Should You Buy Real Estate Directly or Invest in REITs?

Description

Have you ever wanted to invest in real estate and enjoy the peace of mind that comes with earning income off a hard physical asset?

If so, you’re not alone. According to a 2017 study, 77% of people aged 35-44 believe that real estate is a good investment, while 72% of millennials believe the same. Those are high percentages. But despite the near-unanimous agreement that real estate is good, only 15% of people surveyed actually invested in it.

Which begs the question:

Why?

If people believe that real estate is a good investment, it follows that they should be buying it.

The answer may have something to do with barriers to entry. Although Canadian real estate has performed pretty well in recent years, increasing in value at 4.7% annually (not counting rental income), it usually takes a fair amount of borrowing to get in the game in the first place. For investors who don’t want to go the mortgage route, REITs–real estate investment trusts–offer one alternative. Offering the ability to buy a little piece of a real estate empire on the stock market, REITs are perhaps the quickest way to invest in real estate. But are they better than direct property investing?

To answer that question, we need to talk about opportunity cost.

Opportunity cost and the time investment

One of the biggest costs in direct real estate investing is time. Generally, if you invest in a rental property, you have to actively work on it: collecting rent, doing repairs, dealing with complaints, and the list goes on. Any time you spend doing these tasks is time you're not spending on something else. So direct property investments come with a real opportunity cost. Unless, that is, you hire a property management firm.

Property management costs

A property management firm is a company that does all your property management for you, which includes collecting rent, maintaining the property, and more. If you own an entire apartment building, hiring a property management firm can be very much worth it. However, if you hire one just to maintain a few rental houses for you, you'll lack the scale needed to make it profitable and you'll end up with a very low margin investment.

At this point, if you're thoroughly turned off at the thought of a second job as a landlord and the prospect of paying property management fees, you may be about ready to give up on real estate investing. However, we still haven't talked about REITs.

REITs

REITs could be thought of as real estate investments for people who aren't prepared to deal with real estate investing. To invest in a REIT like **Riocan Real Estate Investment Trust** (TSX:REI.UN), you simply buy its shares on the stock market, and passively collect its sizeable dividend. In this way, you avoid mortgages and landlord duties.

So far so good. However, the issue of management costs applies here as well. When you invest in a REIT, part of the revenue your share is entitled to goes to paying company staff, executives, contractors, etc, which makes REIT investing a little like property investing with a management firm. However, because REITs are bigger than rental properties, they benefit from economies of scale that you wouldn't enjoy as a small property investor.

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andrewbutton