REITs can be sexy, too

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Lyle Stafford for National Post files

REITs may lack the sexiness of floor to ceiling glass windows with views of the skyline but they have something else to offer — a return that continues to the outpace the housing market even as residential prices stand at all-time highs.

How would you like a nice 14% average total return each year for the past decade from your real estate holdings?

Before you rush out and start looking for something in the red-hot condominium sector, you might want to take a quick glance at the Canadian real estate investment trust sector.

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The Bloomberg Canadian REIT index has returned close to 275% over the past decade as of the end of November. It has easily outperformed the S&P/TSX Composite Index which has returned about 110% during the same period.

And housing? If you use the average price of a home sold, calculated by the Canadian Real Estate Association, you've had a price increase of about 110% over the last decade with the average sale price $360,396 at the end of November.

REITs have done extraordinarily in the low interest rate environment because they are able to use leverage or debt to increase their returns. "REITs are leveraged 50% typically. When you put $500 into a REIT investment, you are getting $1,000 in real estate," says Neil Downey, managing director, global equity with RBC Capital Markets.

Of course, you can get even more leverage on residential purchases — up to 95% of a principal residences can be financed with debt.

Even condo investments, insured by Canada Mortgage and Housing Corp., can get 80% debt to 20% equity. You buy a $300,000 condo with only $60,000 down and, if it climbs to $330,000, you've made $30,000 but also a 50% return on your original $60,000 investment.

"It has unequivocally worked in housing's favour," said Mr. Downey.

However, there are few things to consider before you jump on that housing bandwagon. For starters, the stock market is "very observable," notes the analyst. Basically, you know the value of your holdings at any moment. Housing can't come close to that type of measurement.

My own bias is towards buying real estate through the market just because you can spread that risk around. Buy an exchange-traded fund pegged to the real estate index and you are getting real estate companies with a cross section of holdings that include office, retail, and industrial space plus hotel rooms and apartments.

"For housing, I guess the aggregate numbers are there but for every individual the outcome could vary substantially," said Mr. Downey, agreeing it speaks to the risks that comes with buying housing.

Housing as an investment is also entirely a capital appreciation play. It's almost impossible, once interest costs and other expenses are considered, to carry a condominium investment on a cash-flow positive basis. REITs? The Bloomberg index has about a 5.5% yield, so even if the market goes flat, you are making money.

"If you are paying $800 or $900 a square foot and condo fees on top of that, it is really difficult to generate positive free cash flow in that type of scenario. The REITs are structured so that they have to be cash flow positive or they are over distributing and that doesn't last very long," says Dennis Mitchell, deputy chief investment officer at Sentry Investments.

You can also enter and exit a REIT investment cheaply through either a mutual fund or an ETF, though you'll pay a higher management fee for the funds. Still it pales in comparison to cost of exiting a direct property purchase. Between real estate selling commissions, land transfer taxes and legal fees, the exit cost on a real estate purchase could be 7% to 8%.

"REITs are going to outperform next year as well," says Mr. Mitchell, pointing to the expected volatility in the market which contrasts with the stability of REIT payouts.

Marc Lamontagne, a certified financial planner with Ryan Lamontagne Inc., says he's a proponent of clients owning rental properties but concedes cash flow positive returns are getting harder to come by. He also points to the tax advantages of owning property directly although REITs have their own special tax treatment.

"Buying a rental property is not just an investment, it's a business. You have to be hands on," says Mr. Lamontagne, adding every other new client that comes into his office wants to buy a rental property. "We have people with a substantial amount of money in the market and they are looking for something different."

There is nothing wrong with something different. There's also nothing wrong with something a little more tried and true.