Diversification

Seeking to Reduce Real Estate Risk

How can risk be potentially reduced in real estate investments? It's simple - by practicing diversification. Instead of investing in a single property with concentration risk, prudence dictates investing in a number of properties with different investment and risk parameters. Remember the proverb: *"Don't put all the eggs in one basket."* Why? Because dropping the basket will break all the eggs. Instead, you should place each egg in a different basket. While there is more risk of losing one egg, there is generally less risk of losing all of them.

Diversification Theory and Real Estate

The modern understanding of diversification dates back to the Modern Portfolio Theory, a hypothesis developed by Harry Markowitz in the 1950s. The theory is based on the premise that risk-averse investors can construct portfolios to maximize returns based on a given level of market risk, emphasizing the face that risk is an inherent part of higher reward. Modern Portfolio Theory suggests that it is not enough to look at the expected risk and return of one particular stock; rather, a portfolio of stocks, an investor can reap the benefits of diversification, particularly a reduction in the risk attributable to the overall portfolio.

Unlike stocks, building a diversified real estate portfolio can be a daunting task. Financial and background information on private real estate is not readily available, and can be costly and time-consuming to obtain.

Moreover, the investment cost of most real estate assets is significantly higher than stocks (millions instead of hundreds of dollars). Still, it's possible to diversify your real estate investments in a number of ways:

- Asset classes, including multifamily, retail, medical, office and industrial
- Geography
- Tenants
- Holding period
- Sponsor

By investing in different asset classes, different locations and properties leased by different tenants, you may have much less risk than investing in a concentrated investment. By diversifying your holding periods, all of your investments will not mature and have to be sold at the same time. If you invest in Delaware Statutory Trusts, it also is practical to diversify by sponsorship so that your assets are not all managed by the same real estate firm.

For example, assume you are a 1031 exchanger who invests all your exchange proceeds in a single replacement property. You are highly concentrated and at maximum risk. If that property suffers a meltdown, you could be wiped our. Instead, let's say you have read the works of Markowitz and divide your exchange proceeds into several investments and invest in different asset classes in different parts of the country with different tenants. The inherent risks of making those real estate investments are theoretically diminished. If one property goes bad, the investor still has several other different investments in their portfolio that are likely to perform as intended.

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Tax Deferral Using 1031s, TICs, and DSTs

From 2000 to 2008, billions of dollars were invested in real estate using the tenant-in-common, or TIC, structure. The TIC structure allows investors co defer their gains under Section I 031 of the Internal Revenue Code on the sale of investment/business real estate by acquiring an undivided interest in a replacement property. By investing in a TIC, exchangers were able to acquire an interest in a much larger, higher-quality (investment-grade) replacement property that they could not acquire on their own.

Back in the TIC era, the minimum investment amount was very high, frequently $1 million. The high investment minimum meant that many well-heeled investors put all their 1031 exchange proceeds into a single TIC replacement property. This is what is known as a concentrated investment with single asset risk. For example, suburban office buildings struggled during the recession, with many of them being lost to lenders following loan defaults. Thus, an investor in a single office building could have lost 100 percent of their investment. By contrast, apartment communities performed much better during the recession because housing is a necessity.

The real estate recession of 2008 to 2012 slammed many real estate investments. A large number of investors who had the misfortune of being concentrated in the wrong asset class. If that single property failed to perform, the investor could lose their entire investment, just like dropping the basket of eggs. They learned the hard way about concentration risk, while investors who owned a more diversified portfolio fared much better.

DST - The Structure of Choice for 1031

Following the real estate recession, the TIC structure was replaced by the Delaware Statutory Trust, or DST, structure. A DST is an interest in a property that qualifies for Section 1031-exchange treatment. Unlike a "whole" property investment, DSTs have a "sponsor" who does all the work in terms of acquisition, due diligence, financing, closing, asset/property management, accounting, investor and tax reporting, and ultimately disposition of the asset at the end of the holding period. It is estimated that sponsors sold nearly $2 billion of equity DST investments to accredited investors in 2017.

DSTs have a very low minimum investment amount, frequently as little as $25,000. Low minimums encourage diversification. Assume you are an exchanger with $250,000 of net proceeds from your sale, and you would like to acquire a diversified replacement property portfolio to qualify for deferral under Section 1031. Unfortunately, if you seek to acquire "whole" properties, you are out of luck. But you have a solution: acquire a portfolio of DSTs.

Also, unlike “whole" properties, where the investor has a heavy burden of due diligence, DSTs are all teed up by the sponsor: Due diligence is completed, the real estate is owned, the loans/mortgages are in place, etc. DSTs are a turnkey investment. And the best part, because the minimum is so low, even a small investor can diversify by acquiring a portfolio of DST replacement property qualifying for tax deferral under Section 1031.

In Conclusion

Bottom Line: Investors who own a more diversified portfolio enjoy reduced risk, especially during challenging economic times, when compared with investors in a single asset. Section 1031 exchangers acquiring replacement property should diversify to reduce risk. In this way, you can seek to both qualify for tax deferral and reduce the inherent risk of making new real estate investments.

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1031 RISK DISCLOSURE

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions; Impact of fees/expenses
- Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits