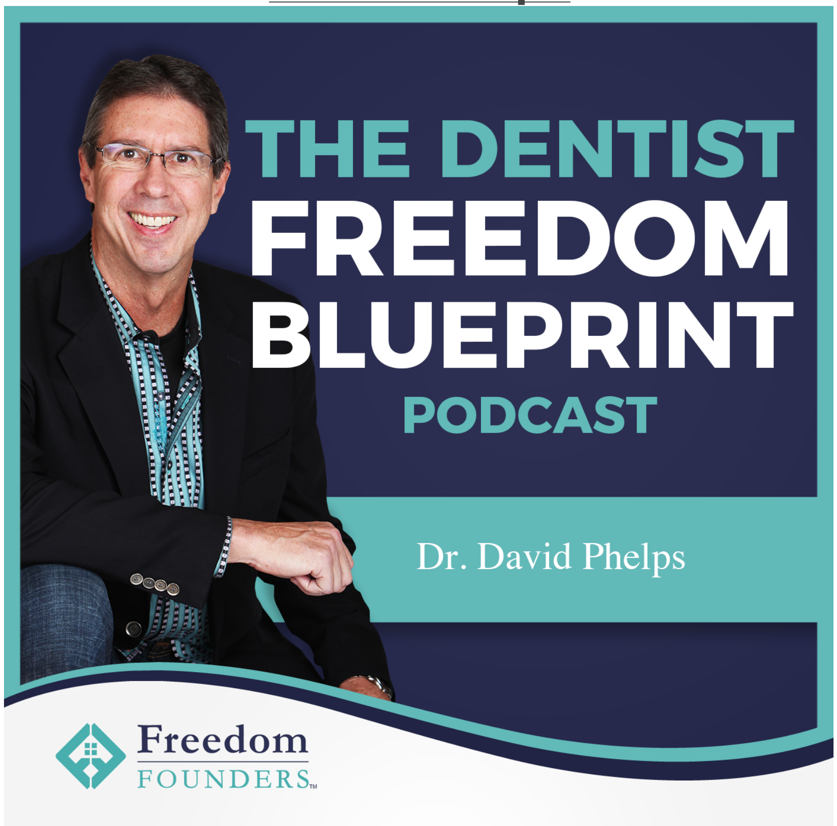
Ep# 157: Cash Flow Investing – Insights from Dr. David Phelps



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Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps and Evan Harris

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You are listening to the *Dentist Freedom Blueprint* podcast, with David Phelps. Navigating you through the uncharted waters of a turbulent economy with straight-forward advice to, transform your practice into a self-sufficient cash machine, compound your net worth assets, and multiply, multiply, multiply your passive cash flow streams.

Alex L.: Welcome to the "Dentist Freedom Blueprint" podcast. I'm Alex Lerma joining our host Dr. David Phelps, career dentist, pioneer of alternative investment strategies for practice professionals, and the founder of the Freedom Founders Mastermind community. Dr. Phelps, thank you for the opportunity to join you on the show today.

Dr. David P.: Alex, it's always fun to talk to you, and entering in to some of the different topics that we have fun with on this podcast. I know you got something that will be interesting today for our listeners, so why don't you lay it out for us?

Alex L.: Excellent. Today we are going to be discussing the top concerns that investors may have when considering income investing or cash flow investing, particularly through real estate, which is a model that you, notably, advocate.

Recently, a notable investment blog for doctors, called "The White Coat Investor", published a blog post that was of interest to you and, I think, to others who are interested in this topic of cash flow investing.

It was titled "The Pros and Cons of Income Investing". Jim Dahle, the founder of "White Coat Investor", y'all are long time colleagues and he has been a notable advocate for helping doctors, helping his colleagues develop financial acumen. Really, his primary focus is on investing through Wall Street, through more traditional avenues of investing.

You, Dr. Phelps, have taken a bit of a different path. So, y'all don't always see eye to eye. Sometimes y'all explore some different avenues for investing.

We thought it would be fun to walk through this blog post today, and just talk through some of the main points that are made. I'll jump in right at the beginning.

This is called "The Pros and Cons of Income Investing". He writes, "Often I run into people who are somewhat dogmatic about cash flow investing. The typical vehicle of choice is real estate, although occasionally it is high dividend yield stocks. By cash flow, I mean that they simply work at building a portfolio of investments which generate cash flow, and when the cash flow is equal to what they generate from their day job they consider themselves to be financially independent."

Then he rolls through some of the concerns that he has with that. It's a very fair and balanced piece. He notes that he thinks investing in real estate is a great idea, it is a great option to include in his portfolio and talks about how he's a huge fan of entrepreneurship and others.

I thought it would be fun to walk through this piece and hear your thoughts, Dr. Phelps, and your response to some of these concerns.

Dr. David P.: Yeah. Great topic today, Alex. I'll say that Dr. Dahle, he's very astute. I give him a ton of credit for developing the platform "White Coat Investor". He has done a world, and continues to do a world, of good, I believe, in a broad financial sense.

He definitely talks about how to help doctors and busy professionals get what he calls a "fair shake" on Wall street. He definitely dives into a lot of the misinformation propaganda that so many financial advisors or insurance sales people really have taken advantage of busy professionals who just don't have the time and never had the financial acumen.

So, Jim is doing a world of good, and we do have fun. We have fun. We interact. I remember when I first put a blog post on "White Coat Investor", gosh, probably five or six years ago. Of course, it was all focused on real estate. I remember at that time, Jim came back, and again, in a very respectful way, but he definitely pushed back hard in some of the things I brought up, which is fine.

Debate and dialog is good, and I think the point here for our listeners today is, you may feel like you're in one camp or the other and that's great. I love to be open, Alex, to listen to other people's positions, particularly people who I know are astute, and they study hard, because it makes me be more convicted, in some cases, about what I believe in, because I really have to prove my point. Or sometimes, you know what? I actually can be convinced to take another look at something, and that's a good thing, too, for all of us. So thanks for bringing that up today.

I think I'll begin with the way Dr. Dahle ended this blog post. Then we'll jump into the points you were just bringing out. The very end he says, "investors should take the best from both worlds." He says, "to sum up, real estate is a great asset class and investing in it has real advantages due to high returns, low correlation with stocks and bonds, and particularly in retirement, relatively high, reliable," he says, "although not guaranteed, income.

But there's important concepts an index fund investor can learn from a real estate investor, and a real estate investor can learn from an index fund investor. Perhaps the most important one is that the intelligent investor takes the best of both worlds, rather than confining himself to just one." I think that's a really good point.

One of the things I'll say first about real estate investing versus what I call passive investing on Wall Street, Alex, the way Dr. Dahle describes it, is that investing in real estate does take a certain amount of time. It takes some effort to not only to study and understand that arena of finance and so many aspects that go along with real estate, there is effort.

Dr. Dahle talks about your value of time. You do have to consider where the value of your time goes. Should a highly paid professional be out in his neighborhood negotiating rental properties or fix and flips, the stuff you see on TV? I say of course not. Absolutely not.

And that's some times where people get a misconception about real estate. They think, "Okay, well, I've got to do like they do on the TV shows. My wife and I" or "my kids and I" or whatever it will be, "We're going to go out in the marketplace and we're going to find those great deals because my golly if they can do it on TV, we can do it too."

To that extent, it doesn't work. Real estate investing is a very inefficient investment, as opposed to the efficiency you can find on Wall Street. Inefficient means there are many local markets and there's not an efficient positioning on the information, so that creates the inefficiency and the time involved to get involved in real estate, but that also creates some great opportunities.

See, there is a correlative there. Again, for me to say to one person, or to Dr. Dahle, or anybody else who enjoys the practice of medicine or dentistry and say, "You should just come do real estate," that would be wrong for me to say that, because they may really love what they do and their time should be spent there and with their families.

If passing investing in the stock market does it for them and they feel comfortable with that, then by golly, yes, stay there. I have concerns about lack of control. That's just me.

Again, I may be speaking to some of our other listeners. I'm a little bit of a control freak. I don't want to just turn my money over to a big, efficient marketplace where more and more people are investing by the index investing method.

In fact, the more people that are piling money into one platform, Alex, the less ability there is to actually really rise above benchmarks. Dr. Dahle does mention in his blog post here, he says something about, we'll get to this in a minute, but about the fact that he thinks real estate investors don't understand what "alpha" means.

Well, I understand what alpha means. It's a benchmark in the stock market or the efficient marketplace. People say well alpha means it's a zero sum game. In other words, if somebody is going to earn more than the benchmark, reaching alpha above the benchmark, then somebody else has to lose.

That's called zero sum game investing, or zero sum game life. Yeah, that's truly an efficient marketplace. Get outside of that into the inefficient world, oh my gosh, it's not a zero sum game at all. I think that's a big difference there, so I'm a little surprised he didn't compare and contrast those two. Definitely alpha applies to efficient marketplace, not to the other marketplace.

All Right, so enough of my intro there, Alex. I can take off here and go too long. Let's dive into a little bit about what you brought out, in terms of his first problem that he describes. He says, "High yield does not equal high return." He says, "High returns come from higher risk, higher leverage, additional work, and additional expertise." I agree. I totally agree with that.

Typically, in the real estate marketplace, in index investing, historically, you can get somewhere between six and seven percent overall. With all the bumps, and ups and downs, six or seven percent. So if someone says that's a good place to put your money, then I would say great. If that's your benchmark, if that's what you're shooting for, go for it because you're making enough money somewhere else and you feel like you can accumulate enough over the years at six or seven percent overall, great. If that's your program and it works for you, great.

But what you're also saying to me is that in real estate, you can't do any better than six or seven percent. Well, I'll say, you can do a whole lot better in real estate and without high risk. What I find, Alex, is that a lot of people who don't understand real estate, it's because they have not gone deeper. They have not taken the time and maybe they shouldn't.

What I know about a lot of people look into real estate market is that they see it from the outside or maybe they've tried it by becoming what I call an accidental landlord. In fact that's actually how Dr. Dahle first got started in his "real estate investing".

Now, this is a story he's told. When he was in his residency, back in the early 2000s in Virginia, he bought a home for he and his family at that time, and lived in it while they were there. They bought it before the downturn, the financial downturn in 2008. So when he left residency and moved to his current state of Utah, he had a house that he couldn't sell, because he was upside down.

Like a lot of home owners, not even investors, you know they bought at the top of the market, didn't think or didn't even begin to think that a market might cycle, now he's stuck with a house. He's upside down on a mortgage. So, what does he do?

He becomes the accidental landlord. Now he's managing a rental property by default, not by intention, from many states away. Well, even in good houses, good neighborhoods, there's issues with long term management. I would never recommend somebody who's a busy professional deal in real estate from that stand point. So that was his first entree.

Now, I will say that going forward in the last few years, Dr. Dahle has definitely ... And through this piece he even says that. He advocates there's good position for both. So

I think he's starting to see the merits of the real estate side more so than he did just a few years ago.

All right, Alex, take me into some of the other points, and let's cover some of them for our listeners.

Alex L.: Yes, great. Thank you David. So, Dr. Dahle mentions the difference between high yield versus total return.

Dr. David P.: Yes.

Alex L.: Can you talk a little bit about the distinction between those two, and what are some of the advantages and disadvantages of both?

Dr. David P.: Yeah. When he's talking about high yield, he's talking about the fact that high yield doesn't mean high return. High yield is what you would currently earn on any investment, whether you're in the stock market getting dividens or in real estate getting your net rental returns.

What he's saying there is, you might be able to claim, "Well, I'm getting 10% cash on cash return on my money and in a good vehicle." Again, whether it's in the stock market or in real estate, pretty much that's predictable year and year out.

Gives an example here. "Give me $100 and I'll give you $10 a year for the next 10 years." That's a 10% return. He says, "If you didn't get anything back after 10 years," in other words, you just got a high return of 10% but you didn't get anything back after 10 years, "you wouldn't think that was a very good investment, would you?" No, I certainly wouldn't.

So that's what he's talking about, total return. You don't get anything back on the back end. You just got the yield. What's the good of that? He gives an example. He says, "You always need to look at the total return, even if you're an income investor. The classic example is that privately traded REIT," that's a Real Estate Investment Trust, "that gives you a guaranteed 8% returns a … decade."

Then he says, "You find out your $10 shares are worth $2.70." Okay, well, first of all, a Real Estate Investment Trust has nothing to do with actual real estate investing. That's more correlated to the stock market. I'm not sure why you'd even use that example. I would never invest, as an income investor, Alex, in real estate if I thought at the end of my five years, 10 years, 15 or 20 years, I've held property 30 years, if there was nothing on the back end.

No, I would never do that. I'll tell you, Alex, that over my 38 years of investing in real estate, I've gone through, now, four major cycles and the properties I bought back in the 80's that I still have, they still produce income. Are the worthless? No, they're actually worth more.

My total returns are better than my initial cash on cash or my "high yield", all day long. Using a Real Estate Investment Trust, I didn't think, was actually a very appropriate example here, in this case, but that's what he's differentiating there.

Alex L.: I see. I see. What about leverage, Dr. Phelps? He talks about leverage. He says, "It really isn't fair to compare a leveraged real estate investment return with an unleveraged stock market investment." What are your thoughts on that?

Dr. David P.: Well, people can buy stocks using margin. You can do that. I think it's a whole lot riskier. Why? Because of the volatility of the stock market. If you have a stock portfolio and you went to borrow against that, you can, through a margin account. A certain amount you could leverage and then take that money and go buy more stocks.

The reason why banks won't lend money against stocks is because of the volatility. Real estate, on the other hand, is easily leveraged or easy financed. Why? Because of the relative stability.

Now does that mean that real estate doesn't cycle with the economy? No, it does. But you can choose where you decide to invest in real estate. If you want to be a high stakes arbitrage player and you know how to do that, you can play the East Coast / West Coast sand states and when the market goes ... When you start with the market that went through the 2008 downturn, and you want to buy in cheap at a low point and then ride that up, and cash out after three, four, five years, that's one way to go. That's more of a business.

When you're looking at long term investing, as I would, leveraging real estate today, because the banks will lend money on real estate ... They're lending it at very low rates, historically low rates today, Alex. 5%, for instance. Very low rates. That ability to leverage real estate, it boosts returns way above what I could do in the stock market.

In fact, a lot of people don't even understand that through a network, through access to the right people, which we'll talk a little bit more about in a minute, that you can't do in the stock market, because insider trading is not legal, but in real estate, insider information, insider contacts, is legal all day long because it's an inefficient market ...

Literally, I can't ... People in our Freedom Founders Mastermind have taken X amount of dollars ... Let's say they had $150,000 to work with and they started by investing in one property, and through the ability to buy low, buy wholesale, have that property fixed up, and then refinance out on the back end, meaning six months later, they're literally getting 100% of their money back with a total of a $400 per month net cash flow.

That's after all expenses, after all debt service. What do they do? They can put it right back out again? In this case, with leverage in real estate, you could take a principle amount, $100,000 to $150,000, and you could literally roll that over, and over, and over again. The same dollar amount.

I can't do that in the stock market, Alex. There's just no way.

Alex L.: Right. So you're saying, "You're right. It isn't fair to compare leveraged real estate with an unleveraged stock market return." That's one of the advantages of real estate, essentially, is that you're able to leverage in ways that you couldn't leverage on Wall Street.

Dr. David P.: Yeah. Again, some people would say leverage is risky and I agree. Leverage can be risky if you do it the wrong way. I'm not a proponent of unsafe leverage.

But using real estate the right way is the absolute best way ... In fact, Alex, it's the only way, I tell people, to accelerate one's estate building or to speed up a recovery if someone is behind in their retirement plan. They're behind. That's the way to accelerate.

Right now, we've got a window of opportunity while rates are still low. They're not going to stay there forever, but right now, it's a window of opportunity. But you've got to learn how to do it and you've got to have connections to the right people.

Alex L.: Fascinating. Fascinating. One of the other problems that Dr. Dahle lays out in this blog post is just a lack of basic investing knowledge that's common with real estate investors. One of the examples that he gives is a lack of knowledge about utilizing retirement accounts in an investment portfolio.

Talk to us about that.

Dr. David P.: I'm just going to say it. I'm not sure he's hanging around with sophisticated real estate investors. I will say that the people I hang with, who I know are sophisticated, are very adept at using the tax preferences, what the tax code allows you to use with real estate, and particularly, as he does mention, about using traditional and, say, Roth IRA, or health savings accounts, or even education savings accounts, and using those self directed accounts in the real estate investing.

You know, Alex, that's a huge component of what we do in Freedom Founders. A big part of our platform is, how do you manage those retirement accounts and use the benefits that are provided within? Again, I would disagree that the people that we work around understand that very well.

Using retirement accounts is a great way to further leverage the return on real estate, because, of course, if you can do it in a tax free distribution account, such as the Roth IRA, such as the health savings account, of course it magnifies that total return. When you take away the tax bites of returns or gains completely, then, of course, the returns are magnified, whether you're in the stock market or real estate.

Again, I think the point here is, he was feeling that real estate investors don't really get how to use taxes or retirement accounts. I just come back and say, "Jim, take us up on our invitation. Come on down to Freedom Founders. Step into our room and we'll expose you to, really, another degree of real estate investing that I think you know inherently is there but you're never had anybody show it to you. I think, Dr. Dahle, you would be amazed and you would become even a bigger fan of real estate than you already are becoming."

Alex L.: Excellent. Excellent. The last concern that he lays out in this blog post is that "income investors work too long and die with too much." Dr. Phelps, in your experience, do you find this to be true with your connections?

Dr. David P.: Yeah, I'm not quite ... I'd love to talk to Jim about this one on one, because I'm not exactly sure what his point was here. I think, again, he may be coming back to his initial premise that ... Something about real estate investing doesn't give you a whole return. It's all about just the income. Of course, there's the asset on the back end, which, in my opinion, has always been more stable than the stock market. Always more stable.

I think he's utilizing that a little bit, saying that because he thinks that real estate investors are just income investors, that they have to work harder and longer. I would say this, Alex, is that in my own experience, and I said earlier and I'll say it again, that learning the ins and outs of how to magnify and utilize real estate as a retirement vehicle, as a long term wealth creator, and predictable passive income generator, it does take some work on the front end.

And I have. I've put the hours in, just as I know Dr. Dahle's put the hours in, studying different aspects of Wall Street investing, and insurance vehicle, and all the things he does a really good job in. He's put time in there.

People who don't want to put time in, or don't have the time to put in, are going to be on the sideline as passive investors in whatever vehicle they decide to invest in. That's a choice. This is all about choice.

I do not see people working harder in real estate investing because they have to. What I see, Alex, is that they enjoy it. The camaraderie, the new skill set, the financial acumen that I know that I achieved through learning real estate, and the people I got to meet, who were very entrepreneurial ...

That's another thing that Jim writes about in this blog piece is that he really respects people that are entrepreneurs. And he is one. I got to hang around with these kind of people early in my career as a dentist, where I typically went to industry meetings where it was all clinical, and I needed that.

But with the real estate side, I got to meet people who thought completely differently than the other people I hung around with. That was a big benefit to me early in my life because it changed my mindset. It changed the way I thought about things.

Yes, as I said, I put a lot of time and a lot of miles into going to conferences and learning how to do this, but here's the big payoff. Here's the big payoff, Alex. I would say that my network, the people that I know in my real estate arena are my biggest safety net.

In fact, my real estate network will add more to my net worth than any stock market net worth ever could. Again, the stock market's all about just pressing numbers, clicking buttons. Again, for some people that's the right way to go.

I look at the people I know and the ability for us to navigate and intrude in the inefficiencies of the market to be a huge benefit. I don't have to be actively boots on the ground doing that, Alex. I don't have to be in neighborhoods or actually dealing with tenants or contractors. My network allows me to participate with other people that I know, like, and trust, and I've done the due diligence on.

Which, again, you better do due diligence on the stock market, so I do the same due diligence in real estate, but I don't have to do all the work. In the stock market, Alex, you also are paying for somebody to do the work. You're investing in businesses. You're taking slices of businesses in index investing.

Well, again, Jim said something about "you're always paying someone to do the management". Well, you are whether you're investing in real estate or the stock market. You are, somewhere, paying for that. I think that's a net zero there. It just depends on which asset you enjoy the most, which feel like gives you the most control, versus the time you put into it.

I think that's really what it comes down to in determining where you should be.

Alex L.: Excellent. Thank you for sharing, David. We've been reviewing a blog post by Dr. Jim Dahle titled "The Pros and Cons of Income Investing". That concludes today's episode of the "Dentist Freedom Blueprint" podcast.

Freedom Founders is a community of dentist, doctors, and practice professionals committed to achieving true freedom in life and business. I know you mentioned Freedom Founders a few times, Dr. Phelps. If anyone would like to learn more about Freedom Founders, check us out on Facebook or visit our website at freedomfounders.com.

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