Why REITs Beat Rental Properties

Description

Here at The Motley Fool, we favour high-quality businesses for our hard-earned investment dollars. There are plenty of Canadians, though, who park their capital in real estate. After all, it generates steady income, tends to appreciate in value, and it's real. It says so right in the title.

Many Canadians shrewdly invest in this asset class by buying their own apartment rentals. But I would argue that there is a far better way to become a property mogul than owning rental properties: owning real estate investment trusts, or REITs.

Essentially, a REIT functions like a real estate mutual fund, but can be bought and sold like a typical stock. And when compared to owning individual rental properties, REITs start to look pretty attractive.

A smart investment

When you step back and think about it, owning individual rental properties is a pretty absurd idea.

Imagine if an investment advisor recommended investing 25% to 50% your net worth in a single stock … and to purchase this stock with 5:1 margin … and it's illiquid and so can't be bought or sold easily. Yet that is precisely what owning rental properties looks like.

Now consider a REIT. In this case you own a basket of the country's largest property managers, which can contain thousands of tenants. Investors can diversify across residential, commercial, and industrial properties. All of this managed by an expert team with the all-day tradability/liquidity of a stock.

Less hassle

There's the story of the Calgary tenant who declared his apartment an embassy and refused to pay rent .

Or how about the renter who left 70,000 beer cans in a Utah townhouse?

Of course, these are some of the most absurd landlord horror stories. But dealing with tenants is a hassle at best and a nightmare at worst. Owning even a few rental properties is a second job in and of itself.

No such problems with a REIT. Finding tenants, collecting rent, and making repairs are all handled by a professional management team. All you have to do is count the dividend cheques as they roll in.

Buying and selling is a simple click of the mouse in your brokerage account. Of course, it could take a few weeks to read through financial statements to determine which trust to buy.

But even this problem can be solved be an exchange-traded fund. I suggest the **iShares Capped REIT Index Fund** (TSX:XRE). It's a basket of Canada's 15 largest REITs and pays a juicy 5% yield. For a management fee of 0.6% per year, you're saved from shifting through individual trusts and can quickly add real estate exposure to your portfolio.

But what about control?
Now, real estate investors will point out that the biggest benefit of owning your own properties is control. And this is definitely true. If a REIT manager sells a property, it could leave investors with an unexpected tax liability. And in the hands of industry experts — such as realtors, developers, or commercial bankers — control could enhance returns.

But if you're an industry expert I'd have to question the logic of holding your capital in real estate to begin with. It's probably not the safest idea to invest your career *and* your retirement savings on a single bet in one sector.

It's also interesting that the idea of control is never brought up in other industries. If I want to invest in the energy sector, no one has ever suggested that I purchase my own oil well. No, it's a far better idea to buy shares of a high-quality business like **Suncor Energy** or **Imperial Oil**. Why shouldn't the same logic apply to real estate?

Leverage is often touted as a benefit of owning real estate. Bankers will sometimes allow you to borrow up to 75%, 80%, maybe 100% of the property's value.

But REITs win once again here. Many trusts have leveraged their balance sheet 2:1 or 3:1 to enhance returns. Risk-hungry investors looking for more aggressive bets can always finance their purchase with margin or buy call options, with the benefit of limited personal liability if things go sour.

But remember, leverage is no free lunch. While it magnifies gains, it also increases your chances of big losses. Some of the smartest investors in the world like Warren Buffett advocate against using leverage altogether, which is why we're generally opposed to it here at the Fool. [Editor's note: Even though he warns most investors against using leverage, an astute reader pointed out that Buffett has used quite a bit of leverage in his own investing career. This seems to be a case of "do as I say, not as I do."]

Foolish bottom line
Donald Trump aside, owning REITs makes far more sense for most investors than buying individual rental properties. Of course, that raises the question as to which trusts to buy. Coming up in part 2 of

this series, I'll explain what to look for when evaluating a REIT.

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Disclosure: Robert Baillieul owns shares of iShares Capped REIT Index Fund.

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