How To Choose an Investment Market and Minimize Your Risk

A Pinnacle Perspective

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OK, everyone's heard the old saying that "Location, Location, Location" is the most important factor when buying real estate right? But what does that really mean? What about a location should you know before buying a property for long term rental? Buying because the property's in your own home town, or because your Uncle George lives in the same city and he can keep an eye on it are the wrong reasons.

Most people want to buy close to where they live, but buying in a local market with poor returns can be inherently more risky than buying in an out of state market with strong returns. The key to success is to minimize risk first and then maximize your returns. So how do you do that?

Start By Defining Your Goals

Before you even start considering locations, you need to figure out why you're investing and what your objective is. Some markets are great for appreciation but not so great for cash flow. Others produce great cash flow but appreciate at about the same rate as the end of the last ice age. Deciding which is most important to you is the starting point. You'll also want to identify some basic criteria. Some investors will only buy homes of a particular age. If you won't buy a home more than 20 years old then you probably want to avoid Pottsville, PA where the median age of a home is the oldest in the nation. Once you've defined your goals, then you're ready to start figuring out what cities or areas will fit those goals. It's a big country so where do you start?

You'll start by analyzing the macro level economic fundamentals of a city. Next you'll study the housing market of the city.

Start big and work your way down

You'll want to start at a macro level and drill down. The way to do that is to identify some Metropolitan Statistical Areas (MSA) that look interesting to you. The Federal Government defines a Metropolitan Statistical Area as one or more adjacent [counties]() that have at least one [urban core area]() with a population of at least 50,000. There are 366 such MSA's which leaves you with no shortage to choose from!

Once you've identified some potential MSA's you'll need to start analyzing the economic fundamentals of the area. What you're trying to determine is the overall health of the city. Here are the most important things you'll want to know.

How many people live there?

You need renters so you want a city with a lot of people in it. This gives you a large, diverse population as your rental base. I like cities with at least 500,000 but some investors are ok with 100,000 or 200,000. The main thing is you don't want a small podunk town that doesn't show up on Google Maps.

Is the population growing or shrinking?

This is one of the most important considerations when choosing a market to own buy and hold property. If the population is decreasing, you not only have a shrinking pool of renters, it's a sign of fundamental economic weakness of the area. Thriving, healthy cities don't have declining populations. Look for cities with population growth that exceeds the national average. You'll also want to know where the people are coming from. If it's simply because birth rates are exceeding death rates, that doesn't help much. New household formation is what is most important. What you really want to see is a net positive migration where the number of people moving in to the city is more than the number moving out. This is a pretty good indication that the city has something to offer to attract more potential renters.

What's the unemployment rate?

Employment is another major indicator of a cities economic health. If people don't have jobs, they can't pay much for rent. Again, look at the unemployment rate against the national average. You'll not only want to look at the current unemployment rate, but look at its trend for the last 12 months. If the unemployment rate is below the national average today but shows a rising trend while the average is declining, that could spell trouble. Conversely, if the unemployment rate is higher than the average but is dropping more quickly, there may be some positive underlying economic factors occurring that you'll want to understand.

It's also important to look at not just the unemployment rate but also the absolute number of people employed. The unemployment rate can be misleading. Because of how the government measures unemployment, it is quite possible for the unemployment rate to drop while the number of people working declines. The number of people working is what really counts. You'll want to see the number of seasonally adjusted, non-farm labor employees and whether that figure is growing or declining.

Where Do All These People Work?

What industries employ the greatest number of people and how diverse are those industries? Cities with a high concentration of workers employed in a small number of industries are at risk of economic downturns in those industries. Find out who the major employers are and how many people they employee. How many are Fortune 500 companies? What is the financial performance of these employers? Are businesses moving in to or out of the city? Have any announced any major expansion plans or reductions? Is the state and local government pro business? What is the corporate tax rate of the state and what is the state and local government doing to attract new business?

Are People Making More or Less Than Before?

Look at per capita and median household incomes. Are incomes going up, down or are they stagnant? Again, cities with thriving economies have rising incomes and are producing higher wage jobs. If the number of people employed is rising but average incomes are declining, it means that the new jobs being produced are mostly lower wage jobs. So, it's not just the number of jobs that's important, it's the quality of the jobs.

How Big Is the Economy?

Gross Domestic Product (GDP) is a gauge of the size and health of an economy. GDP represents the value of all of the goods and services produced over a certain period of time. Most people are familiar with the national Gross Domestic Product, but this data is available for each Metropolitan Statistical Area. You'll want to see what the absolute GDP is in dollars and also, what the growth rate is over the prior period. The higher the growth rate, the healthier the economy. Avoid markets with declining GDP over a long period of time. Cities with large populations typically have higher GDP than smaller cities. It's helpful to look at the GDP per capita of a city. Markets with GDP growth that exceed the national average and high GDP per capita could be good choices.

How Much Crime Is There?

This isn't quite as obvious as it seems. Every market is made up of smaller microcosms and has both high and low crime areas. It's not enough to say that a particular city has a high or low crime rate. You need to understand which are the areas that are safe and which areas you don't dare walk in at night. Crime rates vary from neighborhood to neighborhood and even street to street.

Is It a Landlord Friendly Area?

You should get to understand some of the landlord/tenant laws and who they favor. You don't want to be a slumlord, but if your tenant hasn't paid their rent in 6 months, how easy is it to get them out? This is one of the biggest fears among new investors and rightfully so. Everyone has heard horror stories on how long it took to evict a deadbeat tenant .States and local governments vary significantly on landlord/tenancy laws. Make sure they're favorable to you as an investor.

Property Taxes

Taxes are a significant part of your operating expenses. Some cities are much higher than others. Minimize your taxes and maximize your ROI. Taxes are based on the properties assessed value. Check with the County Tax Assessors office to find out when the property was last assessed and what the possibility of getting it more favorably reassessed.

Do People Own or Rent?

Markets with a lot of renters obviously give you a larger pool of potential tenants. Some markets have higher ownership rates than others. Look for strong renter markets. Markets with high foreclosure rates tend to have a high rent rate as former homeowners have become displaced and are now renters.

What's The Price to Rent Ratio?

Owning rental property is all about cash flow and ROI. High cost markets are not good for buy and hold because of their low price to rent ratio. Look for markets with a minimum of a 1%-1.5% price to rent ratio. The best place to determine market rents for an area is to look at different property management websites and internet rental sites to see actual available rentals.

Are There A lot of Vacancies?

Some markets have had so many vacancies that they are bulldozing neighborhoods to reduce the cities geographic footprint. This probably isn't the best market to invest in. Look at what the rental vacancy rate is in your target market. Once again, look at the trends. Are vacancy rates increasing or decreasing? How do they compare to the national average?

Housing Price Trends

What's happening with housing prices? Are they going up or down? Look at the trend of median prices in the market. Nearly all markets took a beating in 2008. Look at how much prices dropped from their peak to their low in your target market. Some markets lost nearly 50% of their value while some lost less than 10%. Where are prices now in relation to their high and low? The ideal time to buy is when prices have reached bottom and are just beginning to recover. You NEVER want to buy at the top of the market like so many people did in 2006. If you're hearing a lot of buzz about the latest "hot spot", it's probably already too late because everybody and their brother are already buying there. You need to be at the forefront of market trends not just following the herd.

So how do you identify the early signs of a recovery or market boom? In the remainder of this article, I'll discuss the key housing metrics that are leading indicators that a market is about to rebound.

How Many Homes Are on the Market?

Look at how many homes are currently on the market compared to the same period a year ago. More homes on the market could mean that the housing market is losing steam and fewer homes are selling. Also, look at how many sold and how many are pending compared to the previous year.

Month's Supply of Inventory

This is basic supply and demand economics. The months' supply is the ratio of houses for sale to houses sold which indicates how long the current for sale inventory would last given the current sales rate. In a slow real estate market, there are more homes available for sale than there are buyers, and conversely, more buyers than there are sellers in a strong market. Because this is a slower moving indicator it can be a good forward indicator of the direction and potential magnitude of future pricing. Economists believe that 6 to 6 ½ months of inventory is considered market equilibrium—the point where supply and demand are balanced. At the height of the housing crisis, national housing inventory rose to over 12 months. It's important to keep in mind that every market is local and the national level doesn't necessarily reflect your market. As you see inventory levels and months' supply dropping, it is an indication that the market may be moving towards a seller's market.

How Long Is It Taking To Sell?

Days on market (DOM) is a measurement of the average length of time homes take to sell. Are houses sitting on the market a long time or selling as fast as they hit the MLS? You'll want to see what the trend is in your market. If average DOM is dropping, it is an indication of strong sales demand and price increases to come.

Are Sellers Getting Their Asking Price?

The asking price to sales price ratio is an indication of how much sellers are having to discount their price to sell their homes. If you see this ratio tightening, it's an indication that the market is gaining strength and sellers are not having to discount so much.

Who's Buying All These Houses?

It's important to know who is buying. Are they investors or owner occupant buyers? Heavy investment activity in a market can artificially drive prices up dramatically without being a reflection of the health of that markets economy. As investors begin to exit markets, there is the potential for another market bubble. These markets may be well suited for 3-5 year equity gains not be good for long term hold. Timing is key in investor dominated markets.

All investments have risk, but if you do your homework well, you can minimize the risk of out of state investment and open yourself up to some fantastic opportunities that might not be possible in your own hometown. If you're interested in maximizing your cash flow and ROI, give me a call to discuss which markets might be best for you.

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