RECESSION-PROOF REAL ESTATE INVESTING

HOW TO SURVIVE (AND THRIVE!) DURING ANY PHASE OF THE ECONOMIC CYCLE

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BY J SCOTT

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CHAPTER 1

INTRODUCTION

In May 2008, my family and I moved to Atlanta, Georgia. Driving through the city and surrounding counties, we couldn't pass three houses without seeing a "for sale" sign in a yard or a foreclosure notice taped to a front door.

To say Atlanta had been devastated by the 2007 housing crash would be an understatement. It was one of the hardest hit markets in the United States, with housing values in some areas as low as 30 percent of what they'd been two years earlier. Foreclosure rates in Georgia were up 44 percent from 2007 and 117 percent from 2006.

And Georgia wasn't alone.

Nationwide, foreclosure filings increased by more than 81 percent in 2008, with more than 800,000 families losing their homes. And that trend continued for the next two years. From 2009 through 2010, about 45 percent of existing home sales in the United States were REOs (real estate owned) or short sales.

As we drove through the neighborhoods near our house, we couldn't

understand why investors weren't taking advantage of the reduced prices and buying up the distressed properties. I started attending some local real estate meetups to see what was going on. The only information I could get from the two or three investors who attended—down from hundreds just a year earlier—was that they were too scared to buy. They were worried prices would continue to drop, and they wouldn't be able to resell their investments. In other words, these investors were passing up potential deals-of-a-lifetime because they didn't have confidence in their exit strategy.

These investors were waiting for the "perfect" time to jump back into the market. They didn't understand the real estate market works in cycles just like the broader economy—with upswings and downturns—and that there is never a perfect time. Instead, they should have been creating an investment strategy that worked across the full cycle.

This is what we do, and hopefully after reading this book, what you will do as well.

Don't Fear Change, Embrace It

Change is inevitable. And you can respond to it in one of two ways:

- You can embrace it, modify your investment strategy around it, and reap the benefits from the opportunities that present themselves.
- Or you can fear it, refuse to adapt, miss out on the opportunities that come your way, watch your profits shrink, and potentially lose money.

Successful investors are flexible. They understand that to succeed they need to be prepared to take advantage of the opportunities that come their way—whether it's during an upswing, a down market, or an inflection point (more on that later). It doesn't matter if you're just getting started or you're a seasoned veteran, there are ways to make money during every phase of the real estate cycle. But to do so, you need to have a strategy to handle changing market conditions, which is what my wife and I have done over the last decade.

When Carol and I started our real estate investment business in 2008, the housing crisis was at its worst, and the foreclosure rate was the highest it had been in modern history. As flippers, that worked to our advantage. To find our next great investment opportunity, pretty much all we

had to do was choose a random home from a list of foreclosures available for sale by the banks (also known as REOs). For the first couple of years we were in business, we only bought REOs because there were so many, and nearly all of them were good investments.

But in 2010, Carol started to notice a decline in the number of foreclosures on the market. She realized if we wanted to keep our inventory pipeline full, we'd need to start looking for different types of investments by the following year. She'd heard that some real estate agents were focused on short sales, where lenders were giving sellers permission to sell their properties for less than what they owed on their loans. These types of sales were becoming more and more popular, so we decided to start shifting our buying strategy to take advantage of the increasing supply of short sales on the market.

Within a year, REOs dried up in our area, but short sales were taking off. Because we'd started building our short-sale pipeline quickly after the real estate market began to shift, we were better positioned than most investors to take advantage of this new trend in acquiring investment property.

Fast-forward two years, and Carol again recognized a change in the market. She realized banks were getting more conservative in their approvals of short sales, and suggested we find a new strategy for acquiring deals because she didn't believe short sales were going to be a viable option for much longer.

Around that time—2013 or so—I noticed builders were starting to sell off some of their excess lot inventory. These were empty lots in newly developed subdivisions that weren't as optimal as the rest of the lots and didn't have the same level of profit potential. But these lots were perfect for investors looking to build spec houses (being sold for a profit as-is or with minimal changes), which is something we wanted to pursue.

In addition, as the market started improving, we began to see opportunities to buy older homes on "infill" lots. The existing structures could be knocked down and replaced with new construction spec homes. For the next several years, building new construction spec houses was our niche. Because we saw the opportunity before many other investors, we were able to capitalize on our ability to change direction quickly and efficiently.

We continue to do so today. Every few years, we alter our strategy to keep pace with the changing market. Our flexibility has allowed us to keep our deal pipeline filled and has given us a head start compared with

other investors who aren't as flexible.

With all that in mind, at the time of this writing, we're in the middle of the second longest business cycle expansion in U.S. history. Whether this current expansion will outlast the one we saw during the 1990s tech boom remains to be seen. But history has shown us that it won't last forever. There will come a time when growth will start to decline, and we'll experience a downturn in the economy just like we've experienced 33 other times.

The goal of this book is to help you prepare for the imminent changes that will occur throughout the next economic cycle and future cycles. If you're an experienced investor who's been through a full economic cycle, you're probably already familiar with many of the concepts I'm going to discuss.

But if you're experiencing part of the cycle for the first time, understanding and applying the techniques in this book will help you earn more in any part of the real estate cycle. And it will help prevent you from getting blindsided by changes in the market.

Transactions, Markets, Economies, and Cycles

I'm sure you've heard each of these words before and you no doubt have a good idea what they mean. But I'll be using these terms *a lot* in this book, and I want to be certain that we all agree on how they are being used.

A ***transaction*** is simply an exchange between two people. We live in a transactional world, especially when it comes to financial transactions. Every day, billions of times per day, transactions take place between buyers and sellers. Buyers give money in the form of cash or credit to sellers, who in return for that money provide a specific good or a service to the buyer.

For example, I might give money to a restaurant for food. I might give money to a car dealership for a new car. You gave me money in return for this book! Each of those billions of transactions is based around many thousand different good and services.

If you aggregate of the transactions around one specific good or service, that's called a ***market***. In other words, the automobile market is simply the sum of all of the transactions that involve automobiles. The gold market is all the transactions that involve buying and selling gold. And, as you can probably guess, the real estate market is simply all the

transactions that involve real estate.

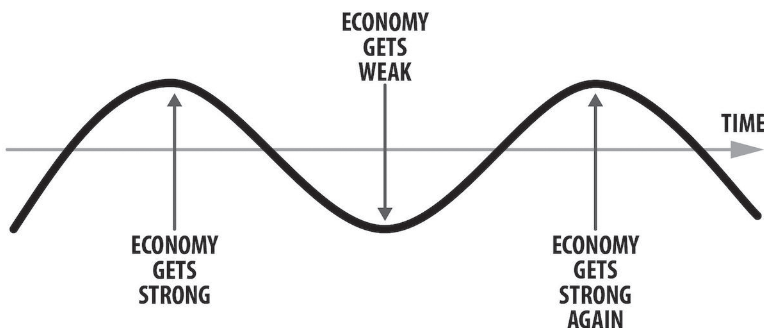
There are thousands of these markets, and when you put them all together, you get an ***economy***. To put it simply, an economy is made up of thousands of markets, which in turn are made up of billions of transactions. When we talk about the economy, we are simply talking about the sum all of those transactions within all the markets within it.

As you might expect, the number of transactions and the size of transactions that take place every day across all markets isn't always going to stay the same. There will be months and years where there are more transactions and bigger transactions; when this is the case, there's lot of cash flowing through the markets, and we typically refer to the economy as *strong*.

There will be other times when there are fewer transactions and smaller transactions taking place over months or years. During these periods, there is less money flowing through the markets, and we typically refer to the economy as *weak*.

Historically, we've found that there are some well-defined factors that need to come together to generate a strong economy. Then, after some period of time, those same factors that led to the strong economy will cause problems that weaken the economy. Eventually, those same factors lead to the economy getting strong again.

This pattern of strong economy leading to a weak economy leading back to a strong economy is called a ***cycle***.



To summarize the relationship of these four concepts:
Markets—including the real estate market—are made up of billions of transactions. Those markets comprise the overall economy. And the economy goes up and down in cycles over the period of years and decades.

Common and Historical Economic Cycles

Economic cycles are not new. Experts have been tracking them for more than a century and a half. Unfortunately, those same experts — even the most respected ones—disagree over how long a cycle lasts and when we can expect a change in the current one.

Just take a look at the headlines on any given day and you can likely find one expert predicting strong economic growth for the next two to three years, while another says we're headed for a recession any day now. Another may even contend that an economic downturn started months ago.

Sometimes the experts are right and sometimes they're wrong. But two things you can count on are that no part of a cycle lasts forever, and every cycle will eventually repeat.

Changes to economic policy, tax policy, and the way businesses operate may impact the length and magnitude of our economic cycles. However, it's reasonable to assume the markets and broader economy will continue to fluctuate in response to macro- and micro-economic factors just as they have throughout history. In other words, while it may be tempting to say, "This time is different!" history tells us that things are rarely different. The details may change, but every economic cycle is going to feel familiar and every cycle will give us—and take from us—financial opportunities.

Before we continue, it's important to point out that the cycles we'll talk about in the rest of this section (and throughout much of the book) are *national* cycles. That's not to say these cycles don't exist independently at the local level as well. They do. But keep in mind that what we discuss in the following paragraphs and chapters may not align perfectly with the cycles you've seen in your local market.

Though, for many of you, I bet it will be pretty close.

CHAPTER 2

WHAT DRIVES CYCLES

We discussed in the previous chapter that our economy moves in cycles. And it's not just one cycle at play. There are many interrelated cycles, and the interaction of these cycles is what drives the length and magnitude of the uptrends and downtrends we see in our economy.

In this chapter I want to discuss three of the cycles that have the biggest impact on our lives as both consumers and investors. While these aren't the only cycles that exist in our economy, understanding these three big ones will help you better understand why we see the economic ups and downs that are so prevalent.

The Business Cycle

The first cycle I want to discuss is perhaps the most commonly discussed and most recognized. It's called the *business cycle*. Because the business cycle occurs more often than other cycles, and tends to affect all parts of the economy, Americans are more attuned to the ups and downs caused

by this cycle than all the other cycles put together.

The business cycle is driven by interaction between two main forces: inflation and interest rates. It's imperative that you understand how and why these forces work the way they do, as that's the basis for the rest of this book and for your entire investing strategy.

With that said, let's a look at how inflation and interest rates drive the business cycle.

Imagine a point in the economic cycle where the economy has emerged from a recent recession and is now chugging along well. This might correlate to what we saw back in 2002 or 2012. Now that the recession has passed, businesses are starting to generate profits again and they're hiring more workers. With all the hiring across the nation, the unemployment rate is finally leveling off and starting to drop, and people are getting back to work.

Now that many Americans are once again gainfully employed, they are starting to spend more money. They're going out to eat, they're buying new cars, and they're buying clothes. All this spending is good for businesses—they're now selling more products and services, increasing production and making more money.

As business owners start to earn more, they'll pass some of these profits onto their employees in the form of increased wages and bonuses. Employees are also consumers, and when employees earn more money, they spend more money. We're seeing a snowball effect: Increased business profits lead to increased employee wages, leading to increased spending, leading to even high business profits.

Over time, businesses hire more workers, unemployment numbers drop, and consumer confidence in the economy increases. We're once again in an economic boom, and evidence is everywhere. Tourism is booming, the stock market is going up, real estate values are going up, and investors are getting confident again.

Eventually, things are *so* good for the average American that demand for products and services starts to outpace the ability of businesses to produce those goods and services. Car manufacturers can't build cars fast enough. Home builders can't build homes fast enough. Electronics manufacturers can't build enough TVs or toys.

To keep up with all the demand, businesses need to hire more workers. Unfortunately, thanks to the low unemployment rate created by the strong economy, there aren't many new workers to hire. Businesses must

increase their wages to get retired workers back into the workforce and to entice workers to leave other jobs and work for them.

At the same time, to ramp up production with all these new employees, businesses need to buy more equipment and build more factories. These things aren't free, and the cost of this new equipment and new factories will eat into business profits.

This quick and steep increase in wages and production costs gets passed onto consumers. Businesses owners will increase the prices of their goods and services in order to maintain profits.

The term we use for an increase in the price of goods and services is *inflation*.

Inflation is a positive sign of a growing economy, but it's also a drag on economic growth. When goods and services cost more, consumers' money doesn't go as far, leading many consumers to either spend less or use credit cards and loans to finance their purchases.

The government knows that too much inflation isn't good. In fact, runaway inflation is such a risk to consumers and the economy that it's at this point when the government will step in and start taking action.

To combat inflation, the government needs to encourage Americans to spend less money—at least for brief period of time. This will give businesses a chance to catch up on production and get ahead of consumer demand. Which should slow down inflation.

And this is where the Federal Reserve comes in...

The Federal Reserve

Sometimes called the Fed, it was created by Congress and its goal is to oversee and regulate the United States financial system. It's the one organization that can manipulate the economy from the inside.

They have two ways to do this:

First, the Fed controls the money supply. They don't print money—that's the Department of Treasury's job—but it's the Fed that decides how and when to release it into the economy. We'll talk more about this in just a moment.

Second, the Fed controls interest rates, and can raise or lower interest rates as they see fit. It's this power to affect interest rates that the Fed most often uses to manipulate the economy.

To understand how the Fed uses interest rates to manipulate the economy, we first must understand what interest rates are and how they

work. Interest rates reflect the rate at which money can be loaned and borrowed. Any time money is borrowed, the borrower must pay back the amount borrowed, plus a little more. This "little more" is the lender's profit and is referred to as interest.

When interest rates are low, borrowers only need to pay back a little extra on top of what they borrowed. But when interest rates are high, borrowers must pay back much more on top of what was borrowed, which reduces their spending power on other goods and services.

By controlling interest rates, the Fed has the ability to decide whether it's cheap or expensive to borrow money.

Interest rates also come into play when saving. Low interest rates mean that when you stick your money in a savings accounts, certificates of deposit, or U.S. bonds, you don't earn very much in interest. But when interest rates are high, saving money is more lucrative.

By controlling interest rates, the Fed has the ability to decide whether it's lucrative to save money; if not, Americans will tend to spend instead.

When inflation starts to take hold, the Fed will step in and raise interest rates. Higher interest rates will have two major effects:

1. It will encourage consumers to spend less and save more—remember, higher interest rates mean higher returns from savings accounts, certificates of deposit, and bonds.
2. It will decrease consumers' abilities to borrow money—remember, higher interest rates mean higher borrowing costs.

When Americans spend less and can't borrow as much, inflation starts to slow.

Unfortunately, this reduced spending leads to a slowing in the overall economy as well. This will lead to businesses laying off workers they recently hired. To avoid losing their jobs altogether, some workers are forced to accept lower pay and fewer hours. Remember, employees are also consumers, so when employees are laid off and their wages are cut, they have less money to spend, and repaying their existing debts becomes more difficult.

At this point, we see another snowball effect: decreased business profits lead to decreased employee wages, leading to decreased spending, leading to even lower business profits.

We refer to this as economic contraction. Unemployment increases, consumers default on their mortgage and credit card payments,

bankruptcies increase, and businesses are forced to downsize, or worse, close down. Depending on how severe the downturn is, the result may be a recession—and in some cases, even a depression, which is a long-lasting economic spiral.

Eventually, the government steps in again.

This time, the Fed decreases interest rates to encourage consumers to stop saving, help businesses borrow more and cheaper money, and stimulate consumer spending. But, speeding up the economy is more difficult than slowing it down. And while raising interest rates is enough to slow economic growth and curb inflation, lowering interest rates isn't always enough to get things moving again, especially during a really bad recessionary period.

Luckily, as we mentioned earlier, the Fed has one other option they can use to manipulate the economy—they control the money supply. It's during a severe economic downturn that the Fed can use their control over the amount of money flowing through the economy to spur additional growth and get things moving again. Specifically, the Fed can "print money," increasing the amount of capital flowing through the economy and providing the funds businesses and average consumers need to keep spending and helping the recovery.

This emergency printing of money is often referred to as Quantitative Easing (or QE). Technically speaking, the Fed doesn't actually print new currency—the term "printing money" is more conceptual than literal. Instead, the Fed gives money in the form of electronic currency credits to some of the largest banks in the country—the banks can then use this new money to loan to businesses and consumers, spreading that money throughout the economy and (hopefully) spurring economic growth.

Now, the Fed doesn't give this money for free. It actually trades these currency credits for real assets, like government bonds. The goal is that once the economy gets back on track, the Fed will reverse the trade, giving the banks back their government bonds and then removing the newly created currency from the money supply. This is important because having too much money in the money supply means that people have way too much money to spend, which can lead to inflation.

This is why we often talk QE being risky to the economy—the extra money spurs growth, but if the Fed isn't careful, it can lead to inflation, which hurts consumers. But, it's sometimes a risk the Fed is willing to take to get Americans borrowing and spending again, and get the

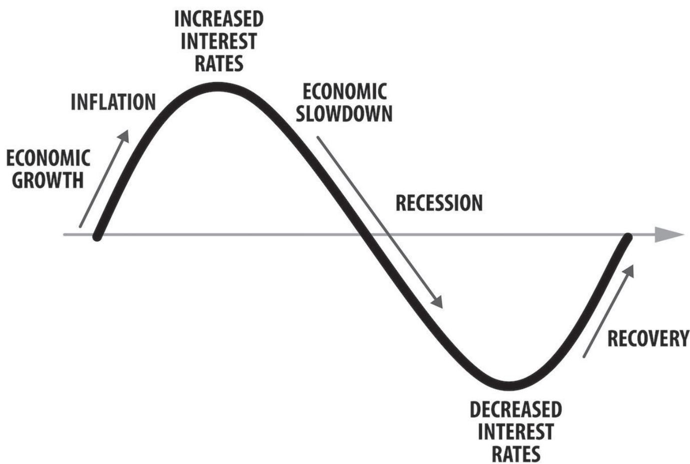
economy back on track.

Assuming this lowering of interest rates and printing of money works, borrowing and spending will increase, the economy will begin to grow, and the cycle begins again.

As you can see, while our economy is an extraordinarily complex ecosystem, the most common economic cycles we see are due to a relatively simple pattern:

- A strong economy leads to inflation;
- Inflation leads to the government raising interest rates;
- Increased interest rates slow the economy, leading to recession;
- A recession leads the government to lower interest rates.

In visual form, a typical business cycle might look like this:



Negative Interest Rates

Given recent events leading up to the writing of the latest edition of this book, I'd be remiss by ignoring the economic elephant in the room—potential negative interest rates.

Like I mentioned in the preface of this book, economics isn't an exact science and those in charge of the economy don't always follow the same rules. This was especially evident during 2019 with respect to interest rates. We discussed in the previous section that interest rates typically rise throughout the strong part of the economic cycle, and the Fed will start to lower rates once we're squarely in the middle of the downturn.

But, starting in the summer of 2019, the Fed changed course and started to lower interest rates during a time of seeming economic prosperity.

It's still unclear whether the Fed was seeing indications of trouble ahead or whether they simply wanted to try to encourage the continuation of the strong economic run that we had seen for the past 8 years, but they started to reduce rates very quickly between July 2019 and January 2020.

At the very start of the COVID-19 crisis in the United States, in March 2020, the Fed recognized the economic challenge posed by the virus, and made one final, large drop in interest rates—locking rates in at near zero percent. As of this writing, we haven't officially entered a recession, but with rates at zero percent, this leaves us in a precarious situation.

During a typical downturn, the Fed needs to reduce interest rates by about 5 percent in order to achieve the necessary growth to pull the nation out of the economic funk. But, with rates at zero, assuming a recession is upcoming, there is no way to reduce rates without going into negative interest rate territory. And, for the most part, this is uncharted territory.

Let's look at the how negative interest rates work, in theory:

Remember, when you borrow money, you pay back the amount you borrow plus a little more. That "little more" is based on the interest rate—the lower the rate, the less the "little more" is that you need to pay back. When the interest rate is zero, that "little more" is zero. In other words, you pay back $1 for every $1 you borrow—no interest!

But, with negative interest rates, not only does the borrower not have to pay back the "little more," but the borrower actually pays back less than what they borrowed (ignoring fees and such). For example, if I borrow $100 at a negative interest rate, I may only have to pay back the lender $98 or $99 instead of the full $100!

You might be asking, why would a lender loan money in a situation where they aren't even going to get the full amount back? The answer is that the lender may not have a better option. If they put that money in the bank, and the bank is paying negative interest, that means that the bank isn't going to return the full amount of the deposit. That's right—instead of paying interest on your savings, negative rates mean you're paying the bank to hold your money.

So, a lender may be happier loaning money at negative .5 percent than putting that money in a bank account or bonds earning negative .75 percent. They lose less money that way.

So far, that doesn't sound too bad. Negative rates help us as investors