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The Real Woes Of Investing In Realty

A higher reliance on real estate as financial planning tool can turn out to be a liability in your sunset days

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A TYPICAL salaried person spends her entire working life, building nest egg for herself and her dependents. We put money in bank FDs, buy post office schemes, invest in mutual funds, subscribe to multiple insurance schemes and invest our life-long savings in real estate. We do all this to make sure that our dependents are not forced to cut their lifestyle after our retirement.

In real life, however, things do not always work to be as planned. Quite often, when the monthly salary cheques stop arriving, we realise that the financial planning falls short of the target forcing painful adjustments for retirees. It gets even nastier if you suddenly have to meet large unexpected expenses such as medical emergency in the family. And we have seen this happening in families where prime breadwinner has retired from a cushy government job and receives generous pensions.

So what can lead to such a situation given that Indians are one of the biggest savers in the world? A typical urban household saves nearly a quarter of his/her recurring income on a regular basis. If planned diligently, this savings would grow into a large pool at the end of your working days.

So what can go wrong? Among the common causes of such a mishap is over investment in a particular assets either because we fall in love with it or due to lack of opportunity. Former is particularly severe in the case of traditional favourites such as real estate and life insurance policies. Real estate assets, especially a residential property, have a special lure in urban India given the housing shortage in the country and the fact that relative to income, real estate prices in India are one of the highest in the world.

Not surprisingly, for those who can afford, house is typically their biggest investment and one that can eat up bulk of their life-long disposable income. But the lure of a house doesn't stop at a roof over your head. It has now transformed into one of the most popular asset classes for upwardly-mobile urban India. And surprisingly, real estate investment doesn't seem to carry any of negative attributes associated other assets such as equities (risky and unfaithful) and banks and post-office deposits (poor real returns). The scramble to secure a pie of the lucrative real estate market has turned into frenzy ever since the government announced a tax-break on housing loans opening floodgates to the private sector investment in real estate projects. It's not uncommon to find individuals owning three or even four residential properties.

But this over reliance on real estate as financial planning tool can turn out to be a liability in old age. Consider this, post retirement, an individual needs an income stream that is regular, fairly predictable, can rise with the increase in inflation and most importantly easy to administer. For all, its advertised virtues, real estate fails on the most of the above criteria. As mentioned above, a house is most often the largest investment for any individual, but it is seldom the biggest source of income/cash flows for a retiree. This is because post-tax yields (i.e. rents adjusted for municipal taxes, income tax on rental income and maintenance costs) are pitifully low in India. For instance, in Mumbai, yields in most localities range from 2-3%, and this doesn't take into account the effort involved in extracting even this nominal amount. Find a "nice and trustworthy" tenant, prepare a lease deed, get it registered and renew the agreement every 11 months and every few years find a new tenant.

Proponents of real estate investment, however, push it as a capital appreciation tool. This requires one to sell the property at the opportune time. This is, however, easier said than done. Even in a market as liquid as Mumbai, it may take months to find a right buyer at the right price. And even longer for the cash to land in your pocket. And this involves a fair amount of footwork and not to talk of the documentation involved. If a real estate transaction is so complex and time-consuming in Mumbai, you can imagine the situation in other parts of the country. Young people or those in the working age group can still hope to do the necessary running around. But the same cannot be said about retirees. They need an asset that is no-nonsense and has almost zero transaction cost and can be liquated in the shortest possible time.

But what if you need cash quickly and an amount that is much less than the market value of the property? Not surprisingly, even for people with large real estate portfolio, it is hardly ever the prime source of cash-flow. This is fine as long as you are working, but post retirement, it could prove fatal. Recently, I came across an old couple, who own six properties between themselves and their son, but can't afford a medical surgery and the post-surgery expenses, despite the fact that one of them earns a decent pension. They are now caught in a bind — they can't rent their vacant houses for fear of losing its control; but neither are they able to sell it despite their best efforts.

Instead, if they had invested in fewer properties and had diversified portfolio, including equities, bank FDs, post-office deposits coupled with a medical insurance, their old age would have been much happier. The lesson is clear: the life is uncertain, so spreads your bets and never fall in love with an asset just because it is in circulation.

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