

## Land Investment Yields: Three Criteria to Consider

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One of the most frequent questions I get asked at seminars or from website visitors centers around land investment yields, or more precisely, how much more money can I make from investing in land as compared to other investments like stocks, bonds, and improved real estate? Certainly the issue of yield is a necessary prerequisite to making any investment but a focus on potential gain alone ignores the complete investment context, especially true in the case of land.

The concept of investment risk can fill libraries of books. But these three particular issues in this article have been on my mind recently and should be viewed with some importance by those considering making investments in land or businesses that have land as their primary focus, such as agriculture, homebuilding, mining, energy production, or timberland management.

**Criteria #1: Investment risk concerns not only the risk of capital but the probability of the expected yield occurring within the projected time frame.**

Only amateur investors focus on overall yield exclusive of other considerations, the most important of which is risk. A lottery ticket can be an amazing investment when viewed from this simplistic perspective. One dollar invested, the potential of \$58 million in return. From a risk/reward equation this sounds like a magnificent bargain. The most that can be lost is one dollar. A 5,800,000,000% yield is possible on invested capital in just one week! WOW!

Of course, the concept of risk does not apply merely to the potential loss of capital but also to the actual statistical chance of really earning the projected yield or profit. When viewed from this more sophisticated perspective, a lottery ticket with a 58 million-to-one yield is a terrible investment because the actual probability of the payout is likely 100 million-to-one or more. This statistical quirk is precisely how lotteries make money for their sponsors. So when I hear investors saying “Yes, it's a

risky investment but no pain, no gain” I am asking “What risk are you talking about?” The risk of the loss of capital or the chance your investment will not earn what you expected? These are not the same considerations. Capital loss is a balance sheet issue while investment losses are more closely visible on the income statement. Risking capital means putting up money that you will never see again. Investment losses mean you buy something that is not making the money you thought it would. The loss of capital has major tax implications while the loss of projected income does not. The IRS cares if you make a \$1,000,000 investment and you lose all your money. The IRS does not care so much if you make a \$1,000,000 investment to earn \$50,000 a year for ten years and you only earned \$2,000. Of course, you can lose money both ways, and this usually is what happens when income streams or return-of-capital events disappoint.

**Criteria #2: All investments maintain a yield ranking when viewed against each other and this rank does not change much over long periods of time. Given this assumption, land is very risky but also extremely high yield and should always be considered as such.**

Historically, it is possible to rank investment performance based on both yield and overall risk and come to some fairly traditional conclusions. Bonds, over time, will not outperform stocks. Real estate investments, over time and even when combined with leverage, will not outperform stocks when viewed from a pre-tax perspective but can when tax considerations like depreciation are considered. These are general rules to be sure, but like most basic guidelines they obtained such status by being more right than wrong, and these shorthand methods can help investors analyze risk issues.

On this spectrum, land is an extremely risky investment that can offer yields well above those offered by other investments . This analysis may seem simplistic at first glance and that is the natural trap for investors. There are bull markets and bubbles like the recent 2001-2007 real estate crash where investments lose their traditional notions of risk. Land, for far too many, was not viewed as an extremely risky investment during the recent bubble. It was a vehicle to make a quick killing in the market, which focused on yield, but the concept of risk was lost in the vapors of investor hysteria.

*But historically, land investment always has been risky and must always be viewed as such no matter whatever the context.* This investment leopard cannot change its spots depending on GDP growth, Fed monetary policy, the unemployment rate, or whatever. Land should be viewed as the most risky real estate investment choice by category, especially given its notorious illiquidity and sales difficulties, but no other real estate investment can match its overall yield, before and after taxes. Again, this is the historical paradigm for land investment, not one that is true in every individual case. But as a general rule, if two investments are promising a 35% return and one is land and the other is anything else, the land investment is likely the more certain to yield that amount if successful, but the chances of obtaining that success are lower than all the other investments as a whole.

**Criteria #3: Yield is relative to the market as a whole and to local markets in particular.**

I usually start every investment decision by calculating the “safe investment rate” over the same time period as my potential investment. A good bet on a safe investment is a U.S. Treasury bond. So if my investment horizon is ten years, I would use the ten-year U.S. Treasury bond rate, which as I write today is 2.07%. The next question, if this is the “safe” rate and what I can earn with no investment risk, (1) how much greater is the risk of the potential investment and; (2) how much greater is the yield? While these questions can be answered in historical or empirical terms, this type of analysis is not current market specific and often useless. For example, the historical average for U.S. stocks is about 10%. So would an investment being made today in the stock market really be 4.83 times riskier than buying a government bond? The current bull (even bubble) market in Treasury bonds makes such a question seem foolish since investors are voting with their pocketbooks on the issue of risk, deciding they would rather earn nothing (and in many cases, a negative return after inflation, taxes, and costs) than bet on historical returns in the stock market.

This analysis affects land investment yields this way. When land markets are hot, projected yields would also rise given the nature of any speculative bubble. But the extent of that rise cannot be viewed historically. The year-to-year variations on land prices are historical and can be used to project

future land prices (assuming, of course, an ultimate regression towards the mean and a decades long time horizon) but current market values pull historical yields up and down much like the wake of a boat has a dragging effect on whatever is around it. What all this means for investors is important. ***Bull and bear markets in land can distort historical yields, making some investments appear less risky than common sense would otherwise suggest.*** In other words, bull markets make very risky investments look less risky relative to other investments and bear markets can spotlight the foolishness of bull market investors by exposing the truth that if yields are distorted to the upside they must ultimately come back down to the mean. The usefulness of this advice can be summed up this way: “Don't chase yields!”