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## How to Find the Best Market for Rental Real Estate Investing

**BY MARTIN HUTCHINSON**, Contributing Editor, Money Morning

The weak U.S. housing market and high inflation, despite their negative effects on the economy have actually created a promising opportunity for rental real estate investing.

Truth be told, we're not going back to 69% homeownership rates anytime soon. With mortgages steadily harder to obtain, more would-be homeowners are renting.

This heightened rental property interest has given landlords more power - which means rent prices are going up and are likely to continue doing so. The national average rate for home and apartment rentals has climbed 6.7% from June 2010, according to housing search engine HotPads.com, and analysts expect another 3% jump in 2012.

Inflation is here and likely to increase, which will also push rents higher.

**Time to Increase Your Rental Portfolio.**

Overall home ownership cost is exceptionally favorable - even if home prices have a little further to fall - since long-term interest rates are currently near all-time lows. Prices in many markets have already dropped far enough that rental yields are quite juicy, especially compared with interest rates.

When choosing where to invest in rentals, my first recommendation - unless you know a local agent in whom you have great confidence - is to focus on the area in which you live. As I have discovered (to my cost), rental real estate can be a mass of minor crises and costs, which are very difficult to deal with for a small investor who is not on-site.

However, that's not always possible, like for those unlucky enough to live in big-city California or Detroit, two areas where rental real estate is unattractive. I would say there are three main criteria you must evaluate when selecting an area to invest in:

- Employment.
- Price trends.
- And rental yields.

**Unless its profitable to be somewhere else and hire a good management company to handle the details.**

Looking at each we can narrow down the best rental real estate market in the United States.



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## Avoid an Unemployed Tenant

In a normal good economy, local employment trends don't matter too much for a real estate investor, although you always want to avoid the obvious black spots like Detroit.

But when U.S. unemployment is close to 10% -- and near 16% when you take account of all the "discouraged" workers who have stopped looking - you want to select a region in which jobs are growing and unemployment is below average. You want to make sure your tenants, should they lose their jobs, have a decent chance of getting another one fairly quickly.

The U.S. Bureau of Labor Statistics publishes monthly data on state unemployment trends, the [Regional and State Employment and Unemployment Summary](#). You can tell from the most recent report that you want to avoid much of the Midwest, Florida, California and Nevada, which all have double-digit unemployment rates. Even though prices in these states may be down 50% from their peaks, the chance of being stuck with an unemployed tenant is just too high.

Conversely, the Plains states, such as North Dakota, South Dakota and Nebraska have almost no unemployment, while Virginia and Maryland have relatively low unemployment.

But beware suburban Virginia, from which I have just moved, and the Washington, DC suburbs of Maryland: They're expensive, have low rental yields and are dependent on the government - avoid them!

## Make Sure It's a Bargain

To get the most for your money you can follow house price trends from the [Standard & Poor's Case-Shiller Home Price Indices](#), which track prices for 20 metropolitan regions. Looking at the latest data you will note that the average house price is still 41.2% above that in January 2000, about the same rise as inflation in that period, so house prices are still not spectacularly cheap.

To choose an investment area, you can look for two types of bargains. One is regions where prices are no higher than ten years ago, like Detroit, Cleveland, Las Vegas and (almost) Phoenix and Atlanta. The other type is areas where prices have dropped more than 50% from their peak, like Phoenix (again), Miami, and Las Vegas.

Eliminating Cleveland, Detroit, Miami and Las Vegas because they have high unemployment, you are left with Phoenix and Atlanta. Both have an unemployment rate between 9% and 10%, around the national average. To these you should probably add Texas, which had much less of a boom, and where reasonable prices combine with relatively low unemployment.

## Find a High Rental Yield

Finally you'll want a high rental yield. You can use the inverse calculation, the price-to-rent (P/R) ratio, which divides the average cost of home ownership by the yearly estimated received rent income.

Moody's Analytics (NYSE: MCO) calculates P/R ratios for about 70 metropolitan areas, as well as the United States as a whole. This data is subscription-only, but fairly recent versions can easily be found on the Web.

From this data we learn that in the third quarter of last year, the average P/R ratio in metropolitan areas was 14.9, while that for the United States as a whole was 10.4, and that both figures were still somewhat above their 1989-2003 average of 12.0 and 9.4, respectively.

With rents rising, P/R ratios will be declining so the arithmetic is now somewhat more favorable. Given that borrowing costs are in the 4% to 5% range, and that maintenance costs and taxes are high, I would personally not consider investing in rental real estate for a rental yield of less than 8% -- in other words, a P/R ratio of more than 12.5. (Yes, one hopes for a capital gain, but a negative cash flow year-by-year quickly eats into this.)

You should note that rental yields are higher in small towns and rural areas than in major metropolitan areas, strongly suggesting you should look outside the major cities for your investments.

## And the Winner Is...

You can then cross-correlate rental-yield data with price and unemployment data to find the best place to invest.

Phoenix had a P/R ratio of 12.4 last year, while Atlanta's was 12.8, both more or less acceptable, since those two cities are attractive in other respects.

However, I would remind you of North Dakota's 3.2% unemployment rate, and suggest that you should at least consider Bismarck. It's too small to be on the Moody's or Case-Shiller lists, but it's a boomtown with cheap real estate at an average home price of \$159,000 as of January 2011.

**Note of caution:** Rental real estate ownership is only for those with very solid cash flows, and should be indulged only in moderation because of the danger of over-leverage. But in the right locations, rental real estate investing can be very profitable.

## News and Related Story Links:

- **Money Morning:**  
How to Beat the Looming Inflation Tsunami
- **SmartMoney:**  
Renters See Prices Skyrocket.
- **U.S. Bureau of Labor Statistics:**  
Regional and State Employment and Unemployment May 2011

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