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M-F Investment: Are Cap Rates Best Indicator in Today's Market?

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During the boom in multi-family housing, we have seen a large compression in what we consider very aggressive cap rates. Why is this happening? The Fed continues to keep rates artificially low in an effort to stimulate the economy and promote growth in gross domestic product (GDP). Many investors are left to wonder what all of this means for them, especially as it relates to multi-family property investment.

That said, these low rates make the multi-family market – which currently yields a much better return on investment (ROI) than almost any other product – attractive to investors. Not only will low interest rates make multi-family real estate the favored product, but in select markets, the high demand and low supply will also give investors better operating fundamentals and returns. The key will be, picking the "right" markets.

However, cap rates are not the only consideration. Capital gains tax rates are also a factor to evaluate when investing in multifamily properties. Even with the recent revision to the capital gains tax rubric, it is still preferable to the higher income tax rates. Couple this tax benefit with the low cap rates and investors will be more economically satisfied when investing in multifamily assets.

Will that stimulus – the artificially depressed cap rates – last forever? No. Because of its inflationary nature, the stimulus is not sustainable in the long term. Our ability to continue printing greenbacks and adding to the debt cannot be maintained. Interest rates will eventually go up and cap rates will follow.

As a result, investors must be particularly sensitive to the interest rate movement over the next five years. The fundamentals of this current market require investors to be on their toes, hedging their investment portfolio while watching rates as well as supply and demand. Nevertheless, those who watch, then wisely invest, have the potential to be rewarded greatly. While the Fed can print greenbacks, they cannot print real estate – this is the ultimate fundamental.

Moving forward, I would caution investors to keep an eye on interest rates, lock in rates for the long period and, if you are going to exit over a two to five year term, make sure you have some type of cap rate and interest rate increases in your baseline underwriting. As a result, when those fundamentals are carefully monitored or hedged, the investment will be a success.