



Investing Observations: Things I Wish I'd Known Sooner

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Feb 23, 2025

A Beginner's Talk



- This talk is for beginners in at least one of:
 - Stocks
 - Bonds
 - Real estate
- If you are familiar with all of:
 - Covered calls
 - Bond ladders
 - 1031 exchanges
- You don't need this talk

Disclaimer

- SRI takes no responsibility for this presentation
- I am not a trained investment advisor
- Not all of my investment decisions have worked out well
- This presentation contains mostly generalizations – there are always exceptions
- This presentation contains mostly simplifications – learn more before you invest
- Don't make any investment decisions based solely on this presentation
- Become more informed, then decide for yourself

Taxes



- The U.S. has a progressive tax system
- Marginal tax rate is tax paid on **last** dollar taxed; nearly always **higher** than mean tax rate
- Marginal tax rate, not mean tax rate, is what matters for investments
- Combining federal and state, most will have a marginal tax rate between 25% and 50%
- Investment performance after tax effects is what matters
- Tax regulations change
 - Someone, your accountant, your investment advisor, or you, must stay on top of the changes

Stocks



- A share of stock represents a (tiny) fractional ownership of a company
 - Primary benefits: dividends and growth (capital gains)
- Three dimensions to categorize stocks:
 - **American** vs. international
 - Large company vs. **small**
 - Growth (stock price goes up) vs. **value (pays dividends)**
- Over long periods of time, the **bold** categories tend to have greater, total returns
 - American stocks have outperformed international stocks over the last 15 years
 - Foreign exchange costs and currency volatility make international stocks slightly less attractive
- Many stock charts do Not include dividends and so are not accurate. **Totalrealreturns.com** does include dividends and so is accurate.

Stocks (cont'd)

- Stock mutual funds and Exchange Traded Funds (ETFs) offer ownership of large “baskets” of stocks
- Good to have stocks in every one of the 8 combinations of categories
- Good to have more stocks in **bold** categories
- Many mutual funds/ETFs cover more than one of the 8 combinations
- Nobody beats (correctly predicts) the stock market over long periods
- Passively managed, index mutual funds/ETFs are best
 - passive management means low fees
 - index means minimal, realized capital gains each year

Bonds



- Bonds are loans; they typically pay interest twice a year
- Long term bonds mature in 20-30 or more years
- Corporate bonds
 - loans to corporations
 - interest received is taxed at marginal rate
 - rates 4% - 8% on low risk, long term bonds
- Municipal bonds
 - loans to cities, counties, states
 - if issued in local state, interest is usually federal and state tax-free
 - rates 3% - 5% on low risk, long term California bonds
- Treasury bonds
 - loans to federal government
 - state tax free
 - rates 1% - 4% on nearly zero risk, long term bonds
- Bonds usually better than CDs
 - Comparable interest rate; no taxes on municipal bonds
- Risk: treasury < municipal < corporate

Bonds (cont'd)

- Par value of a bond is \$1,000; bond prices are listed as though par value is \$100
- Minimum of 5 (\$5000) or more
- New bonds usually sell for \$1000; existing bonds (the majority of sales) may sell for any price
- Many bonds are callable; borrower may redeem them prior to maturity
- If there is no default (almost always true), you get par value (\$1000) at maturity; if bond is called you get par value or more
- Bond values move in the opposite direction of interest rates; effect is greater for longer term bonds
- You can sell bonds at any time, but may have gain or loss due to changing interest rates or other reasons
- To avoid loss, hold bonds to maturity or call
- When held to maturity:
 - Will lose part of investment if bond was purchased at a premium; this is compensated by the fact that you benefitted from above market interest rate
 - Tax effect of the loss or gain is likely to be 0 as basis of bond changes, moving toward par value as maturity date approaches

Buying Bonds

- Yield takes into account bond cost, interest rate, and time
- Worst case yield is often most important measure
 - Higher risk (poorer credit rating) has higher yield
 - Longer term has higher yield
- Bond mutual funds/ETFs/target funds must buy and sell bonds to manage cash flows
- In a rising interest rate environment, bond mutual funds/ETFs/target funds will go down in value, i.e. you'll lose principal
- It is usually better to **buy individual bonds, not bond mutual funds/ETFs/target funds**, especially when interest rates are rising
- In any environment, bond mutual funds/ETFs/target funds will reduce your income due to their fees
- Several agencies rate bonds based on risk of default
 - The agencies tell you what ratings they consider to be investment grade
- To keep risk low and income high, buy individual, **investment grade** bonds (specific rating depends on rating agency) with **high, worst-case yield**

Real Estate -- Why?



- Income – tenants pay rent/lease
- Appreciation – real estate goes up in value
- Leverage
 - Purchase \$100 worth of real estate
 - Purchase with 25% down (your investment, \$25), 75% from loan (borrow \$75)
 - Your tenants pay off the loan through rent/lease payments to you
 - Property appreciates 5% in a year (5% of \$100 = \$5)
 - Your investment went up 20% ($\$5 / \25) in a year
 - **Caution: leverage works both ways**
- Tax treatment
 - Income offset by depreciation
 - Depreciate building only; don't depreciate land
 - Offsets approx. 1-3% of purchase price / year for approx. 30 years
 - Loan interest is tax deductible
 - Capital gains when real estate is sold have a lower tax rate
 - Tax-free (1031) exchanges

Real Estate Measure and Types

- Real estate investment measure: capitalization rate
 - assume purchase with all cash
 - capitalization rate is $(\text{income} - \text{expenses}) / \text{purchase price}$
- Bare land
 - expenses, e.g. property taxes, with no income (risky)
 - capitalization rate $< 0\%$
- Residential (apartments)
 - capitalization rate very roughly 3% - 6% locally
 - vacancies common but short (a month or two)
- Commercial (retail, warehouse)
 - capitalization rate very roughly 5% - 8% nationally
 - vacancies uncommon but long (can be years)

Real Estate Income and Expenses

- Income:
 - Tenant(s) paying rent or lease
 - Reduced by vacancies
- Expenses:
 - Loan payments
 - Property taxes
 - Maintenance (from fixing a light switch to remodeling a kitchen)
 - Management fees
 - Insurance
 - Utilities
- Roughly 20% - 40% downpayment needed for breakeven (income \geq expenses)
- Over time, usually income rises faster than expenses

Investing in Real Estate

- A single apartment unit in Silicon Valley is \$350K and up. You can't usually buy just one.
- Bigger complexes have lower per unit cost.
 - Less land / unit
- Use leverage – get a loan.
- Buy with other people to reduce individual investment.
- Pay experts to manage property.

Ways to Own Real Estate

- Tenants-in-Common
 - Despite name, TICs are typically owners, not tenants
 - Multiple parties pool funds to buy real estate
 - Self-organized
 - Typically, high minimum investment (100K+)
 - Illiquid (can't easily sell when or how much you want)
- Limited Partnership
 - Multiple parties pool funds to buy real estate
 - Organized by general partner
 - Typically, medium to high minimum investment (50K+)
 - Illiquid
- Real Estate Investment Trusts (REITs)
 - Organized by REIT manager
 - REIT buys multiple properties
 - For many REITs, shares are bought and sold like stock mutual funds
 - Very liquid
 - Typically, low minimum investment
 - For many REITs, significant variable interest rate loan risk
- Typical, relative returns: TIC > Partnership > REIT

Real estate risks

- Variable rate loans
 - In rising interest rate environment (often the case in the past few years), loan payments on these loans will go up
 - Many REITs mostly or solely use variable loans
 - Risk level depends on variable loan details which may constrain rate increases
 - Fixed rate loans are safe but have higher initial interest rate
- Vacancies
- Reduction of property value
 - rare in California, not so elsewhere
- ~~Famine, Pestilence~~, Earthquake
 - Insurance
 - Superior construction
 - No tuck-under garage

Retirement Account Types



***** Always contribute enough to your work retirement account(s) to get the full employer match *****

- Traditional:
 - Limited amount each year
 - May delay taxes on contributions
 - Pay taxes at full, marginal rate when distributions are made, regardless of how distribution was generated
 - Distributions are required starting in your early 70s unless it's an employer account and you continue working
- Roth:
 - Limited amount each year
 - Can usually only contribute if income not too high; may be able to contribute through employer despite high income
 - Pay full, marginal taxes on contributions
 - Pay no taxes when distributions are made
 - No required distributions
 - Can convert traditional to Roth, but must pay taxes on converted amount

Regular vs. Retirement Accounts

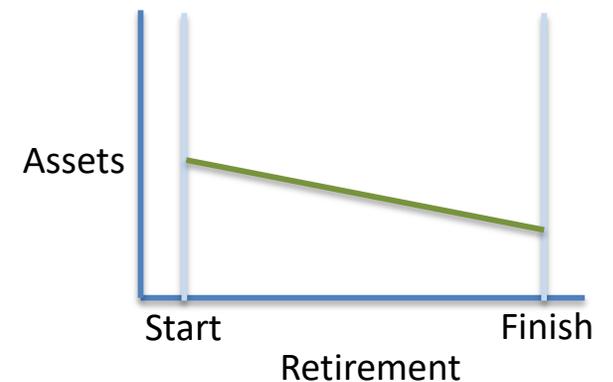
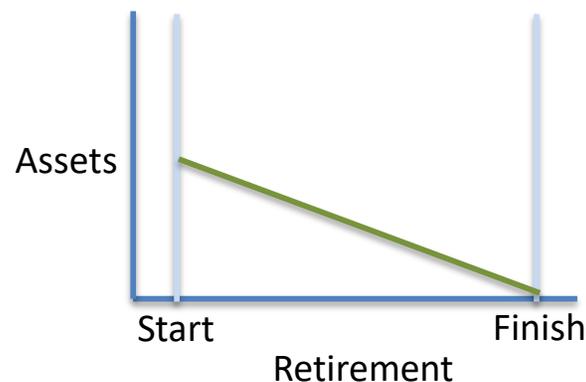
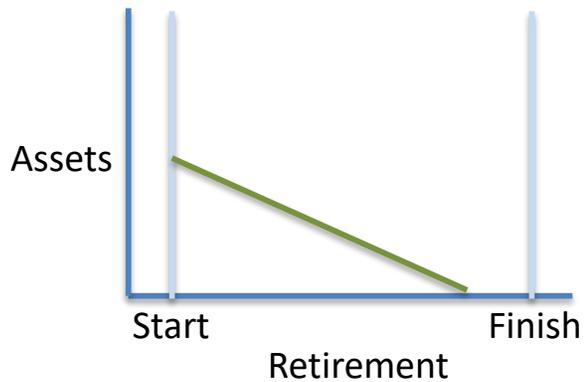
- Best investments for retirement accounts are those that generate income that is not tax-advantaged
- Ideal retirement account investment: individual corporate bonds and a very few other things
- Ideal regular account investment: everything else
- SRI Only
 - Can't hold individual corporate bonds in SRI 403b accounts by law
 - What to do?

Regular vs. Retirement Accounts (cont'd)

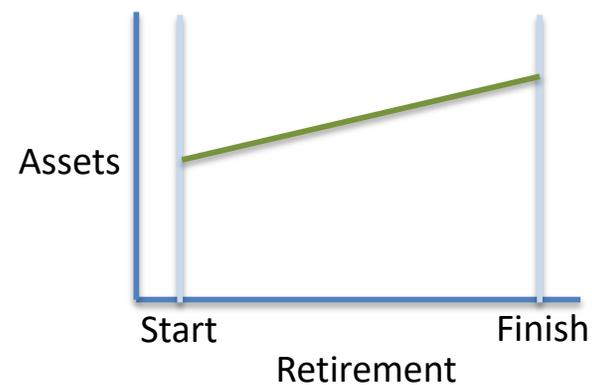
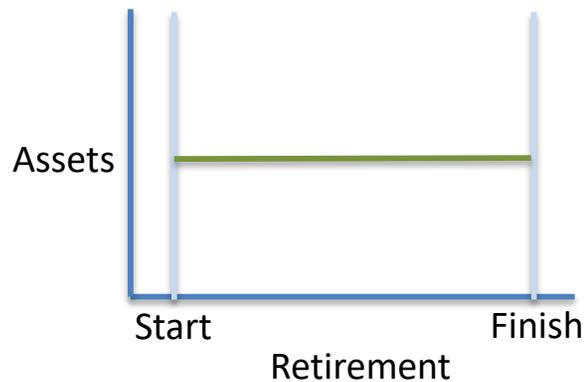
- An approach for an SRI retirement account:
 1. Now, hold Vanguard Total Market Index Fund
Low fee, broad stock index fund
 2. When interest rates peak, consider moving to a bond fund/ETF that invests in corporate bonds
 3. When you're allowed (at age 62?) or leave SRI, rollover funds to IRA and buy individual corporate bonds

Retirement Financial Scenarios

Must Sell Assets



Can Retain Assets



Diversity

- Diversity – good in workforce, good in investment portfolio
- Different asset classes perform better under different circumstances
- Most people should have stocks, bonds, and real estate in their investment portfolio

Investment Mix



- Over long periods of time, stocks do better than bonds
- In general, investment grade bonds held to maturity are safer (less volatile) than stocks
- An old rule of thumb for investment mix for retirement: your age as a percentage in bonds, the rest in stocks
 - As you get closer to retirement, you want to reduce risk, especially of large losses
 - 30 year old would have 30% bonds, 70% stocks
- Probably too conservative (i.e. too much in bonds); doesn't include real estate
- A more modern approach for investing for retirement
 - Decide on real estate fraction, say 35%
 - Divide remaining fraction (65%) between bonds and stocks based on $(age / 2)$: $30/2 = 15$; $15\% * 65\% = 10\%$ bonds
 - Overall: 55% stocks, 35% real estate , 10% bonds for 30 year old
 - Adjust annually
- Some will say:
 - too much in bonds
 - too much in stocks
 - too much in real estate
 - just right

Conclusion

- Presentation available at:
- <http://csl.sri.com/people/poggio/>
- Learn more about investing
 - Ask questions
 - Read up on the topics
 - “Investing for All-in-One Dummies” (actually, for beginners)
 - Consult trusted, investment advisor
 - Fiduciary advisor (must act in your best interests)
 - Fixed fee, not percentage
 - Not just a hammer (stocks)
 - Also need a stapler (bonds) and a shovel (real estate)
 - May need more than one advisor
- **Decide for yourself**

Extras

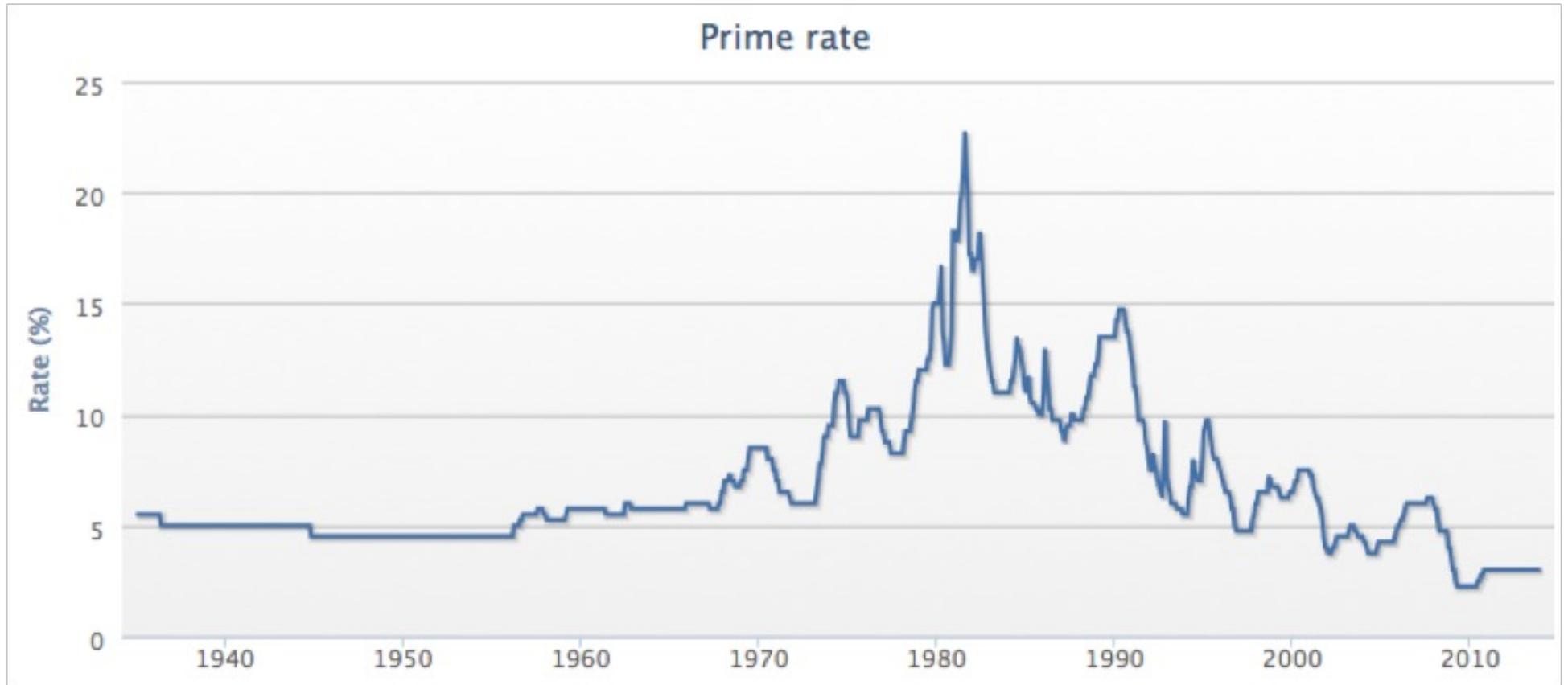
Real Estate Limited Partnership

- **Dearborn Park Commerce Center:**
- 118,350 square feet on 9.3 acres
- 18 tenants (100% leased)
- 7% Yield (paid monthly)
- 8% Preferred Return (paid before general partner is significantly compensated)
- 14% Targeted Total Return (speculative estimate of total monthly payments plus capital gains on sale)
- 1.89x Multiple -- \$189,000 return on every \$100,000 invested (also speculative)
- Expected 3-5 year hold (sell property in 3-5 years and dissolve p'ship)
- \$50,000 minimum investment
- Closing in June 16, 2016

Everything Goes Down When Interest Rates Go Up

- Other investments must compete with very safe CDs offering high interest rate
- Buying stocks on margin (leveraged) is more expensive – stock prices go down
- New bonds offer higher interest rate than existing bonds – bond prices go down
 - But bonds held to maturity (or call) don't go down
- Buying real estate with leverage is more expensive – real estate prices go down

Interest Rate History



Tax-Free Exchange Example

Party	Has	Wants
Buyer	BuyerCash	LittleProp
Trader	LittleProp + TraderCash	BigProp
Seller	BigProp	cash

- Trade benefits only Trader, who defers paying cap gain on LittleProp
- Step 1: Trader trades LittleProp + TraderCash for BigProp with Seller
- Step 2: Seller sells LittleProp to Buyer for BuyerCash
 - Seller now has TraderCash and BuyerCash
- Seller usually has cap gains; Trader and Buyer do not have cap gains at this time