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Is it Smart to Invest in REITs in 2018?

Description

Real estate investment trusts — REITs for short — are not the most popular investments in the world. But with high distribution income and solid (if not frothy) returns, they're a worthy consideration for any long-term investor. However, the performance of REITs is tied to that of real estate as a whole, which means that these securities may do poorly when real estate is cooling off.

So, is 2018 a good time to invest in REITs?

To answer that question, we need to look at the state of the Canadian real estate market.

A cooling real estate market

Broadly, the Canadian real estate market is cooling (and expected to cool further) in 2018. A recent **Reuters** report said that rising interest rates and new mortgage rules have led to a situation where home prices will rise just 1.7% this year. That might appear to be a modest gain, but remember that inflation is running at about 2.8% this year. This means that real estate on the whole is expected to lag the consumer price index, which, in practice, means a negative return (not factoring in rental income).

Valuation

Valuation is an important consideration when investing in REITs, even more so than with other types of stocks.

The reason? Investing in a REIT is somewhat like investing in a rental property, but with added costs. If you could buy a rental property and manage it yourself, why invest in a REIT that has a similar business model but with added expenses for employee and management compensation?

The above was the reason that Warren Buffett gave for not liking REITs in a talk a few years ago with MBA students. However, Buffett included a stipulation: if the price is low enough, a REIT may be worth it. For example, if a REIT has a price-to-book ratio so low that it's valued *less* than the properties it owns, than it may make more sense than investing in property directly. But such a low price-to-book ratio would be *extremely* rare.

High distributions

One thing REITs have going for them — even in today's cool market — is high distribution income ("distributions" are like dividends for REITs). **RioCan** (TSX:REI.UN) currently pays a distribution of about $0.12 per month, which gives a yield of about 5.86% annually. This is well above the average dividend yield for a TSX stock. RioCan is also seeing some growth in its distribution, as it is up from $0.1175 a month last year.

Bottom line

Between high distributions, "OK" capital gains, and attractive P/E ratios, REITs have many things going for them. However, with a cooling real estate market, 2018 may not be the best year to buy in. But if you have a passion for real estate and don't want the hassle of managing a property, buying REITs can be a great way to own a slice of Canada's real estate market.

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Date
2025/08/17

Date Created
2018/10/02
Author
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