Investors: Read This Before Buying a Rental Property

Description

Thousands of Torontonians headed downtown on Sunday to the Toronto Real Estate Wealth Expo, a celebration of everything to do with real estate. Celebrity guests included Tony Robbins, *Dragon's Den* star Jim Treliving, and pop music sensation Pitbull, along with a healthy selection of HGTV personalities.

The message was simple: the time to buy Toronto real estate is now. Get in the market before it zooms up again. Everybody is making money. Why shouldn't you?

The numbers seem to back this up. Over the last year, the average house in the Greater Toronto Area shot up 23.8%, outpacing almost every other asset class on the planet. It's hard to argue with those results.

There's just one problem. The Toronto real estate market is in a giant bubble. Pundits like famed investor Stephen Jarislowsky have been saying this for years. Several prominent bank economists have also come to the same conclusion.

Real estate has always been about cash flow. But many properties in Toronto are so expensive they don't even rent for enough to cover the mortgage payment, never mind other expenses. Landlords care about nothing but price appreciation.

But what happens when the party ends?

This affliction isn't just seizing Toronto. It's not a particularly good time to buy real estate in most Canadian cities. A condo or rental house in Vancouver, Calgary, or even Winnipeg doesn't offer a very attractive cap rate, although some markets are better than others.

There's a better way to buy real estate. Investors who buy real estate investment trusts (REITs) get instant diversification, attractive yields, and the satisfaction of knowing they'll never have to deal with a plumbing emergency.

Which REITs?

Most landlords limit themselves to residential property because they know the market. It's also more expensive to venture into commercial space.

REITs allow an investor instant diversification into a real estate sector they couldn't normally access. Canada's REITs invest in things like shopping malls, office towers, warehouses, mobile home parks, and even self-storage. Some even own a combination of different types of real estate.

One example is **H&R Real Estate Investment Trust** (TSX:HR.UN), which owns everything from office buildings to shopping malls to industrial space. It's even expanding into the apartment sector in the United States.

H&R shares currently yield 6.1%, which is better than owning physical real estate in most Canadian markets. It also just recently raised its distribution.

Another interesting REIT is **Smart REIT** (TSX:SRU.UN), which is the largest landlord for **Wal-Mart** Canada. Approximately 30% of the company's revenue comes from the world's largest retailer.

Having so many Wal-Marts is a big plus. Wal-Mart attracts plenty of foot traffic, which helps other retailers — even those that compete directly. This has helped keep Smart's occupancy above 98%, which is one of the best in the business.

Smart shares pay out a 5.2% distribution and has raised its payout each of the last three years.

How to increase your yield

One of the major advantages to owning physical real estate is it takes a small amount of money to control a lot of property. A $200,000 condo can be purchased for just $10,000 down.

It's impossible to get that kind of leverage on REITs. But an investor can use a little debt to goose their returns.

Say you had $100,000 to invest in REITs and could put that money to work earning a 6% yield. You could then use that as collateral to secure an additional $50,000. Interest rates vary between brokerages, of course, but that debt can be had for under 3%.

If you invested $150,000 at 6%, it would spin off $9,000 per year in annual income versus $6,000 a year with $100,000 invested. If margin rates were 3%, it would cost $1,500 in interest. Which is fully tax deductible.

Adding a little leverage increases your yield on cost to approximately 8%, including tax savings. The more leverage you add on, the greater the yield. Of course, risk also goes up as you add more debt.

The bottom line

REITs are a fantastic way to invest in real estate. They offer great yields, instant diversification, and, perhaps most importantly, exposure away from Toronto’s real estate bubble. Smart investors have known this for years. Perhaps you should join them.

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