Amateur investors tap 401(k)s to buy homes

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NEW YORK (CNNMoney)

In order to get in on hot housing markets, amateur investors are buying up homes and taking risky measures -- like tapping their retirement accounts -- to fund the deals.

"We're seeing many people cash out 401(k)s or IRAs because they want to take advantage of the market," said Sean Galaris of financial services firm LM Funding, based in Tampa. "This new scenario involves people losing significant personal funds since they are financing real estate through retirement accounts, savings and life insurance."

Galaris should know. His company buys delinquent fee accounts from condo associations and collects the debts. Many of the condo owners he collects from either resort to tapping their 401(k)s or IRAs when they come up short for expenses like maintenance fees or have already used up those funds to buy the property in the first place.

Lori McDermott, an insurance broker from West Seneca, N.Y., took out a $50,000 loan against her 401(k) for a downpayment on a home in Sarasota, Fla., last December. A short sale, McDermott got the place for $225,000 -- a steal considering the seller owed $465,000 on the mortgage.

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But still, it's a risk. If McDermott loses her job or quits, then any unpaid part of the loan will come due immediately and will be subject to income tax and possibly a 10% early withdrawal penalty.

"The decision to take money from your 401(k) is not for everyone," said McDermott. At the age of 48, she has already had five arterial stents implanted. "Having heart disease put me in a position where I was scrambling for life insurance," she said. " I looked elsewhere to create a legacy: real estate."

Adam Bergman, a tax attorney for IRA Financial Group in New York, gets several calls a day from clients like McDermott looking to invest their retirement funds in real estate.

"Our average client has retirement accounts of about $150,000 and is looking to buy one or two properties," he said. "After

2008, they didn't trust Wall Street. They wanted hard assets."

'I can't let this town become Detroit'

But Wall Street is getting into this market as well and that is driving prices higher. Many of the single-family homes and condos that have been purchased over the past three years have been snapped up by hedge funds, foreign investors, private equity and wealthy real estate partnerships.

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The large-scale purchases these investors are making are driving up prices in markets that were hit hardest during the housing bust. **Atlanta** home prices jumped 16.5% in the 12 months ended in February, according to the S&P/Case-Shiller home price index.

In **Las Vegas**, which was ground zero for the foreclosure crisis, prices have climbed 17.6% and **Phoenix** has seen an increase of 23%. In Florida, **Tampa** and **Miami** have recorded double-digit increases.

"They bought a lot of stuff cheap last year, but now they're paying market value," said Jack McCabe, a Florida-based real estate consultant. "Sometimes they're overpaying."

As home prices rise, profits are harder to come by for investors than they were a year or two ago. "There's no way they can get an 8% return buying at today's market prices," said McCabe.

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After deducting all the fees, taxes, maintenance and other costs, "They're lucky to get a 2% return," he said.

And that's if all goes well when they rent out the property. It often does not. Investments in rental properties can quickly sour if, say, a tenant stops paying rent for a few months or if a condo or homeowners association imposes special assessments to pay for major repairs.

"When that happens, investors may not have the wherewithal to pay their monthly common charges and property taxes," said Galaris. "A whole lot of the people in the markets are not experts."

Galaris said amateur investors sometimes spend all their free cash on their purchases and then have to scramble to pay the fees. If the real estate market turns south again, that could leave a lot of investors in dire financial condition for their golden years. ■

Have you ever bought an investment property and then later regretted becoming a landlord? Share your story with us.

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