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Portfolio Watch

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Fee FO Only

The Importance of Cap Rate

The financial world has all kinds of funny terms that are designed to make sure normal people don't know what we're talking about. Cap Rate is a good example. To a normal person, the "Cap Rate" is what Make America Great Again hats are going for on eBay (about $0.75 I'm guessing). But not when you're talking to a financial person. Fortunately, most people don't talk to a financial person unless they absolutely have to, like when you want to know what those weird buttons do on your calculator. It turns out that the Cap Rate is not just a term designed to confuse people (although that's part of it). It's actually a useful thing to understand.

Simple Definition

Cap Rate usually applies to real estate, but it can apply to any kind of business that produces income. Let's say you buy a house in Modesto for $100,000 because you believe that's where the next housing boom is going to happen. You rent it out to a very nice marijuana farmer for $10,000 per year ($833.33/mo). Wow, this thing is producing a 10% return! Well, not quite. You need to pay property taxes and electricity bills, hire a landscaper (maybe not in Modesto), replace broken windows, etc. There are expenses involved and when you add them all up, they average about $4000/year. So really, your $100,000 investment is producing $6000 that you get to keep…what we call Net Operating Income. The return on your investment based on this net income is 6% and THAT is the Cap Rate. It's like a bond yield, but if we called it "yield" it would be less confusing, so we call it Cap Rate.

Using the Cap Rate

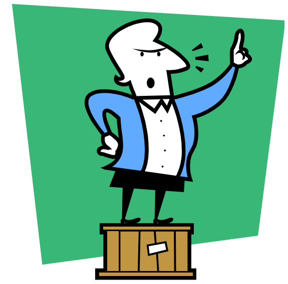
Cap Rates tend to be the same for similar types of real estate in the same area. For instance, office buildings in Modesto will all have about the same

Cap Rate. But how could this be? If you buy a rental property and fix it up so it produces more income, won't the Cap Rate go up? Not likely. By increasing the income, the current value of the property will likely go up so that the Cap Rate stays the same. Office buildings in Modesto have a Cap Rate of about 5%...period (I'm guessing, by the way). In general, increasing the cash flow changes the value of the property, not the Cap Rate. That's a good thing because you receive more income AND the value of the property increases.

Cap Rates change over time depending on whether a certain type of income property is popular or not. If people are willing to pay a higher price for a given cash flow, the Cap Rate goes down. So ideally, you would want to buy an income property when the Cap Rate is high (and prices are low), and then sell when the Cap Rate drops due to higher prices. Easy.

Problem With Cap Rates

Right now investment income is very hard to find, so Cap Rates on almost everything are very low. In other words, most businesses that produce income are expensive. An office building with long-term leases may produce a steady income, but for the investment value to grow the Cap Rate must drop. That's difficult to do when the Cap Rate is already low. By contrast, an older apartment building can be fixed up so that rents can be raised. In this case, the higher income will also drive up the value of the property, so you get growth even with Cap Rates staying the same. Renewable Energy is another area where Cap Rates are attractive, but in general, decent Cap Rates are very rare right now.



Market Comments

I'm not sure what the market is waiting for, but it's not doing much. Stocks keep breaking historical records for the lack of volatility. At these levels there's not a lot driving stocks higher, but investors don't want to sell either. So the market just kind of lays around like an unemployed teenager waiting for…something.

Since the market hasn't done much, my comments from last month still hold. The Price/Earnings Ratio of the S&P 500 is currently 25.79. The higher the number, the more "expensive" stocks are. The long-term average P/E Ratio is 15.66, so the collection of stocks in the S&P 500 is currently 65% more expensive than the long-term average. There aren't many people arguing that stocks are still cheap, but as I mentioned last month, they exist. The only way for stocks to be "cheap" right now is if you believe that widespread company earnings are about to grow significantly AND the expectation of earnings growth isn't already priced in. The market has gone up significantly since the presidential election in anticipation of tax cuts and reduced regulation even though earnings haven't risen significantly, so that would seem to indicate that the expectation of earnings growth has already driven the market up. In any case, it's an undisputed historical fact that if you started investing when the average P/E Ratio was above 20, the long-term average return has never been good. This is why I made the largest purchase of structured notes last month that I've ever done. Barring a complete market crash, the notes locked in about an 8% annual return for the next 6 years, and I don't think stock gains are going to come close to that.