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NAREIA NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT ADVISORS

PRESIDENT'S MESSAGE

Can you Invest your 401(k) Plan Directly in Real Estate?

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It's likely your 401(k) plan (or 403(b) or 457 Plan for that matter) is managed by one of the following companies: Ameriprise Financial, Credit Suisse Securities, Deutsche Bank, Edward Jones, Graystone Consulting, J.P. Morgan, Merrill Lynch, Morgan Stanley, Oppenheimer & Co., Raymond James, RBC Wealth Management, UBS Financial Services, or Wells Fargo Advisors. These companies and their financial advisors control most of the retirement wealth in the United States.

Can you invest directly in real estate with your current plan? Ask your financial advisor. They will probably say you cannot, but they will offer to invest your funds in a number of Real Estate Investment Trusts (REITs). The name is misleading. REITs are not an investment in real estate; they are an investment in a fund that obtains its cash flow from real estate. These differ from a direct investment in real estate.

REITs do not typically leverage an investment, which is one of the most powerful forces for creating long-term wealth. Even with an investment in a REIT, your retirement portfolio is likely 70 percent or more invested in various mutual funds, all of which experience stock market volatility. That's neither diversification nor smart asset allocation investing. The Internal Revenue Service will let you invest directly in real estate, but your plan administrator will not. Why? Because they're not set up to handle the administration nor do they earn a commission by recommending direct investment in real estate.

Let me give you an example: Say you have only one asset, $200,000 cash and no liabilities. You decide to invest $100,000 in mutual funds and $100,000 in direct real estate investments, both of which are appreciating at 6 percent per year. The only difference is that you can borrow additional money from a bank to buy more real estate. You obtain a 20-year amortizing loan at 5 percent. To be conservative, you borrow only $300,000, so you have a 75 percent loan-to-value ratio. After 20 years, your mutual fund investment has increased to $320,714, while your real estate investment has increased to $1,282,854, an increase of $962,140 over the mutual fund investment. That's a 300 percent increase in value with the same $100,000. That's the power of real estate.

What about the payment of the debt over the 20-year holding period? The mortgage has been paid off by your tenant who operates his business on your property. You get the tax benefits of depreciation and interest write offs, if you've invested personally. If you've invested your money through a Self-Directed 401(k) that money is growing tax-deferred or tax-free, depending on whether you have a Traditional or Roth account.

You think this is unrealistic? The only unrealistic expectation is to think that your mutual fund accounts have appreciated at 6 percent. According to Dalbar, Inc., the average mutual fund investment has gone up on average of 3.27 percent over a 20-year period. The National Association of Realtors, on the other hand, reported that real estate has appreciated in value an average of 6 percent over the past 30 years, even with the downturn in the economy that occurred in 2008.

If most financial advisors preclude you from investing directly in real estate, how do you invest in real estate with your 401(k) account? The answer is, you don't with your company 401(k) account. The only money you should be investing in your company 401(k) account is enough to get the full matching funds. For instance, if you are making $100,000 a year and your company offers a 4 percent match, you invest $4,000 in your company 401(k) to get the 4 percent match. They do a 100 percent match up to 4 percent of your income. Then you create a Solo or Individual 401(k) account with an administrator/custodian that handles Self-Directed Accounts and invest the rest of your retirement funds in that account up to the $51,000 contribution limit if you're under 50 or $56,500 if you are 50 or older.

So, if you contributed $4,000 to your company 401(k) and your employer matched it with another $4,000, you can contribute $43,000 to a Self-Directed Solo 401(k) account. If you're 50 or older, it would be $48,500. That amount can be invested each year for you and your spouse, if you have it set up properly. No income limits exist.

Eligibility for a Solo 401(k) account requires two things: (1) the presence of a self-employment activity; and (2) the absence of full-time employees. So you set up a consulting business either as an S-Corporation or limited liability company (LLC) and pay yourself a salary, 100 percent of which can be contributed to your retirement fund. Then you invest in commercial, income-producing real estate investments.

If you have questions, send me an email at kholman@overlandcorp.com. I'll help you get it set up and introduce you to real estate investments that are earning 7 to 8 percent cash-on-cash returns with Fortune 500 companies as tenants. I have many clients who have done it. It's a no-brainer.