

# Personal retirement plan term paper

[Business](#), [Marketing](#)



## **Abstract**

Before making any decision on the choice of an investment plan, it is very important that the individual carries out an intensive evaluation on the available investment options. Real estate is a very significant part of investment portfolio due to its numerous advantages and the less associated risks as compared to other forms of investments. As a Personal Retirement Plan, I opt for real estate. In this work, I have thoroughly investigated the theories and literature on real estate as an investment plan, and examined the both the benefits and the risks associated with such kind of an investment. There are various diversification benefits which have made me decide on real estate as my personal retirement plan. Other than real estate, I have explored the mutual fund as other option of my Personal Retirement Plan.

## **Introduction**

As the population swells, demands for housing increase day by day. Real Estate investment includes the purchase, management, ownership, and sale of real estate with the aim of making profit. The improvement of the property is also an important aspect of the investment. It is an asset form of investment with limited liquidity. It is capital intensive; however, the capital can be obtained through various sources. It's also very dependant on the cash flow. Proper understanding of these factors makes real estate a very lucrative form of investment; however, as any other business, it can turn out to be a very risky venture.

## **Background**

My focus on real estate investment plan lies in three key areas:

1. The indexing, the benchmarking, and the measurement issues considered in real estate market
2. The properties of real estate investment including the diversification and the risk – returns within the markets.
3. The determinants in real estate (economic determinants).

## **Real Estate Benchmarks**

Real estate investment is achieved through two investment types; the direct, and the indirect. For a direct or a physical real estate investment, there is the acquisition and the management of the actual properties. Indirect investment, also called financial or securitized investment, involves the buying of shares of the real estate management companies. The shares are then traded on the financial exchanges. The industry analysis trends and the descriptive statistics are provided by Ziering and Taylor (1998) on their overview of major real estate benchmark indices in US.

The measurements of both direct and indirect investments vary. For the direct real estate performance in the U. S, the National Council of Real Estate Investment Fiduciaries (NCREIF) Index is used. This is a quarterly benchmark set apart by geographical region and market sector forces. The relative liquidity of the direct real estate market requires that the index be based appraisals instead of the market transaction data. In such a case, appraisals may lag hence the turning points in the market values of properties are underestimated resulting in volatility (Geltner, 1997 and Lizieri and Ward,

2000). Physical real estate benchmarks have problems which suggest the use of data from financial real estate. Indices of real estate securities are provided by the National Association of Real Estate Investment Trusts (NAREIT), which helps in the analysis. Three categories of REITs are in existence: mortgage, equity, and hybrid.

## **The Properties of Real Estate Risk-Return and Diversification**

Real estate return distributions properties are very important as they provide major inputs into the asset allocation process. The return distributions and return generation processes of financial and physical real estate in both UK and US are reviewed by Lizieri and Ward (2000). Testing for the normality in the real estate returns is highlighted by various researchers. In terms of skewness and kurtosis of direct and indirect market, normality is rejected (Young and Graff, 1995),

Also, there is non-linearity in real estate terms as depicted by Maitland-Smith and Brooks (1999). Returns on indirect real estate follow a mean reverting process around a positive trend in lower interest environments, while around a falling trend; there is random oscillation when the rates are high. Lizieri and Ward (2000) tell us that the logistic distribution provides the best fit securitized real estate returns to U. K.

Kallberg and Liu (1996) explore the diversification benefits of real estate investment. Applying the mean-variance efficient framework, a 9% allocation to real estate is optimal in cash, stocks, and bonds. There are strong gains resulting from adding a real estate to dynamically managed stocks and

bonds portfolio according to Grauer and Hakansson (1995). This kind of investment yields numerous diversification benefits.

## **Economic Determinant of Real Estate Returns**

Real estate returns are functions of various fundamental economic variables. Globally, there is a great link between real estate returns and the changes in GNP (Goetzmann and Rouwenhorst (2000)). Just like any other economic fundamental, cycles are followed by real estate markets. At the regional, the national and the international levels, there is the occurrence of Macroeconomic Cycles. They include the inflation and currency cycles, technological, demographic, employment, and the general business cycles. These cycles work best on metropolitan areas.

The microeconomic cycles include physical life cycles, urban and neighborhood cycles, and rent rate and occupancy cycles. Demand and supply cycles also exist as either micro- or macro. These cycles jointly interact to affect the real estate investment returns. If a cycle is focused perfectly, there is a resulting improvement in the dynamic strategies.

Economic risk factors which dictate the pricing in real estate markets have been analyzed by Ling and Naranjo (1997, 1998). According to them, the systematic determinants of real estate returns are real interest rates, growth in consumption, the unexpected inflation, and the term structure of interest rates. These relationships are very important for asset location.

## **The Sources and Acquisition of Investment Property**

In my plan, I have considered the following real estate property sources: Market listings; Wholesalers like banks, public agencies, and real estate

owned departments; Retail agents; Private sales; and Public auctions. After the location of the property, investigation and evaluation of its conditions are mandatory. This, I intend to do through the involvement of real estate attorneys and agents.

## **Management of the Risks**

In every business venture, risks can not be avoided. However, the manner in which the risks are managed is of utmost importance. In my plan, I intend to use the mitigation strategies shown in the table bellow:

- Risk
- Mitigation Strategy
- Fraudulent sale
- Proper verification of the ownership, and the purchase title insurance
- Environmental contamination
- Obtaining the environmental survey, test for contaminants (lead paint, asbestos, soil contaminants, etc.)
- Overpayment at purchase

Obtaining third-party appraisals and performing discounted cash flow analysis as part of the investment pro forma. I shall not rely on capital appreciation as the primary source of gain for the investment.

## **Market Decline**

My purchase of the properties shall be based on a conservative approach that the market might decline and rental income might decrease as well.

## **Economic downturn**

The purchased properties shall have distinctive features in desirable locations so as to compete favorably. I shall also control cost structure, and have tenants sign for long term leases

## **Underestimation of risk**

I shall carefully analyze the financial performance using conservative assumptions, and ensure that the property can generate enough cash flow to support itself

## **MUTUAL FUND**

This is a company which invests in a diversified security portfolios. The owners or the shareholders are the individuals who buy the shares for a mutual fund. A mutual fund can then buy securities like stocks and bonds. From the securities, a mutual fund makes money in two ways: the security can raise the value of the mutual fund; or the security can pay interest or dividends to the fund. However, as any other business venture, a fund can lose money and drop in value.

## **Mutual funds exist in three basic types:**

Stock mutual funds - this is also called the equity. The investment is primarily in the shares of stock issued by U. S. or foreign companies.

Money market mutual funds - investment is in short-term securities which are issued by the U. S. government and its agencies, state and local governments, and the U. S. corporations.

## **Diversification**

Diversification greatly helps in minimizing the adverse effects of a single investment. With the mutual fund, there is diversification of the investment portfolio through holding of a wide variety of securities. As a result of the common pool of assets of different investors, mutual fund allows for a more diversified portfolio. It gives the investor an opportunity of investing in various market sectors.

## **Low Costs**

Within the mutual funds, there are various securities. An investor pays for the services depending on the total value of the account. Due to the existence of numerous competing firms and various funds, the level of the fees varies. In most cases, mutual funds provide diversification and professional management at a lower cost.

## **Liquidity**

The shares of the Mutual funds are liquid investments. The shares can be sold on any business day. The price per share at which the shares can be redeemed is the fund's net asset value (NAV).

## **Professional Management**

The experienced professionals normally manage the portfolio of securities for the investor. The professionals are the deciders on the securities to buy and sell depending on the market research. The funds are managed by a team of by an individual through choosing an investment which matches the objectives of the funds. Meeting the fund's objectives is the major concern at all the economic conditions.



## **Variety**

There are varieties of investment approaches within the broad categories of money market funds, stock, and bonds, where an investor can choose from.

## **Convenience**

Mutual fund is very convenient as the investor can purchase or sell the shares directly from a fund or a financial planner, broker, bank or insurance agent.

Stock Market Returns - There are upswings and downturns of the stock market which affects the return on the stock funds. The diagram below shows the volatility of the stock market.

## **Bond Funds**

Such funds invest primarily bonds. They are used for diversification, they provide a stream of income, and are very essential for intermediate-term goals. The risks include Interest Rate Risk, Credit Risk, and Pre-payment Risk.

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