Investing Observations: Things I Wish I'd Known Sooner

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1

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

2

Outline

- Taxes
- Risk / Reward
- Asset Classes:
  – Stocks
  – Bonds
  – Real estate
- Regular vs. Retirement accounts
- Diversity

3

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

4

Risk vs. Reward

- Every investment choice has both risk and reward
- Bury cash in the backyard
  - reward: can't (easily) lose principal
  - risk: no income, so inflation reduces value over time
- Junk bonds
  - reward: high interest rate (can be > 10%)
  - risk: significant chance of principal loss if bond holder defaults (likely because they went bankrupt)

5

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. **Morningstar** does include dividends and so is accurate
  - On Morningstar, must set Data Type to "growth with dividend".

6

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

7

Some Recommended Stock ETFs

- In no particular order:
- ONEQ – NASDAQ composite, American, large, growth
- IWN – Russell 2000, American, small, value
- VB – American, small, growth+value
- IWB – Russell 1000, American, large, growth+value
- SCZ – EAFE, international, small, growth+value
- SDY – S&P dividend, American, large, value

8

Bonds

- Bonds are loans; they typically pay interest twice a year
- Long term bonds mature in 20-30 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 now 3% - 5% on low risk, long term California bonds
- Treasury bonds
  - loans to federal government
  - state tax free
  - rates now 1% - 3% on nearly zero risk, long term bonds
- Bonds usually better than CDs
  - Comparable interest rate; no taxes on municipal bonds
- Risk: treasury < municipal < corporate

9

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)
- 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 interest rate change 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
  - Will have gain if bond was purchased at a discount

10

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 must buy and sell bonds to manage cash flows
- In a rising interest rate environment, bond mutual funds/ETFs will go down in value, i.e. you'll lose principle
- It is usually better to **buy individual bonds, not bond mutual funds/ETFs**, especially when interest rates are rising
- In any environment, bond mutual funds/ETFs will reduce your income due to their fees
- Several agencies rate bonds based on risk of default
- To keep risk low and income high, buy individual, **investment grade** bonds (specific rating depends on rating agency) with **high, worst-case yield**

11

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

12

Real Estate Measure and Types

- Real estate investment measure: capitalization rate
  - assume purchase with all cash
  - capitalization rate is (income – expenses)/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)

13

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
- 20% - 40% downpayment for breakeven (income >= expenses)

14

Investing in Real Estate

- A single apartment unit in Silicon Valley is $300K 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.

15

Ways to Own Real Estate

- Tenants-in-Common
  - Despite name, TICs are owners, not typically tenants
  - Multiple parties pool funds to buy real estate
  - Self-organized
  - Typically high minimum investment
  - 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
  - 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 rate loan risk
- Typical, relative returns: TIC > Partnership > REIT

16

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 initially higher interest rate
- Vacancies
- Reduction of property value
  - rare in California, not so elsewhere
- ~~Famine~~, ~~Pestilence~~, Earthquake
  - Insurance
  - Superior construction
    - No tuck-under garage

17

Retirement Account Types

- 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 at age in early 70s
- Roth:
  - Limited amount each year
  - Can usually only contribute if income not high
  - 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

18

Regular vs. Retirement Accounts

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

19

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

20

Diversity

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

21

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

22

Conclusion

- Presentation available at:
- http://csl.sri.com/people/poggio/
- Learn more about investing
  - Ask questions
  - Read up on the topics
    - "Investing for Dummies" (actually, for beginners)
  - Consult trusted, investment advisor
    - 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**

23

Extras

24

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

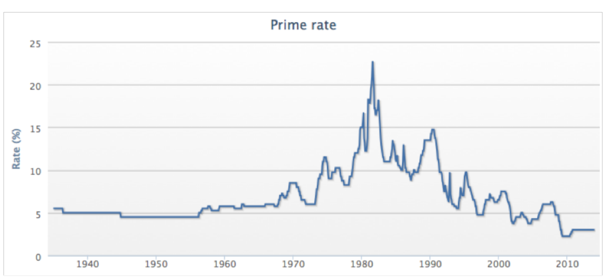
25

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

26

Interest Rate History



27

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

28