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Investing in real estate

There are several options available, either active or passive

BY DANIEL COHEN

Personal Finance

The market value of all real estate in the world is more than $200 trillion – more than triple the size of the value of all stocks and almost double the value of all bonds.

Considering this staggering value, it may seem unusual that most financial advisors and their clients have little to no money invested in real estate, aside from that invested in their own homes. Maybe there are good reasons to avoid most real estate investment offerings. It might also be that most financial advisors have too little experience in the specialized field of real estate investing to offer the right kind of advice to their clients.

Real estate investments can be either active or passive. A popularized example of active real estate investing is buying a home or condo, fixing it up and then selling it for a profit. There are all sorts of TV shows popularizing this "flipping" activity and fortunes have been made flipping properties. However, in times of declining home values, big losses can occur with this short-term trading strategy, especially if debt is used to buy the property.

A recent Morningstar report estimates that the long-term return of home values is one percentage point over inflation. But keep in mind, this estimate is before factoring in the carrying cost of the property, so the actual return on owning a home is likely less than inflation.

Another popular form of active investing involves renting out a home or condo for the income. The owner is the landlord and is responsible for finding a suitable tenant and handling problems that occur.

The biggest risk of investing in a single home or condo is losing your single tenant and not being able to re-rent for an extended period of time. In this case, there will be a negative cash flow as the expenses of owning this property must continually be paid. This risk is reduced if the investor owns multiple properties or a multifamily property. Borrowing money to buy the property is common and adds to the risk.

There are various ways to invest in real estate without the day-to-day hassles.

Investing in publicly traded real estate investment trusts, or REITs, is the simplest and most popular passive alternative. REITs are required to pay out 90 percent of their income to shareholders so they are a good source of stable income.

REITs can be diversified into multiple types of properties and can specialize in sectors of real estate like apartments, offices or storage. Some diversify geographically.

The potential downside of REITs is that they exhibit much the same volatility and risk as the stock market. A widely held diversified REIT would have lost more than 50 percent of its value during the 2007 to 2009 market selloff.

There are many non-traded REITs, and the SEC recently warned about the risks of investing in them. They include lack of liquidity, meaning you cannot sell them when you want to, and high fees – as much as 15 percent upfront as well as other ongoing costs.

Distributions may come from principal rather than income, which is misleading to investors. The lack of share price transparency means that you don't know what your position is really worth, and conflicts of interest may exist among the managers of the REIT and its service providers.

Another passive way to invest in real estate is to participate as a limited partner. The partnership raises money from investors to buy either a single property or a group of properties. Limited partnerships can focus on any type of property depending on the goals of the limited partners. These partnerships are not liquid like publicly traded REITs but may provide the stable income and long-term appreciation many investors desire.

Limited partnership investments are often limited to accredited investors – people with $1 million or more in investable assets or an annual income of $200,000 or more. There have been discussions in Washington about loosening regulations to allow more individuals to participate in these types of private partnerships.

It's crucial to know exactly what all of your investment costs are. Many limited partnerships have been organized by a small group of related individuals and the costs are kept to a minimum. However, there are partnerships formed by firms that require a high cost to participate. Some general partners charge a combination of these fees, while others charge all of them. So beware of all the upfront and ongoing costs before investing. NHBR

Cohen, CEO and chief investment officer at Cohen Investment Advisors, Bedford, can be reached at 603-232-8351 and investwithcohen.com.