Ep #132: Spectator or Speculator? Positioning Your Investment Strategies in a Volatile Economy with Dave Stech

Full Episode Transcript

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David Phelps

Dentist Freedom Blueprint with David Phelps

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Dave: One thing you don't want to do is take a risk at putting your money into something you don't know at the wrong time in the market. And I don't understand anything other than real estate, so I'll stay in real estate.

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David: Good day everyone. This is Dr. David Phelps of the Dentist Freedom Blueprint Podcast and Freedom Founders Mastermind. Back to you today with another what's going to be I think a really interesting podcast interview with a person who's become a really good friend of mine. I'm in a mastermind with him, I heard him speak on a number of occasions, and somebody I have a great deal of respect for in the real estate and the economic market cycles. That person is my friend Dave Stech. Dave, how are you doing, sir?

Dave: I'm great Dave, how about you?

David: Doing very well, thank you. Great to have you on today. I want to give people a little bit of your background, so let's kind of start there a little bit. You grew up with a family that didn't have a lot of means. You want just give a little of that background and then talk about briefly your rise through school and where you are today with Purpose Built Investments?

Dave: Sure. Yeah, I started in a trailer park. We were in the bottom 1% socio-economically and after my dad fell off a bridge as an iron worker, for the next 22 months, I had mayonnaise sandwiches every day and that's all we could afford. And we had two per day, couldn't afford three per day. And that eventually drove me to get out. I first went to college, undergrad to Purdue, and then later went to the London School of Economics for grad school. I was in corporate America for too many years, I guess is the best way to put it. The good news is I was with Kodak and Disney and launched the first disposable camera for Kodak, the first digital postcard for Disney. The bad news is I couldn't get rich doing that.

So I ended up leaving and I founded three different technology companies. And fortunately, I was in the right place at the right time, and each one of them got taken out in a good way, either through the sale or otherwise acquisition of the companies. And then I decided to get into real estate, and I'd really only been in it for 15 years and really taking advantage of it lastly during this last real estate cycle. And now, over the course of the last seven years, we've done over 5,000 deals. Some of them have been vacation rentals, some of them have been flips, a number of them have been buy and holds. But by far the largest percentage had been private loans. So we've been a private lender for most of that last seven years and we've done over 5,000 deals. So, it's been a great run and fortunately the market handed it all over to us and we took advantage of it.

David: Well, yeah. The market handed it to you, Dave, but you're also ... With your background in economics and also I know that you are very data driven, that's one of the things that you bring to the mastermind group, it's something you bring to conferences or to your investors is the fact that not only do you know how to look at data and to analyze it, but you have access to it. And access to good data is not something that rank and file people have. It's not something you just go on the internet, and you look at things. You actually purchase access to big data, and that's part and parcel because you're partnered with one of the largest lenders in the country. So you have access to that and you analyze it and you've been able to really foresee to a great extent the market cycles.

As you said, 15 years ago, you got started in real estate. So I guess that was right after 9/11, maybe the year or so after, and you rode that cycle up. We had the great recession in 2008, '09, and '10. And you very quickly took advantage of what the market handed you there in working the arbitrage in primarily the Las Vegas market. So talk a little bit about that data, Dave. And is that just come from you background in economics and statistics and something you just always loved to look at. Do you always use data, or do you use it mostly in real estate today?

Dave: Yeah, I only use it for real estate because as you've heard me say, I don't know anything about the stock market or precious metals or ... I don't know about anything other than real estate. And I think I've pretty well got that figured out, but there's things that I learn all the time and that I didn't think I'd realize. But, yes. We spend a lot of money on data, and we spend even more money on people to actually analyze that data and make sense of it. Because it's just bits and bites until you can make it make sense for you. At one point I was trying to raise money for investors, I didn't even think anybody would ever invest in me 'cause what did I know? I mean, I'd flipped a few homes and so on. And I found that research was my competitive advantage.

The only reason I started doing research was because no one else was doing it. You just can't find, I think you said in the rank and file space, the average investor has no clue what's going on in the market. They really don't. They're just followers like everyone else. And in the commercial space, there's a lot of research done by a lot of big companies and a lot of private equity and hedge funds. There's not much done in what I'll call the residential market for every day investors. And so that's what we decided to do, and it ended up becoming our competitive advantage for two reasons. One, we could make better informed decisions. And number two, we could attract investors to our way of thinking.

And so in 2005, that research led me to get out of the market, as you know. I went pretty public with it and everyone that I was an idiot. And then in 2008, I went all in in Las Vegas when everyone else was running out of there because it was the foreclosure capital of the world and then I just took it from there and we bought and held for a three or four year period. We've been lending for several years. We've just really kind of taken what each of the four sort of ... I'll call them four chapters or four stages in the real estate cycle offer. And we figured it out, it's worked out pretty well for us.

David: So Dave, where would you say we are in the four stages right now today?

Dave: Well, it's a good question. I would say that we're in the fourth quarter. I mean, it's my perspective that the market does kind of go through these natural stages in a cycle. And if you look at real estate cycles like a football game where there's four quarters, I think we're in the fourth quarter. We started this game, what I'll call this cycle, in 2008 and 2009 post-crash. And that was what I'm ... I view as the first quarter. And what people forget is that we're 10 years later now.

David: Right.

Dave: I mean, we're 2017 and this thing imploded in 2007. So typically market cycles will run between five and seven years, and we're 10 years into this one. So we're in the fourth quarter. And so I'm doing things different in the fourth quarter than I did in the first, second, and third. And it's probably worth noting that when I got into this in the first quarter, I was confident having done the research on the last three market cycles. I was confident that it was going to come back. But my time horizon was longer than it is now. It was really about a four year time horizon. In fact, when I put together our first fund, it was a three to seven year all things real estate fund. And we're at the end of year seven in that fund right now.

So I went into it with kind of a four or even seven year horizon. Then in 2011 when the market was at or near its bottom, I shrunk my horizon to two years. And then, in 2014, I shrunk to another year. And right now, my horizon is six months with quarterly reviews because I think there's enough going on in the market now that I feel more like I'm a speculator than an investor now because the market's already made its run. And investors get in near the beginning, not near the end. So I don't know if that answers your question, but yeah. I think we're in the fourth quarter and that's kind of how things have evolved for us.

David: Yeah, so Dave, when you say you're doing things differently, and I understand what you mean by your horizon is quite short now because we are in a fourth quarter where you're not going to go long with anything right now, Dave. Six months is your horizon and you're keeping a really close pulse on that. So you've had a great track record and had several funds. What do you do when people want to give you money today? How are you advising them? Or are you taking much money today based on where we are in the market?

Dave: No, I'm actually giving money back. And it pains me to say that, but I'm at the point, for two reasons, where I feel like it's just best to start returning money. Now, it's going to take a while, but I'm basically taking chips off the table and I'm segueing out. I won't be out completely or forever because I'll always want to manage my own money, but I'm just at the point where two things are happening in my life. One, I think that the market has greater risk now than it's had for the last few years for obvious reasons. It's gone up significantly. And I do believe that every year in a market cycle that you stay in, you go from an investor to a speculator. So nearest to the end of a market cycle, you're mostly a speculator, not an investor.

So, I believe that we're in the fourth quarter. That's not to say money can't be made, it's not to say the market's going to crash and it's not to say that you can't find deals. 'Cause everyone can find deals in any market. If you know what you're doing, you can always do that. But there are less. And I'll call them fewer and thinner deals. So it just makes more sense for me to move on professionally. And from a personal standpoint ... You and I talked about this at the last mastermind meeting, I just feel as though every potential for a million dollars now is not as significant to me as it used to be back when I didn't have a million dollars.

And so, I just think it's a good time for me to transition to managing a lot less money. We have eight figures under management. That's a significant amount of money. And, as I told our investors on our call last Thursday night, it's time. It's time. I think this will be my fourth and final retirement.

David: I've heard people say they're going to retire before they come back, but I totally appreciate where you're coming from, Dave. I think you've been ... You're very prudent with your capital investments, not just for yourself, but for your investors. And I think that approach is novel because what I see in the marketplace today, and I think you see the same thing, as the market does rise and people do forget or maybe greed takes over, and a lot of syndicators, promoters, fund managers, people who raise capital ... Well, there's a ton of capital looking for a home today, Dave. Right? I mean, you have them actually actively turn money away, and yet there's a lot of syndicators out there today, they're taking money hand over fist. And they'll find some deal to put it in, but will that be a good deal or not? I think that's ... You said there's always good deals out there, but are there enough good deals for all the money that's chasing deals to find a great deal still today in this market place? That's a tough one, isn't it?

Dave: It's a great point, it's a great point. And I think it underscores the fact that, you already know this, that I'm a contrarian. I'm a complete contrarian. I love doing exactly the opposite of what everyone else is doing because my believe is that that's how I became successful. When I was following the crowd, all I was doing was doing what they did. And it just doesn't make sense to follow the crowd. It only makes sense to blaze your own trail. And by being contrarian, you have much less competition. It's just a wonderful place to be. So you're absolutely right. I think it's very interesting because right now, there's a lot of ... It's sexy to be a real estate investor because of what's happened in the recent past.

Well, that was the same exact feeling that people had in 2004 and 2005. And I don't ... That's not lost on me. And so not just for personal reasons, but for professional reasons, I think this is a great, great time to take the chips of the table. In fact, if you thought of this as an 80/20 rule, at the beginning of a market cycle, there's 80% upside and 20% downside. And I think it's the reverse now. I think there's 20% upside. Sure, the market can go up and it will a little bit. But if you look at what's going on right now in terms of why the market's going up, specifically why prices are going up, it's primarily driven by increased demand.

So, if you look at it it’s the lowest point that it's been since 2005. And that's what's driving multiple offers, and that's what's driving higher prices. It's not really demand. And you have to ask yourself, well, what's going to happen then? Well, what if prices keep going up? And what if interest rate goes up?

David: Right.

Dave: If interest rates go up and price goes up, those two things are three of the things that contribute to the affordability index. And the only other one is income, which rarely changes much. So I believe that if interest rates go up a little bit and if price continues to go up, there has to be a point at which affordability is impacted. And during the last three market cycles in California when affordability hit 17%, the market tanked, and I think it can again. So, anyway ... That's my two cents.

David: Yeah, no. Good, good points, Dave. Really good points. And when you talk about affordability, wage prices have not really been keeping up very much with overall inflationary price points real estate, have they? I mean, pretty much what I've seen, wages are staying pretty stagnant for the most part.

Dave: Yeah. Yeah, the most you can anticipate out of income change is one to three percent per year. Whereas we obviously know that real estate can increase double digits per year. And when you think of an interest rate, think of the difference between four percent and five percent. That's one percent which is 25% than four percent. So it doesn't take an awful lot for the combination of interest rates and price hikes to significantly impact affordability. And I think that's probably the greatest risk to an investor in today's economic client, is the potential for an affordability for the market.

David: And can the affordability issue, can that, in your opinion, trigger another steep decline like we saw back in 2008? I mean, is there an opportunity for that trigger to occur and all of a sudden things decline. I know the under-riding is different than it was back in pre-2008, but what do you see is the trigger if there is one out there? Is that what it is?

Dave: Yeah, I think ... I believe it's the combination of price and interest rate that's going to trigger a turn in the real estate market. Is it going to go down like it did the last time? No, because to your point, the under riding is different. And the financing that was in place at that time was ludicrous. But I do think, oddly enough, that banks are going to start loosening their credit criteria because as demand slows, they're going to have to try to figure out a way to fill the coffers. And it'll be by loosening their credit standards. And when that happens, then ... It's not a good thing, but it won't be nearly as significant as it was last time.

I expect interest rates ... Or I should say appreciation to slow, and it has to. I mean, we look at some markets, San Francisco. Prices in San Francisco today are 50% higher than they were at the peak in 2007. New York City, prices are higher than they were at the peak. Miami. Those markets don't allow for any additional uplift, in my opinion. Will they? Probably. But they don't deserve to. Because if you look at the affordability index in San Francisco, it's

10% or less now. That means that one out of every 10 people mathematically can afford a home, and yet, people keep buying. So, it can't continue to go up forever. But for most of the markets, it'll just kind of slow in terms of appreciation and plateau. And that's not why I'm in this market, it's not why I'm in real estate. I want to take full advantage of volatility. It's why, as you know, I invest in the four most volatile states and the other 46 I don't invest in.

David: Got it, right.

Dave: So I think the volatility is behind us now, and it doesn't of- ... Volatility equals opportunity to my way of thinking, and it's been a great run for the last decade.

David: Dave, when you talk about taking chips off the table, obviously you're talking about harvesting profits, capital gain, equity that you've maybe taken on this rise in the last eight years or so. So you take the chips off the table, where does one put them? I don't know. Do you want to talk about what you personally do, Dave? Or what would you tell ... Let's call an average investor, let's say a business owner who has a quarter of a million to a million dollars and they can harvest that equity. Where would they put those chips today if they want to still stay invested in real estate? Or would you stay out of real estate? Would you stay in cash for a while? What would you do?

Dave: Yeah, there's two answers to that question. The first is a significant amount of my money will be in cash. And it pains me to think that it won't be making the kind of money that I'd like, but it won't be losing any money. Yeah, sure, there's inflation, but it's not going to take a hit like it could if it were invested in the wrong vehicle. And number two, I'm going to be figuring that out. I honestly don't know exactly where I'll end up, but I've been redeploying my capital right now into other investment vehicles. I really can't mention them, but they are there.

David: Okay.

Dave: I'm also looking at something, which is I think, the next big play. And I don't know enough right now to believe and share with you in confidence that it is. But I ... Everything I've seen so far in our initial research is leading me to feel pretty good about it. We'll see, but to answer your question, A, I'm going to have a significant amount in cash. B, I'm going to put some money to work with people who I know will treat my money better than their own because that's the approach I've always taken with our investors and it's why they've never lost a penny in a deal. I just want to make sure I can find somebody who, A, knows as much as I know about their space as I do about real estate. And B, that they'd rather lose their own money than money than mine.

And those people are hard to find. And so if I don't find them, I'll stay in cash, or continue to invest my own money in private lending, 'cause there will always be deals out there that I can find at the right price. There will always be opportunities. It's just not worth chasing deals now, and I feel like the pendulum has swung from the days in 2008 when my buyer would be at the auction at the courthouse steps and there was no one else there to buy other than us. We were our own competition. To now, you go to an auction and there's more people there than is in the rest of the city, I think.

So, when the pendulum swings, you know it's time to move on. And so, I don't have a complete answer for that other than to say that the one thing you don't want to do is take a risk at putting your money into something you don't know at the wrong time in the market. And I don't understand anything other than real estate, so I'll stay in real estate. And I honestly don't really feel comfortable with anyone else in the market investing my money except for me. So I'm going to be happy to just have a lot of cash.

David: Yeah, it makes sense. One thing, Dave, that I know we both appreciate, and you've really alluded to that already, is the people you know. You talk about the power of six, the fact that doing anything in life, living your personal life is not fun solo. Being in business totally solo, not necessarily in partnerships, but finding other people either through which you can invest money. You've done a great job of that. I mean, you handle money for your investors, you have handled that, you've managed for investors. But by managing it, you've invested through other people that ... In real estate, primarily, that you'd have vetted. So from that standpoint, how high a degree of importance do you put on the people you know? You said you're the best person you know to manage your own money, and I agree, but when you talk about managing your own money, still Dave, that means at some point you're going to manage your money through other opportunities, through other people typically, right? Or from some aspect of other people, correct?

Dave: Absolutely. And you and I talked about this before, but I'll answer it the way I do when people ask, what's most important when you're loaning money? So, there are three things that I'm focused on when I'm loaning money. The borrower, the deal, and the market. And people always ask, well, what's the most important of those? And the answer is the borrower. It's ... Because a great borrower will always find a way to get out of a bad deal. And I'll be there with them to support them. So the borrower is critical because I've had people go dark who borrowed money, and it's not good. And so, at the end of the day, it's the borrower number one.

Number two, it's the market. The market has forgiven an awful lot of borrowers these days. You think about all the people who are flipping homes who go long because they ... The rehab takes longer. They run over budget. It doesn't sell for what they thought, and it's on the market too long. All those things kill deals, but if you're in the right market and it's going up one to two percent a month, it forgives you. Well, unfortunately, that forgiveness is coming to an end as appreciation is softening.

And then the third thing is the deal. So back to your question. I'm looking for fewer, better markets. Fewer, better borrowers, and fewer, better deals. That has been my focus on how to mitigate risk, eliminate it where I can, and ensure that my investors and I don't lose money. And we had one loss in 5,000 deals, so I think it works. It goes better with fewer, better people. Just does. It's much more important than cash, it's more important than access to credit, it's more important than your education. It's basically sourcing money and opportunities through fewer, better people.

David: Yeah, you knew exactly where I was going with that. One of my questions was going to be and you ... And I don't want people to miss this point because I think what you just said is golden. I think people should go back and listen to it again about mitigating risk. One of my questions to you was going to be, Dave, if I had four assets and I said, "Pick the one that's most important to you." One asset would be cash on hand, so you have liquidity. Or access to credit or capital, or relationship capital, people that you know. Or higher degree and education. And you just answered the question. You said, by far it would be the people you know.

Dave: Yeah. And I'll even expand on that given where we are in today's market. Cash on hand, well that's always valuable, but it's mostly valuable when you want to prepare to capitalize on a market. If we're in the fourth quarter of a real estate cycle, how much opportunity is there to capitalize? I don't think as much as there was if you had cash seven or eight years ago. Credit or capital, same answer. You said higher education or a degree or specialization. My perspective is this, 50% of people that go to college change their major at least once, at 80% of us 10 years after we graduate are in a work discipline completely unrelated to our major. So how much did that help? Honestly, people think I really am great at economics and research or whatever. I use very, very little of what I learned at arguably the best economic school in the world. I just don't use it. I don't focus as much on the economy and the economics as I do my economy.

David: Right.

Dave: And that's really where I've been able to, I think, realize that it's more important for me if I just focus on the economy, it's going to be pretty good. Think about it. I mean, you've got ... Or my economy, rather. If you think about the four general economic indicators, you've got GDP, consumption, unemployment, job growth. If you look at that, 2016 was the slowest GDP growth in five years. Unemployment is at an eight year low, so that's good news. Consumers are more confident, so that's good. The CPI is at two point five and climbing, so that's not good. So you've got pluses and minuses there. But how is that impacted my economy? It hasn't impacted it at all. My family's economy, my economy, my mastermind member's economy, my friend's economy, that's really what I focus on. So I care about the economy only to the extent that I can capitalize on it by taking what the market gives me. And it's been a great run, but maybe it's at the end.

David: That's really, really sage advice, Dave. Focusing on your personal economy versus the general economy, and I think so many people try to out guess the general economy when they could be working on their own. So I really appreciate those words of wisdom. Last question for you, and one I could have put anywhere in this segment with you, but obviously you have focused on single family residential. And there's a reason for that, and we know that there's many different asset classes in real estate and money can be made in all of those. Why single family for you?

Dave: Yeah, it's a great question. There are pros and cons to each, but for me, residential ... At least the pros of residential real estate investing outweigh commercial. I guess I'll rattle them off as I think of them. First, I understand residential. We all do. I mean, homes are a consumer product. So we really do understand it. But ironically, as I said earlier, there's little research in residential real estate or investors. There's plenty of home owner research, but when we realized that we could do research in residential and distinguish ourself from others and actually be good at it, we found that we had no competition. So that helped.

We all live in homes. You've heard this before. And we need a place to live, but what people don't always say is that there's always a buyer or a renter for residential, even in downturns. You just have to find them and place yourself right. But if you look at commercial, instead of renting to people, they rent to businesses. And oh, by the way, 90% of them fail.

David: Right.

Dave: Maybe I don't want to necessarily have tenants who have a high likelihood of failure. Here's another thought, if I won a ten-plex, I have one perspective buyer, an investor. There's no home owner that can buy a ten-plex, so I have to find one investor to sell all 10 units to her at once. By contrast, if I own 10 homes, I have at least 20 prospective buyers. 10 home owners and 10 investors. So I like having 20 times more prospects when I sell something than somebody else has. It's like have 1000% more prospects or even 2000% prospects. So with 10 homes, I can literally sell a slice, in other words, one home, rather than have to sell the whole pie. I really like that. I like the fact that the barrier to entry in residential is low. It can be as little as just putting up earnest money on a wholesale deal, whereas commercial requires a lot more money, it's more difficult to get.

And for residential, there's always a hard money lender in town if you really do find a good deal. Because as we both know, great deals find money. Commercial competitors have deeper pockets and more research than you and I do, in a lot of cases they know more than you and I do. So my whole feeling is I like the fact that I can buy things at a discount, and most commercial deals, people are willing to pay retail. Whatever the cap rate is at the time, that's what they pay. And I like to find deals. So we can find 60 or 70, or 80% deals. And I like that. And I think probably the last couple of thoughts I'd have is when you buy a home and you whole sale it or fix it and flip or hold it, you can comfortably ... If you want to, be out in 30 to 180 days.

In commercial, you're typically doing a repositioning, you're trying to refi it, you're trying to hold it, you're eventually selling it. And right now, especially, I like deals that are short time frame because I don't know what the market mood may be for sure next month, but I just think it's going to be worse than it is this month. So, I don't know. I think for the masses, commercial investing is not beginner friendly. And residential is probably the place where I'd recommend anybody new try to get themselves ... At least get their feet wet.

David: I'm 100% with you, Dave. That's really where my bread and butter's been and that's where I advocate, as you said, new investors who want to get started. Single family just has so much more stability, liquidity. As you said, less competition and you have multiple buyers. So financing is always readily available. There's just so many positives there to it, and people want to climb the chain and go into other asset classes once they get their foundation set, then so be it. But I'm with you. I think single family really has more advantages than disadvantages, so ...

Well, Dave Stech, Purpose Built Investments. I want to thank you for being on the podcast. I want to thank you for being a friend and a mentor, not just to me, but to so many people and all the people that you've helped over the years investing their money and providing such rock solid, stable, excellent yields. You've done a world of good, my friend, and I thank you for it and I want to stay connected for many years. So I'll definitely want to follow you and get your sage advice as markets continue to turn as we know they will.

Dave: My pleasure.

David: All right, Dave. Signing off, I'll talk to you soon.

Dave: All right, buddy. Take care.

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