



Own Your Life Article

How Passive is Passive Income?

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The term "passive income" became a household word when Robert Kiyosaki started publishing his books about a decade ago. The passive income we are referring to is not that defined by the IRS in the tax reform of 1986...it's the mental shift to thinking about passive income that has affected the way investors make decisions. I would like to share with you some thoughts about what passive income really means.

To put things into perspective, let's consider two extremes of passive income. One is hitting the lottery and getting annual payments with doing virtually no work except going to the mailbox once a year and depositing a check in your checking account. That's pretty passive. At the other extreme is rental real estate. You can achieve total financial freedom through significant ongoing passive income from rental real estate. But the reality is that such a level of financial freedom typically requires hundreds (or even thousands) of hours to build a "buying, fixing, renting & selling machine" and a lot of hours of ongoing property and tenant management.

In reality, passive income has different levels of passiveness. How to view the passiveness of the income is more than a question of semantics. For example, once a buying-renting machine is in place, much of the income is passive, though some of it requires continuous investment of effort. Tenants are almost always involved in passive income from real estate (rehab-retailing activities are not passive...one project = one check + much involvement).

No matter how you define "passive income," many of the most successful full-time real estate investors I know have their lives dominated by real estate activities 365 days/year. A large portion of the income is indeed passive but the "machine" allows for almost no sunbathing in Hawaii as some of the 2:00 AM No-Money-Down infomercials suggest. Some people talk

about outsourcing the machine, but there are few who do so successfully.

Defining Passive Income

I define the "degree of passiveness" of the income by **the ratio between the # of repetitive dollars received per unit of time invested and money invested.** That's my personal definition based on owning my life since my time and effort are as or more important than the money. People usually talk about "passive income" as if it was an absolute concept and money continuously appears with no ongoing effort and without accounting for the upfront effort. It's not just about "no money down" or "little money down".

Example #1 - Private Lending

According to this definition, the closest I have come to nearly truly passive income was for several years in the early 2000's doing private lending using OPM (other people's money). I borrowed about \$100K from 5 credit card companies at 0% interest and private loaned it to rehabbers at 15% interest secured by a mortgage. The total amount of work was [1] writing 5 "minimum payment" checks per month to the credit card companies, [2] once every 12 months doing a balance transfer at 0% interest and [3] depositing income checks from the borrowers once a month. I had \$0 of my own money invested. This generated over \$1200/month and the "work" involved never exceeded 30 minutes per month.

**Time and effort
are major Own Your Life issues.**

When the lending crisis hit in 2007, the 0% offers for 12 months started to dry up (shorter term & higher interest rate) and I reduced my private lending activity using credit cards as the

source. While it lasted, I still couldn't feed my family on \$1200/month, but it was VERY worthwhile as one of several multiple streams of income.

As Robert Kiyosaki says, there is good debt and there is bad debt. Borrowing from a bank at a low interest rate and private lending it to investors at a higher rate, is good debt. It generates truly passive income.

Example #2 – Website Advertising

This next example is less passive because it required more upfront work but it was/is not bad. I invested (I never 'spend' only 'invest') 60 hours in front of the computer during three weekends in October 2002 setting up a website for “catalyst suppliers” in my field of expertise in the chemical industry.

It is one of the least visually pleasing websites you are likely to see. I then invested about 20 hours contacting catalyst suppliers around the world (by free E-mail of course) to ask them to advertise their products on this site. Since then, I generate \$15-30K per year of passive income from advertising fees. The actual work involved since 2003 is about 3-4 hours per year for updating the catalyst product pages, invoicing and depositing checks (most of the payment comes by wire transfer, so I don't even have to drag my butt all the way to the neighborhood bank). Again, I can't sustain my family off \$15-30K per year, but if you do the math, it was worthwhile to set this up as another of multiple streams of income.

The point is that this small business has a very good income-to-effort ratio. Most people should think about small businesses they could start based on their personal area of expertise that could generate passive income with low effort and low investment. In fact, maybe you should take a few minutes right now to do this mental exercise and see if you can come up with a practical idea. **You probably have some area of expertise you could leverage**, whether you are a teacher, a car mechanic or **whatever you do for a living or as a hobby**.

Example #3 - Royalties

This example is not as good as #2 based on my definition of passive income. I wrote a book on catalysis published in 1994 in which I invested about 500 hours of after-work time. In those days, I had a “real job” as Director of R&D at a local company with a 9-to-5 job. I still get

royalties from the book, though they diminish every year. It's time to write another book on this subject and not share the profits with a large publishing company. The book sells new on amazon.com for \$345 or used for about \$200. Unfortunately, the royalties at this point are small, but it had a good run for a few years.

So if I invested 500 hours writing a book and made money in author royalties plus it allowed me to launch another business...could that be considered “passive income”? The income was passive after the work was done. Sort of like rental real estate. A lot of upfront effort, then collect checks. Passive? Somewhat.

Example #4 – Licensing an Invention

This example is less attractive than #2 and #3 because it required a lot more upfront work plus lab resources and there is no guarantee that it will generate income. I developed and patented an improvement for a production process for biodiesel. I invested a solid month of work plus about \$10,000 in legal and patent filing fees. The goal was to license the technology to manufacturers and generate ongoing income streams. When and if this technology is successfully licensed, the income stream will be repetitive, passive and potentially quite significant.

But the point is, even if wildly successful, can Example #4 be truly defined as “passive income” after having invested much time and at-risk funds to get to this point? Should I count the 30 years invested in developing the expertise that enabled me to develop this process in 30 days? What if I never get a penny from this investment? If I make a million dollars or more in licensing fees, I will be able to retroactively say that the income-to-effort ratio was good. Until then, not so good, though it was fun to develop.

Example #5 - Real Estate

How much effort is justified to generate \$300 per month per property of passive rental income? If you have 20 rentals that generate \$6,000 per month, that's not bad until you take into account the effort and time involved in buying and preparing the house for rental upon acquisition, maintenance during tenancy and time and effort to fill the unit after vacancy. Personally, since I'm a part-time investor with an enjoyable full-time career in chemistry, I am driven more by capital gains than by ongoing passive rental income. Every person's situation is different. The passive income “Cash Now” aspect of rental units must

be considered in relation to the income-to-effort ratio versus active work from a job.

learn MUST be modified for your specific local market and for your very personal preferences and goals.

This once a year analysis will give you a pretty good idea of how effective you are in investing your resources (time, expertise and money) to generate financial gain.

We have established that passive income is a matter of extent, not a black or white passive or not passive activity. We

Then again, the “Cash Much Later” generated from a long term Buy-Rent-Hold is enormous. As we wrote in the book, “We Buy Houses, Sometimes!”, the equity generated in 15 years from a Buy-Rent-Hold of a median \$200,000 house is about \$280,000 (not including passive income cash flow). Most of that is due to 5% per year average appreciation and a bit less than 20% of that is from buying down the loan balance. In any case, a few hundred thousand dollars of equity for one single rental house in 15 years is quite impressive, especially compared to savings invested in mutual funds. My driving force for rentals is a lot more about the equity increase than about the passive income.

also know that **time and effort are major Own Your Life issues**. Let’s discuss a simple and practical way to measure passive income from an Own Your Life perspective. I actually do this periodically and it is a simple calculation of the income-to-effort ratio for the different things I do to generate money. It requires two pieces of paper and one pen and almost never more than about 30 minutes. Here it is:

Recommended Exercise

Get two piece of paper. Divide each one into five columns.

Label the columns on page 1:

- [1] activity that generates income
- [2] hours invested in the **past** 12 months,
- [3] income generated in the **past** 12 months
- [4] capital gains generated in the **past** 12 months
- [5] income-to-time ratio

In fact, the income-to-effort ratio in a lease-option is quite attractive in our area in Southern New Jersey in late 2008. When you buy a \$200,000 house at 15% below retail and sell it on lease-option at 15% over retail 2-3 years later, the \$60,000 “equity packet” is quite attractive when considering the number of hours of effort invested for achieving an impressive return in just 2-3 years. The \$300/month passive income is nice, but the \$60,000 payday in just 2-3 years gives a very high income-to-effort ratio without having to wait forever to actually bank the profit.

Label the columns on page 2:

- [1] activity that generates income
- [2] hours planned for the **next** 12 months
- [3] income planned for the **next** 12 months
- [4] capital gains planned for the **next** 12 months
- [5] income-to-time ratio

When I look at the “degree of passiveness” of income for the equity packet of a lease-option, it seems to have one of the better income-to-effort ratios in real estate or anywhere else. You just have to make sure that you are not starting a lease-option at the beginning or middle of a strong buyer’s market. I think that the buyer’s market in our area will be over when the lending crisis is resolved, so I am starting to do lease-options in 2008 with a 2 or 3-year term.

Make sure you list EVERY financial activity including real estate, your day job, the # of minutes you spent on your miserable stock portfolio and all of your hopefully multiple streams of income. Now write down the numbers for each activity. I did this on an airplane recently and it became obvious that I can make a lot more per time invested from writing another book on catalysis than from some other activities (my next project?).

In summary, the “passive income” mantra has many of us spellbound. Many oversimplify the concept of passive income and how to achieve it. There is no question that real estate is a major very do-able method to generate wealth, income and financial security by almost anyone’s definition. However, the passive income aspect is obviously not as simple as some speakers make it sound. Everything you

This once a year analysis will give you a pretty good idea of how effective you are in investing your resources (time, expertise and money) to generate financial gain. You may be surprised at what you learn about yourself and your investments. You might decide on course corrections. You might decide on owning your life through real estate investing if you haven’t already done so. Happy Investing!