Forget Buying a House: This Is the Best Way to Invest in Real Estate

Description

There's nothing wrong with buying a house, as long as you view it accurately. It isn't an investment; it's just consumption in a slightly different form.

Think about all the expenses homeowners face compared to renters. Property tax and insurance are big ones, of course; so is home maintenance in all of its forms. Some homeowners are smart and only replace things as needed. But many aren't, giving into temptation and spending thousands on unnecessary upgrades and aesthetic improvements.

Then, after the market goes up and this homeowner sells for a healthy profit, they conveniently forget about all these upgrades when figuring out how much cash was made on the sale. They just take their tax-free gain and smile all the way to the bank, eager to make the same mistake on another property.

Now, this isn't to say home ownership is a bad idea. There are a number of benefits to owning your principal residence. It creates stability for your family. It helps establish roots in a community. Real estate can also be borrowed against in a pinch.

The evidence is clear, however. For many people, renting a property and then investing the difference into diversified real estate investment trusts (REITs) will be the more profitable path.

Why REITs?

A popular phrase people like to use when comparing renting to owning a property is, a mortgage payment is "building up equity." But let's take a minute and break down this misconception.

Every mortgage payment consists of interest and principal. As the mortgage dwindles, so does the portion going to interest. But why does only the homeowner get credit for contributing to their equity? Why couldn't a renter do the same thing?

But remember, we can't just look at equity contributions from the mortgage payment alone. A homeowner pays property taxes, home insurance, and property maintenance costs. A tenant doesn't have those expenses. This means, all things being equal, a renter has more cash to throw at building a nest egg. One could argue a tenant building a portfolio of REITs has a more secure future than someone who pays off a mortgage, since that portfolio is diverse and oozes income.

Let's look at a specific example. By choosing not to own a home, a renter puts an extra $500/month in their pocket. This person then uses the proceeds to buy **H&R Real Estate Investment Trust** (TSX:HR.UN) shares, enticed by the trust's diverse portfolio — which consists of office, retail, industrial, and residential property — as well as the company's 5.9% dividend yield.

H&R's portfolio is much safer than putting all your eggs in one basket. Millions of homeowners have made the mistake of buying at the top of the market. A diverse portfolio — like the one H&R owns — minimizes that risk.

We'll assume H&R returns 8% going forward. This is likely conservative, since it only gives the company credit for continuing to pay its dividend and a 2.1% annual increase in the value of its properties. Over the last 20 years, H&R has returned closer to 11.5% annually, assuming investors reinvested their dividends.

$6,000 per year invested at just an 8% annual return would give our renter a nest egg of $734,075 over a 30-year investment horizon. Perhaps most importantly, that much invested in H&R REIT would spin off an annual distribution of just under $43,500.

For the sake of argument, let's say a homeowner ends up in the same situation as our renter and ends up with property worth just under $750,000 after a lifetime of upgrades and interest costs. How is the owner supposed to convert that equity to cash? It's possible, but it likely means they'll have to move. That's not an ideal outcome.

The bottom line

I don't want to unfairly disparage buying a home. I own my own home, and I have no plans to sell it, even if it does make more financial sense. But you have to remember that the investment is much more nuanced than the gross profit made when the property is sold. Once you plug in accurate numbers, renting a place and using the proceeds to invest in a solid portfolio of REITs is likely the better option.

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