How to Profit From a Cooling Real Estate Market

All over the U.S. there are stories of a rise in real estate foreclosures. Many people who took those exotic mortgages -- borrowing 125% of home value or choosing adjustable-rate mortgages -- are struggling to make their payments, and some aren't making it.

Also, a glut of new property supply, especially condominiums, is coming on line. A friend of mine, a very seasoned real estate investor, says in San Diego County, once one of the hottest real estate markets in the country, thousands of new condominiums are getting ready to come to market -- just as the market softens. He estimates that over 12,000 new units are coming on line, and the market, at the best of times, can only absorb about 1,000 condominiums a year. If he's correct, that means 12 years of supply will be ready for market in the next year.

As interest rates rise and the number of eager new buyers begins to diminish, adding supply to an already bad real estate market for sellers may mean a very good market for buyers and for property investors.

Hungry Alligators

The people who are in the most trouble are flippers -- people who aim to buy low and sell high within a short space of time. Many were buying condominiums off the plans, which means the projects were yet to be built, in the hopes that when the homes were completed, they would sell for a tidy profit. The trouble is many of these flippers, lured into the market by stories of people making a huge killing earlier with a similar strategy, are now the ones to be slaughtered. Now, they either lose their deposit or have to cough up the money for the purchase in the hopes there's a greater fool than they were somewhere out there real estate.

If you recall, the same thing happened around the year 2000 as amateurs jumped into the stock market, buying up tech stocks or any IPO with a dot-com after the company name.

In the coming months, I predict we'll see an increase in people dumping real estate they can't afford. They'll be forced to sell because they'll be eaten alive by a phenomenon known as negative cash flow. Investment properties that you have to feed money to every month are fondly known as alligators -- if you can't afford to feed the property every month, it eats you.

I know of one so-called real estate investor (and I prefer to call people like him speculators rather than investors) who has three homes he thought he could flip for a profit -- but he priced them too high. Now, $7,500 comes out of his pocket every month to feed the negative-cash-flow alligators. The problem is, he and his wife don't earn that much a month. Their three alligators are literally eating them out of house and home, consuming the profits they made from other flips -- and their savings.

To add more pain to the misery, they still have to pay the capital-gain taxes they made from their previous successful flips. They're toast. The alligators are eating them alive. They can't afford to feed them, and they can't afford to sell them because the prices they paid for these alligators are more than they're worth today. And this is only one story -- out of who knows how many. Over the next couple of years, keep your eyes open for some great bargains.

It's Time for the Pros

Some people say we're now entering a bad real estate market. I disagree. I think we're entering a great market. A bad one is when amateur investors become real estate experts and they bid up prices. They make housing expensive for homeowners, often adding little to no value to the property. They simply muddy the waters and make a valuable investment, a home, expensive.

Now, I must admit, I sometimes do buy to flip, so I can't be too critical. Yet it's the amateurs who come late to the party -- and who eventually donate their money back to the professionals. What I'm saying is: Now is the time to turn pro. Now is not the time to be an amateur. It's the amateurs who jump in when the market is hot. It's the professional who comes in when it's cooling down. Get the message?

When the red-hot bull market of real estate was beginning to overheat, you didn't have time to make considered decisions. Sellers were receiving multiple, over-asking-price offers. In a bull market, you had to be quick, have money, and be a little foolish. Now that the market is cooling down, sellers are a little bit more humble. You have more time and can do your due diligence carefully. You can negotiate better terms and make a better deal, especially if the seller has his leg inside an alligator's jaws.

Bad News That's Good

But don't be in too much of a hurry. I think we still have some bad news yet to come -- and I believe it may come from the bond market. I suspect that many of our foreign investors who have been buying our debt may be becoming more cautious about investing in American assets, especially U.S. bonds. Many foreign bankers may be having doubts about the U.S. government paying the interest on our debt. In other words, many investors will be moving increasingly out of their cash into tangible assets such as gold, silver, and other metals. Again, this is only a suspicion. We should know more by September of this year.

If investors stop buying U.S. government debt, who knows what might happen? The U.S. may need to raise interest rates even higher, which will drive home values down even further. So be patient, keep looking at real estate, but keep your hand on your wallet (unless of course you find a seller with a really mean alligator eating him alive).

A year ago, I sent out a warning to investors, especially flippers, to cash out quickly. I received a lot of irate e-mails from people who thought I was turning on them. They thought I was spreading bad news. Little did they know that by forecasting a real estate downturn, I was spreading good news -- good news for real investors and bad news for amateur alligator wrestlers.

Credit – Robert Kiyosaki

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