REITs vs Dividend Stocks: Which Offers a Better Passive Income?

Description

Real estate investment trusts (REITs) are a popular means of generating a passive income. They provide the opportunity to invest in a range of properties through buying part of the company that owns them. They are traded on the stock exchange, which can make them more liquid than investing in an open-ended property fund.

However, do they offer a superior means of generating a passive income compared to dividend stocks? Or, should investors seek to own a wide range of companies, rather than simply buying REITs?

Returns

There are strict rules on dividend payments for REITs. They must distribute at least 90% of their income to shareholders in order to quality for REIT status. This means that shareholders are guaranteed to benefit from any uplift in their income, which may lead to a higher dividend return in the long run.

By contrast, dividend stocks face no such requirement. It is entirely up to their management team as to how much, if any, income is paid out as a dividend. For some companies, they may wish to pay out a high percentage of income as a dividend. This may include mature companies, for example, who do not require large amounts of reinvestment.

In some cases, of course, dividend policies can change. For example, a new management team may place less importance on dividends, which could lead to slower growth in income returns for investors.

Risks

While REITs offer investors the opportunity to buy a range of properties through owning the stock of a single company, they lack diversity when compared to dividend stocks. In other words, it is possible to build a portfolio of dividend stocks that operate in a variety of industries, so that if a particular segment of the economy underperforms an investor is not over-exposed.

REITs ultimately are only focused on property. Therefore, should property prices fail to rise, or demand for property falls, they could experience disappointing returns. This lack of diversity means that their risk versus owning a range of dividend stocks could be relatively high.

Investment prospects

For many investors, buying property is an appealing idea. Property prices have generally performed well since the financial crisis, and have a long track of growth in a wide range of economies. Therefore, owning REITs has appeal from an income perspective.

However, solely focusing on REITs could leave an investor over-exposed to the property sector, while not being able to benefit from the prospect of rapid dividend growth in a range of other industries.

Therefore, it may be prudent to own a range of dividend stocks, as well as REITs, in order to generate a passive income. Doing so may allow an investor to access a wide range of income sources in order to reduce risk, while also benefitting from the growth potential of a number of different industries – including the property segment.

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