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Real Estate: Seven Smart Strategies

Here are some tips for dealing with your biggest investment as you approach retirement

by Ben Steverman

For millions of Americans approaching retirement, a big part of their fortune is tied up in something they might never want to sell: their homes.

Even with the recent drop in home prices, the real value of a single-family house in the U.S. has more than doubled in 10 years, according to the Standard & Poor's Case-Shiller index, and home values in some markets have tripled.

Many who bought midpriced houses in the mid-1990s now find themselves living in homes worth a small fortune. They could retire comfortably if they could somehow tap into that. But it's easier said than done.

YA GOTTA LIVE SOMEWHERE

Unlike stocks and bonds, a home can't be sold quickly for a profit. The costs to sell a home and move are high, and the declining real estate market makes it doubly difficult these days. And even if you can find a buyer, many longtime homeowners simply don't want to sell. Too many memories and hard work are tied up in their houses. And after a sale, they know they'll still need a place to live.

We asked financial advisers for some tips on how to handle real estate as you approach retirement. Their advice is aimed at those age 55 to 65, but it can be used by anyone investing in real estate.

1. Figure out how much your home is worth—to you.

For most people, a home "becomes an integral part of their identity, of who they are," says Avani Ramnani, of New Jersey-based Athena Wealth Advisors. Their status in the community is linked to their home, which also holds memories of raising children and the "sweat and hard work" that went into improving it.

All this can make it difficult to sell, even if it's financially smart. Some people will pay almost any price to stay in their homes for as long as possible.

If you know you need to sell, Ramnani advises first going out and finding a new place where you'd love to live. That may make it easier to load up the moving trucks. While lamenting the home you're losing, you can also get excited about the one you'll be gaining.

2. Run the numbers first.

If you're planning to retire soon, you've probably already crunched the numbers: How much will you have to live on? How much will you need? The value of the real estate you own is apt to come into the equation eventually.

But many planners advise running those numbers first without including real estate sales. If you can afford to do so, "don't look at [your home] as an investment," says Marshall Groom, a planner in Richmond, Va. "You have to live somewhere."

3. Downsizing early can pay off.

If your home is worth a lot, and you don't mind moving to cheaper digs, you can unlock a lot of extra retirement money by downsizing. If that's your intention, Kristopher Johnson, a planner at Timothy Financial Counsel in Wheaton, Ill., advises doing it sooner rather than later.

The cash raised can provide money to live on early in retirement, while you leave other accounts—like individual retirement accounts—untouched. That gives your nest egg more time to grow untouched, Johnson says. It also gives you more flexibility in dodging tax bills.

Keep in mind, however, that you might need to pay taxes on any real estate windfall. Consult an accountant or planner to make sure your calculation of the benefits of downsizing reflects this possible penalty.

4. Avoid too much real estate exposure.

A key principle for investors is diversification: Putting your money in many different types of assets protects you from bad luck in any one investment.

By the same logic, you should avoid putting more than one-third of your retirement assets in real estate, says Rebecca Preston, a Providence-based planner and member of the Alliance of Cambridge Advisors.

There are a couple reasons for this, beyond diversification. First, real estate is illiquid, i.e., it's expensive and difficult to buy and sell. An unsold, vacant house can be a big drag on your budget, to stay nothing of your psyche.

Second, real estate isn't that great an investment over the long term. This decade saw a huge runup in prices in many markets, but prices can also stay stagnant for long periods of time, as they did in the 1990s. From 1990 to 2000, home values on the Case-Shiller index grew less than 3% per year, while stocks on the S&P 500 grew more than 15% annually..

5. Think carefully before buying a second home.

As they approach retirement, many Americans think about relocating—to the beach, to the mountains, to a warmer climate, to a place closer to downtown. To try this out, many buy a second home while holding on to their primary dwelling.

Planners say this is a very expensive move. If you're not careful, doubling your housing expenses can put a big strain on your budget.

Plus, what if your second home doesn't work out? Many retirees move to a new community only to find they don't fit in there or miss home. A better idea may be to first take long vacations in a new spot and then rent for a while. "Usually we encourage our clients into a slow transition, rather than a sudden move," Ramnani says.

If you're going to be spending only a small part of the year in a secondary location, Preston says it makes sense to rent rather than buy. Unless you'll be spending more than three or four months at the vacation place, "it's not worth it," she says. "You can usually get a nice rental place these days."

6. Beware of alternative strategies.

There are ways to profit from the value of your house while you're still living in it. But they get mixed reviews.

One way to tap into your home equity is with a home equity loan. By borrowing money against your home's value, you can then invest it in the stock market or other investments. "It's a very risky strategy," says Mark Rylance, a planner at RS Crum in Newport Beach, Calif. If you invest in a flat or down market—which the stock market could well be for the near future—"it can be pretty brutal."

Getting better reviews are reverse mortgages, where a lender pays a homeowner as it takes ownership of more of the home equity over time. However, there are limits to this product: It's relatively new, and fees can still be too high, planners say. The reverse mortgage market is "not mature yet," Rylance says. Also, it's better for older retirees; those 55 to 65 may be expecting another 25 or more years in their homes. Finally, a reverse mortgage can make it tough if you want to leave your house to heirs.

7. Deal with falling prices.

As a planner in the formerly hot real estate market in Orange County, Calif., Rylance sees a lot of stress among homeowners worried about their plummeting home values. In the past, a popular strategy was to sell an expensive home for a nice house at half

the price in places like Oregon, Nevada, or Idaho.

Now, many have put off plans to move. "People are waiting," he says.

If you are forced to move or really want to sell, Ramnani advises cutting your price early to win a buyer rather than letting a property sit on the market. The carrying costs of a vacant home can be hefty, and you're also losing out by not being able to invest that money elsewhere. It's "the cost of missed opportunity," she says. "You have all this money stuck."

Amid falling home values, there is some consolation. "They are going to sell for lower now, but they're also going to buy for lower," Preston says.

It can be painful to sell for less than you think your home is worth, but sometimes it's better to cut your losses and move on. And with home prices expected to continue to fall, you may soon be able to snap up a good deal in a popular location.

Steverman is a reporter for BusinessWeek's Investing channel .