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Should you own real estate as an investment?

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By [Steven Podnos MD, CFP](#)



I'm often asked about owning a rental house or two as an investment. My answer is, of course, "it's complicated."

Potential benefits of owning rental real estate as an investment is having some diversification away from stock and bond markets, as well as the potential for income and capital gains on a sale.

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The first thing to consider is whether or not you are suited to be a landlord. Will it bother you to get a phone call on a Saturday night about a malfunctioning water heater? Will you do the work necessary to screen potential tenants with interviews and background checks? Will you survive a bad tenant? Are you willing to evict tenants who have fallen on hard times and cannot pay the rent?

Consider these and other questions before even thinking about making this investment. There are some excellent books on being a landlord in bookstores, and you should read one or two before starting.

If you have decided to move ahead, you must now find a property that is hopefully at least cash neutral. That is, the expected rental income should cover all your costs-insurance, taxes, mortgage, repairs, deferred maintenance like a "replace the roof" fund, etc.

Unless you are a full time real estate practitioner, you are grossly limited in deducting losses above a small amount. In addition, a property that starts out cash flow negative will take that much longer to make any money on.

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I'd also strongly recommend that you own properties where you live. Trying to maintain a rental property far away is fraught with difficulty and extra expenses. Stories of rental management companies far away doing unneeded expensive repairs and hiding rental income are legion.

Understand that this type of investment usually takes ten years or much longer to bear fruit. Slowly, the rents increase, hopefully faster than the fixed costs of ownership. The price of the property may appreciate, but you will probably pay capital gains on the profit, despite the fact that much of it is really just adjustments for inflation.

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Overall, I'd say that you should not invest in residential rental real estate unless you are prepared to eventually own several properties and are willing to invest a great deal of ongoing time.

In contrast, owning the building that your business/practice is in often makes good financial sense. You 'know' the tenant, and are paying off the mortgage with tax deductible funds.

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Steven Podnos, MD, CFP, is the principal of Wealth Care, LLC in Merritt Island, Florida. Send your financial questions to medec@advanstar.com.