting a well diversified investment that provides them multiple assets and multiple income options. This article describes methods used by LJCooper Capital Management to properly diversify client real estate holdings within the 1031 Tenant In Common (TIC) and Delaware Statutory Trust (DST) classifications.

Diversification as a principle for spreading and reducing risk is widely viewed by financial professionals as the “sine qua non” a Latin term that literally means “without which, nothing” or an indispensable element or condition. Yet within the securitized 1031 industry, principles of diversification are too frequently overlooked, misunderstood or just ignored.

Several beliefs and a few misconceptions among advisors have led to this situation:

- There’s not enough money to diversify.
- The client wasn’t diversified before, so why start now?
- It’s more work for me – more properties, more paperwork.
- Real estate doesn’t lose value over the long run, so diversification isn’t that important.
- Don’t all real estate investments respond similarly to market/economic events?

Concentrated Risk Comes Home To Roost

If there’s anything the last 18 months has taught us, it’s that diversification has proven to be paramount to an investor’s ability to weather the changing economic storm. Recently we’ve heard the horror stories from far too many new prospects – they were advised to place their entire exchange proceeds into a single property from a single sponsor whose marketing materials implied very attractive returns and, in some cases, company guarantees. As the market turned, the guarantees and attractive returns they relied on disappeared or dried up. To add insult to injury they’re now facing lost income, management problems, capital calls and in the worst of cases unforeseen legal

costs. We have had many of these unfortunate investors referred to us by their legal counsel. The story is the same, and the panic in their voices is heart wrenching. The frustration lies in the fact that had representatives understood true diversification they could have better protected their clients from the effects of concentrated risk.

No Sure Thing

In the past several years we have been shown, yet again, that there is no sure thing. The more diversified you can make your client, the more you lower risk exposure and improve the likelihood of success. As a financial advisor I would never recommend that a client buy \$1,000,000 of just one company's stock as their only investment. Why then would I advise a client to put their entire real estate portfolio in a one-tenant investment property? The short answer is "I wouldn't."

Diversification – It's Easier Than Ever Before

A few years ago the minimum required investment into most TIC offerings exceeded \$500k and in some cases was more than \$750k. This made diversifying anything under \$1,000,000 in 1031 exchange assets very difficult. With the advent of the DST, diversifying clients' real estate holdings into multiple offerings has become much easier. The DST format has allowed for smaller equity placement amounts – in some cases as little as \$100,000 is required. This creates greater diversification of real estate assets and reduces the overall risk to the investor's income. The good news is that all of the diversification strategies we will discuss are easier to employ than ever before.

A Piece of the Portfolio – Not the Only Piece

As a matter of course, real estate should be viewed as just another asset class in an overall portfolio geared toward a client's financial goals. The philosophy that real estate should be a part of every investor's portfolio pre-dates all of modern civilization. According to the Jewish Talmud, "Let every man divide his money into three parts, and invest a third in land, a third in business, and a third let him hold in reserve."

Not that every individual should invest in this particular allocation percentage, but the idea of owning and investing in real estate is an ancient concept, one that still deserves proper attention today and in the future. How this asset class should be held and how much of a portfolio it should command is a matter of personal preference and proper planning. ▶▶

A good advisor should not overlook real estate that may already exist within a client's current holdings. Many clients have real estate holdings that I term "sacred cows," meaning that it is property that they will (under no condition) ever sell. That's fine, but the property still needs to be included in the investment goal planning phase, and all too often when the "sacred cow" becomes the "golden calf" the client, or in some cases the heirs, have a change of heart on selling. A well informed advisor can be proactive and really add value to the client when this happens.

Inversely, there's the situation where you have a client who just sold an industrial property and tells you they're just about to sell one of their apartment complexes. Through the review process, you may discover the client is over weighted in this multi-family asset class. The client may desire that you replace the industrial property with another apartment complex. If you acquiesce to the client's wishes, you are contributing to a real estate portfolio that resembles a telephone pole rather than the root system of a mighty oak tree. The client and the advisor also run the risk that the property may never sell. This obviously does not provide the client a very well diversified structure. When the time comes and the property does sell, the advisor can then re-address proper portfolio diversification tactics that will strengthen and stabilize the client's real estate holdings.

For the sake of improving future portfolio diversification, it is prudent to never forget about existing real estate. Especially when the client views it as a "sacred cow" or expresses a desire to sell in the near future. A wise advisor will never take real estate completely off the table.

Types of Risk

Not only should we as advisors place a client's 1031 exchange assets into more than one offering, we should be strongly considering more than one asset class, geographic location, tenant and where possible, more than one sponsor.

The risks associated with 1031 TIC/DST are similar to those facing real estate as a whole: business failure, reduced value, economic crisis, finance and credit concerns, unemployment, increased vacancies, lowered or lost rents and greater difficulty in selling. Additional issues of the above mentioned risks are in attracting new tenants, causing higher tenant incentives, shorter lease terms and fewer potential tenants due to the supply and demand of greater space and location options.

On top of real estate risks you need to consider the sponsor risks. Is the sponsor experienced in the asset class they offer? Do they have strong financing and credit options? Can they provide audited financials? Do they have a history of standing behind their products? Is their management team experienced? These are serious risk factors that must be considered.

The solutions to these risks can be dealt with by careful and focused diversification planning. The advisor can effectively reduce many of the above

Specific risks to consider in a 1031 TIC/DST:

- **Economic** – recession/depression/expansion global-national and regional, unemployment rates, and demographics
- **Financial** – tight credit, loan terms and maturity, valuation issues, and ability to buy or sell when appropriate
- **Property** – age, location, functionality and maintenance issues
- **Market** – local inventories, competition for and quality of tenants, lease terms and incentives
- **Property Management** – experience and expense, ability to market the property
- **Sponsor** – experience, reputation, financial strength, underwriting assumptions

Table A 1031 Asset Classifications

1. Office

- a. Professional
- b. Medical
- c. Government

2. Industrial

- a. Warehouse
- b. Manufacturing
- c. Self-Storage

3. Land

- a. Agricultural
- b. Commercial
- c. Residential

4. Multi-Family

- a. Apartment Complex
- b. Student Housing
- c. Senior Living and Assisted Care

5. Retail

- a. Single-Tenant
- b. Multi-Tenant
- c. Hotel/Resort

mentioned risks, but cannot completely eliminate all risk factors. The strategies that provide the best possible diversity are geographic location, asset class, multiple tenants and various sponsors.

If offerings from multiple sponsors are not currently available or you are dealing with a limited investment amount, we suggest sticking with the most experienced and where possible best funded sponsors offering the DST programs. Another factor to consider is the number of sponsors available to you through your broker/dealer. Again, when in doubt stick with the more experienced and better funded sponsors and always do some additional due diligence.

Real Estate Asset Classifications

Within the real estate component there are five key categories or property types. In Table A you see a list of major 1031 asset classifications and sub-categories. The idea with real estate as an asset class is to consider the long term implications of the type of property you are offering to your investor. Diversification should occur not just across multiple properties, but across multiple property types.

Asset classes often react differently to various economic conditions. For example, under current concerns about the private residential housing market and the difficulty in the finance community, some retail outlets and office properties are struggling as disposable income drops and vacancies rise. Multi-family residential and self storage, on

the other hand, are holding a greater appeal as many families and individuals are now putting off buying a home, or due to foreclosure are moving back into a rental situation, storing their extra property in the mean time. These asset classes have shown strong potential over the last year.

Correlation Coefficients

By considering the correlation coefficients between different asset classes within the 1031 community, the advisor can increase the level of diversification and reduce the risk in a real estate portfolio. A high correlation (closer to 1.0) indicates that properties tend to perform similarly. Low correlations (closer to 0) indicate dissimilar performance. For example, if office properties and industrial properties have a correlation of .77 meaning they are more closely correlated, while office properties and retail properties have a correlation of .16 meaning they are less closely correlated.

What does this mean, and how can this information be utilized? Carefully consider what types of properties you place in any one client's portfolio. Too many client portfolios have exchange assets placed in very similar offerings: all office buildings, all retail or all multi-family, etc. Similar assets would be highly correlated, meaning that the risk factors that could adversely affect any one asset class would likely affect all assets within that classification the same way. The same philosophy applies to placing all of a client's investment with only one sponsor. This has proven to be a very painful lesson for many reps and clients alike over the past 18 months. ▶▶

“**THERE ARE NO TRAFFIC JAMS ON THE ROAD TO THE EXTRA MILE.** — Author Unknown”

To improve a client’s portfolio and their chances of weathering a change in economic conditions be it global, national or localized downturns, you should consider the following. A client that already owns office property may need to consider a different asset class for their next investment. Based on the correlation coefficient of real estate discussed above, the next property added to the portfolio should probably be a retail center rather than an industrial park – the client gets a larger diversification benefit which translates into less risk and potentially a more stable income stream. By correctly taking advantage of correlation data it is an easier process to fill gaps in a real estate portfolio or build a more diversified portfolio for the client, as we will discuss.

What if you can’t determine the correlation coefficient of a particular real estate asset? The best answer is to talk with the sponsor’s experts. Many wholesalers have access to the appropriate individuals within their company that can help you determine the correlation of the offering you are considering. If you prefer to do this on your own, I highly recommend *The Journal of Real Estate Portfolio Management* and a calculator.

Two Proven Methods

The approaches discussed in the following paragraphs reflect years of research and education and a little trial and error thrown in for good measure. The process of applying the concepts is simple. Start by evaluating the client’s current real

estate holdings. Ascertain where each property fits in the overall real estate asset classification model. Then implement the appropriate strategy and follow up regularly. The evaluation process serves two purposes. **1.** To better identify what the client currently owns to avoid duplicating or overloading any one asset class. **2.** To fully explore the client’s experience and understanding of real estate management and investment history. This is of vital importance and fulfills FINRA Rule 405, “Know your customer.”

LJCooper Gap Analysis MethodSM

This approach is one we use for individual investors that already own a significant amount of real estate in only one or two asset classes. The specific asset class isn’t as important as the client’s willingness to become better educated to the inherent risks of the asset class they own and how to reduce this risk through a diversification strategy. Once current holdings of your client’s portfolio are properly identified, the advisor can be more focused on building a more diversified real estate portfolio or filling the gaps of the current portfolio with less correlated assets to create more stability.

This type of an approach requires as much advanced planning as the client can allow. In many cases months and in more complicated cases even years of preparatory meetings are required. Where possible try to build real estate holdings that compliment the client’s other investments, taking into account the real estate correlation coefficient discussed earlier. This allows the advisor to take advantage of better risk analysis and overall wealth and estate planning opportunities.

LJCooper Mini-REIT Portfolio MethodSM

We are not creating a true real estate investment trust as the name may imply. We are conceptually building a real estate investment portfolio with multiple and varied properties, which is where the similarity to a REIT ends. We’ve seen great success employing what we call the “mini-REIT” strategy with 1031 TIC/DST offerings. With lower

Regardless of which method you use, the important factors to success in real estate diversification are:

1. Exploration of clients needs
2. Ascertaining clients level of experience
3. Advanced planning, as much as possible
4. Personal research and due diligence for offerings
5. Investment in multiple offerings, asset classes, and geographic locations, tenants, and sponsors.

minimum investment amounts available through the DST program, it has become easier to build a greatly diversified portfolio. As little as \$500,000 is enough to build a “mini-REIT” program.

DST programs are becoming more common – offering assets in retail, industrial, multi-family and office properties. Many of these current offerings have minimums starting at \$100,000 - \$150,000. This could potentially create three or more separate holdings with potentially more than three individual properties and multiple tenants. By building this type of a real estate portfolio, the advisor can offset many of the potential risks through a variety of sponsors, asset classes, geographic locations and multiple tenants.

That is what makes the DST platform so versatile – potentially multiple properties within one package. We have used this approach not only with the DST platform, but with multiple TIC offerings and even combinations of TIC and DST programs. The possibilities are only limited by your clients’ needs and your imagination and research. I cannot stress enough the importance of doing your own due diligence and research. The more time you put into this phase, the better you serve your clients, and the fewer problems you are likely to have.

Future’s So Bright...

Several good things have started happening in the real estate industry. Cash heavy private buyers are gobbling up a lot of good deals that will bode

very well for their investors and reduce the overall existing real estate inventory. Consolidation is taking place in the publicly-traded sector also, with better positioned publicly-traded companies taking advantage of real estate companies that were too exposed to the credit crisis and, in some cases, mismanaged their portfolios. The cap rate has greatly improved. According to Real Capital Analytics, the average cap rate has jumped from 6.9% in Q1 2008 to 7.2% in Q1 2009, and based on the continued unrest in the overall market, cap rate predictions for 2010 are as high as 10%.

Capital gains rates are likely going up. From the perspective of a stock holder this may be bad, from the perspective of the 1031 exchange industry this is sweet music to our ears. I am not worried about the viability of the 1031 industry, albeit there will be changes and likely fewer participants in the near term. The industry will likely continue to grow and thrive. ►►

— Ronald Reagan

“THE FUTURE IS NOT FOR THE FAINT OF HEART.”

The combination of higher capital gains tax rates and potentially higher purchase amounts makes for an exciting future in the 1031 TIC/DST arena. This also makes it even more important for advisors to properly educate themselves and employ diversification strategies for their clients. Ronald Reagan once commented, “The future is not for the faint of heart.” Neither is the real estate investment world, but education and preparation goes a long way towards improving your odds of success. ■

ABOUT THE AUTHOR



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Craig is the Chief Executive Officer at LJCooper Capital Management, specializing in direct investments and real estate disposition planning in addition to wealth management. He has extensive background in real estate investing and capital gains tax issues. Craig enjoys writing and speaking nationally about direct investments and served on the Board of Directors of the Real Estate Investment Securities Association (REISA), a national trade association for professionals who offer securitized real estate related investments. Craig is a Registered Financial Consultant RFC®, is active in the community supporting many local charities and serves on the Government Review Council for the Utah Valley Chamber of Commerce.

About LJCooper – The Educated Path to Investing

Founded in 2000, LJCooper Capital Management, LLC is an independent wealth management firm registered with the SEC as an investment advisor. LJCooper provides a holistic approach integrating all of the major areas that impact a client’s wealth. We specialize in helping businesses and individual clients convert appreciated assets (land, business assets, 401k, etc.) into a safer, more-diversified investment portfolio in a way that reduces taxes, avoids costly mistakes, and preserves their wealth. LJCooper is the #1 firm in Utah offering the acclaimed Dimensional Fund Advisor’s (DFA) portfolio of investments. LJCooper is nationally ranked by Wealth Manager Magazine’s Top Wealth Managers list for 2008 and 2009. LJCooper is also ranked among the Top Independent RIA Firms in the U.S. for 2008 and 2009 by Financial Adviser Magazine. In 2010 LJCooper announced a college scholarship for high school seniors focused on financial literacy.