Real Estate Investors: Should You Buy the Income Property or the Bank?

Description

Owning income properties has proven to be a savvy investing strategy over the past 20 years, and many people are wondering if they should get into the game.

Let's take a look at whether buying residential real estate is a good idea right now or if it would be better to simply buy the bank that offers the mortgage.

Property tycoon

People make money in the property market by using leverage. You put a small down payment on a house and get renters to pay off the mortgage over the next 20-30 years. Ideally, the rent is high enough that you don't have to kick in any more of your own money along the way, and the value of the property steadily increases, giving you a double win.

In the current market, the scenario is not the same guaranteed home run than it has turned out to be for investors who'd bought two decades ago. Property prices have risen to the point where many investors now have to put down a much higher amount to ensure the payments are covered by the rent. In addition, there is a chance the value of the property won't increase significantly in the next 20 years, and property buyers should expect a market dip at some point in the medium term.

As interest rises, the situation could get tricky. A big boost in borrowing costs on a mortgage renewal isn't easily passed on to renters. If cash flow is already tight, you might find the property becomes cash flow negative. In that case, the only reason for owning it is the bet on rising prices, which higher interest rates will impact.

The value of your time must also be considered, as rental properties require significant maintenance. Either you do the work yourself, or you pay to have it done. When a tenant leaves, the process for finding a good replacement can be extensive and exhausting, and funds have to be available to cover the mortgage if the place sits vacant. Everyone hopes to have wonderful renters, and that certainly should be the goal, but things don't always work out that way. You have to be prepared for periods where someone doesn't pay or the place gets damaged beyond a level of reasonable wear and tear.

On the positive side, the steep increase in home prices is making home ownership difficult for a larger pool of people. This, in theory, should ensure strong demand for rental properties in the coming years.

Own the bank

Let's say you put $20,000 down on a $100,000 house 20 years ago and the place is now paid off and worth $300,000. That same $20,000 investment put into shares of **Toronto Dominion Bank** (TSX:TD)(NYSE:TD) two decades ago would currently be worth slightly more than $300,000 with the dividends reinvested, and that's without using any leverage. There is no guarantee TD will generate the same returns over the next 20 years, but it's also extremely unlikely a condo or house you buy today will triple in price over that time frame.

Rising interest rates are going to be tough on property investors, but they should be good news for banks and their shareholders as they drive up net interest margins.

There is also a tax consideration. Income and capital gains generated on the property are taxable. In the case of the bank shares, they can be held in a TFSA where no taxes are payable on the dividends or any gains in the stock price.

The bottom line

If you find a fixer-upper, have the time and skills to do your own maintenance, and can line up great tenants, the income property might be worth a shot. Otherwise, the bank looks like a better bet today.

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