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Owning Rental Real Estate versus Real Estate Stocks

Introduction

For centuries, real estate has ranked among the best investments in developed countries. As our sophistication has evolved, so have the vehicles that make Real Estate more accessible to investors. Let's explore and clarify this deep and vast area.

IMPORTANT NOTE: Your home is not a part of this analysis. Whether to own a home, lease it, finance it with a mortgage, these are where-you-live decisions more than where-you-invest decisions. We also support the strong American urge to own one's home and stand ready to help analyze those choices, too.

Investment Options Defined

Direct real estate investing means you buy a property (either entirely yourself, or in partnership with other investors) and then hire a manager to find and rent to tenants as well as managing maintenance. You could save about 10% of the rental income by managing the property yourself, but that could cost even more and take many hours a week.

Stock market real estate investing is done through real estate investment trusts (REITs) which enjoy special tax advantages in exchange for distributing most of their annual income to shareholders (the owners.)

While owning stock in a company doesn't feel as real as visiting a house you own, that stock is very real and represents your actual ownership in **every piece of real estate the company owns**.

Investment/Rental Residential Properties

Buying a string of homes to rent out has been a very popular route to building wealth. While it appears attractive on the surface, the returns are much lower and risk much higher than you might think.

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Annual total returns (rental income plus price growth):

Benefit/Cost	Rental Property	Real Estate Investment Trust (REIT)
Benefits:		
Average Annual Total Return (over the last 25 yrs.)	9.5%[1]	10%[2]
Depreciation Tax Benefit	0.73%[2]	0%
Costs:		
Property Taxes	1.3% avg. (ranges from .3 to 2.3%)[4]	0%
Maintenance	2.0%[5]	0%
Professional Management Fees	0.95%[6]	0%
Net Annual Return on Property	6.08%	10%

[1] – Roofstock.

[2] – Assuming a 20% long-term capital gains tax rate.

[3] – NAREIT (REIT Industry Association.)

[4] – National Association of Realtors and the Tax Foundation.

[5] - *Forbes* and *US News and World Report*

[6] – National Association of Residential Property Managers (NARPM)

If you're surprised that owning a group of rental homes returns about 60% what the average publicly traded REIT returned, wait until you see the risks:

Risk	Rental Property	Real Estate Investment Trust (REIT)
Location Concentration	Single locations near one another will experience more price volatility.	Spreading out over entire regions or countries reduces the risk of an above average decline in prices.
Liquidity (ability to convert to cash)	Can take months or years and cost as much as 5% of the property value.	Can be sold within minutes on major stock exchanges during operating hours (5 days a week) without any sales commissions (free).
Mismanagement	Property managers can be hard to monitor and compare.	Must publicly report all their revenues, expenses every 3 months`. Additionally, they offer guidance for the coming year and answer analyst questions about current performance.
Financing	Individual mortgages you may have to guarantee.	Larger financing packages at lower rates with no personal guarantees.
Property Selection	You or your realtor.	Professional management team that only spends their time evaluating and managing the portfolio in which you own a piece.

Location Concentration

Let's say you own 10 houses in Los Angeles County. That can feel pretty spread out, but you are also subject to the Greater Los Angeles economy trends and environmental risks. If you own any REIT of any size, you own pieces of houses spread throughout many states, or even the entire country. That geographic spread systematically reduces your risk that only your areas suffer a bad economic downturn or prolonged rental loss.

REITs tremendously reduce your risk compared to owning house in the same county or even state.

Liquidity

Your ability to turn your investment into cash is your liquidity.

Because publicly traded REITs can be bought and sold on major stock exchanges, they are the most liquid real estate investments – you can have your cash within 48 hours of selling Mondays through Fridays, except for major holidays.

Selling a house can take weeks, months or even years unless you heavily discount the price (reduce your profits) to get things moving quickly or take advantage of bulk cash buyers who may be in your market. And, you will pay up to a 5% commission to your broker(s) on top of everything else.

Mismanagement

There are no industry statistics because it's impossible to measure in a systematic way. We have direct experience in hiring property managers and it's a very hit-or-miss business because there's not a lot of quality control – only some states require licensing for professional managers. We do know that each time any property was overly vacant or not well attended to by managers spread too thin to deliver quality service, those properties underperformed.

Financing

Most of us know we can borrow to buy a house, which includes investment properties. In this area, both individuals and REITs can borrow about 50% of a house's value, but the REIT gets better terms because it has a less risky portfolio while individuals often have to personally guarantee each rental property loan. This is where geography and professional management create borrowing advantages that make direct investing even riskier.

But that's not all folks, if you had to personally guarantee the loans on your rental properties and things go wrong because of some outside event like an earthquake, you can lose not only your rental house investments, but also everything else you own. In a complete REIT disaster, you can only lose what you invested and we can exit long before that happens because we have a huge liquidity advantage. When anyone has to sell a house fast, they have to discount a lot unless the market is hot. In a REIT, we just need the market to be open to get the market price without having to discount today.

Property Selection

You may know your neighborhood and those around you really well, but how can you know whether owning some houses in Arkansas and Texas makes better sense today? How do you know whether you are buying at the right values given other opportunities in other markets? How will you manage properties in other states? REITs enjoy a huge advantage here – they are in the market everyday and see deals you and I never get the chance to buy. Size and ability to close deals quickly has significant advantages.

The Only Rental Property Advantage

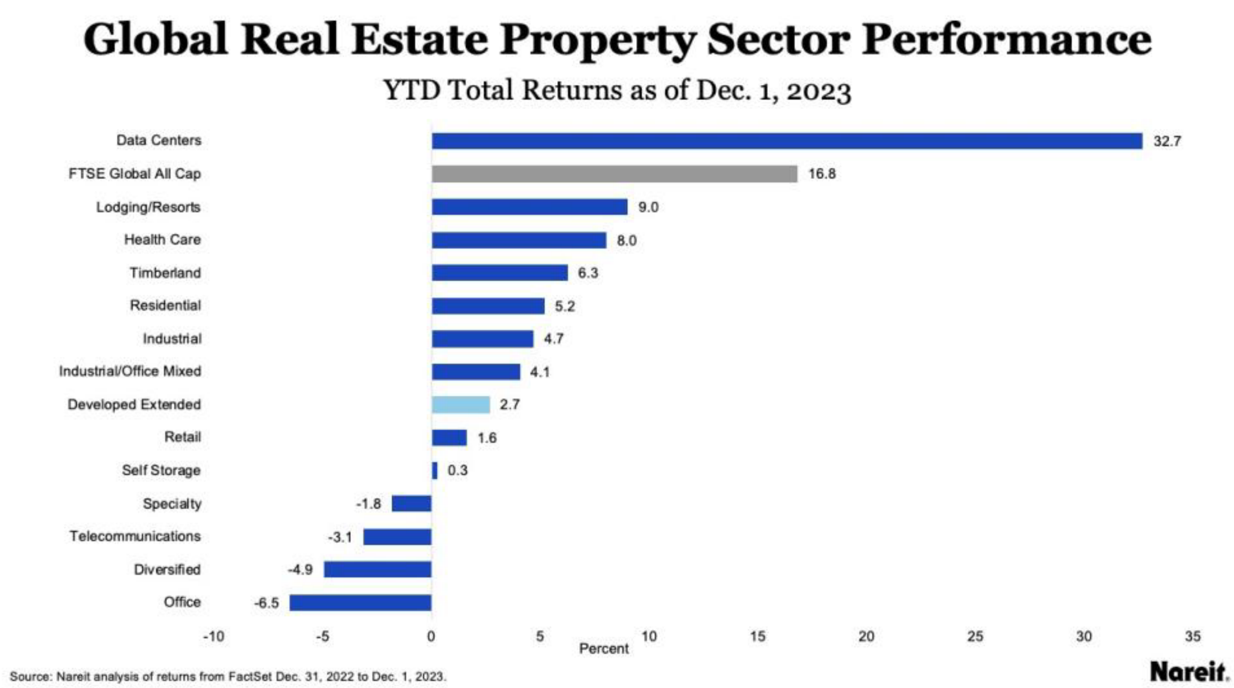
Rental properties do enjoy one advantage over REITs – depreciation. Residential rentals can write off the entire cost over 27.5 years against income, which is worth a little less than 0.73% in positive total return each year.

Conclusion

REITs are much less risky and enjoy almost 40% better returns over time, based on the last 25 years. Of course, that is not a guarantee of future performance, which will vary.

Investment/Rental Commercial Properties

When we enter the world of commercial real estate, we have to recognize the wide range of uses and markets it addresses. From offices to healthcare to warehouses to cell towers, there is almost a REIT for every flavor of commercial real estate use as represented in the graph below:



Not surprisingly, returns will vary greatly depending on the sector and the economy at any given time. We further need to distinguish that direct investing in commercial real estate is quite different from residential in the following ways:

1. Properties are owned in individual Partnerships;
2. The General Partner makes all decisions;
3. Limited partners have no say and do not have to guarantee any loans; and
4. Liquidity is even more limited because the General Partner decides when to sell and who can buy.

Publicly traded commercial property REITs enjoy several advantages:

1. Same liquidity as other publicly traded REITs – you can sell on the stock exchange most days of the week and have your cash in about 48 hours;
2. Investments spread across a wider geography and tenant base for reduced risk; and
3. Better financing terms.

Direct investors have a similar depreciation advantage REITs do not, but the annual benefit is a little lower than the residential tax benefit at 0.5% per year.

While we do not have a breakdown by sector of private versus public returns for commercial REITs, you can see how systematically riskier the direct investing partnerships are. Of course, with greater risk, one should expect greater total returns (income plus price growth), but we do not see this in the markets today.

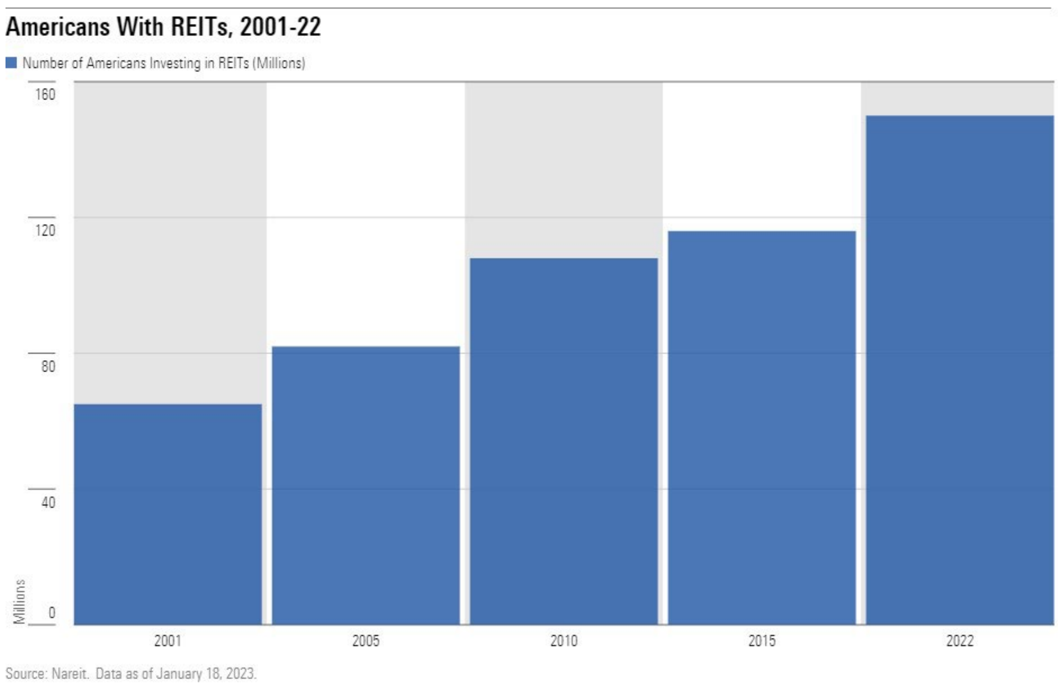
Let us illustrate a very realistic challenge facing direct investors today that can hurt them for years to come: You have a successful piece of an office building where growth has slowed to a crawl with the current popularity of hybrid work. Now, you want to shift to warehouse and industrial properties because companies are relocating their manufacturing back to the US (has been happening for a few years now) and returns are better in that sector.

How do you sell your office building interest? If it's private, you have to ask the General Partner and then find a willing buyer at a discount to the actual value because the General Partner has so much control. That's the liquidity problem and you could slightly sidestep it by borrowing against your investment, but you may not get any loans if the office sector is under pressure because lenders know you have little ability to sell your interest if the cash is needed to repay the loan – yikes!

If you held a REIT in the same sector, you had none of these problems.

REITs Are Gaining Among All Investors

Given a REIT's advantages, it's not surprising that almost 50% of all US households owned at least one REIT stock by 2022.



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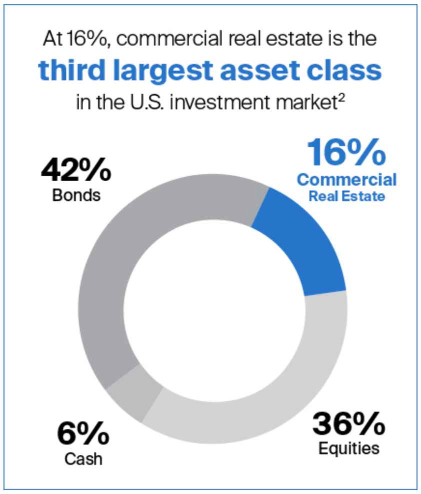
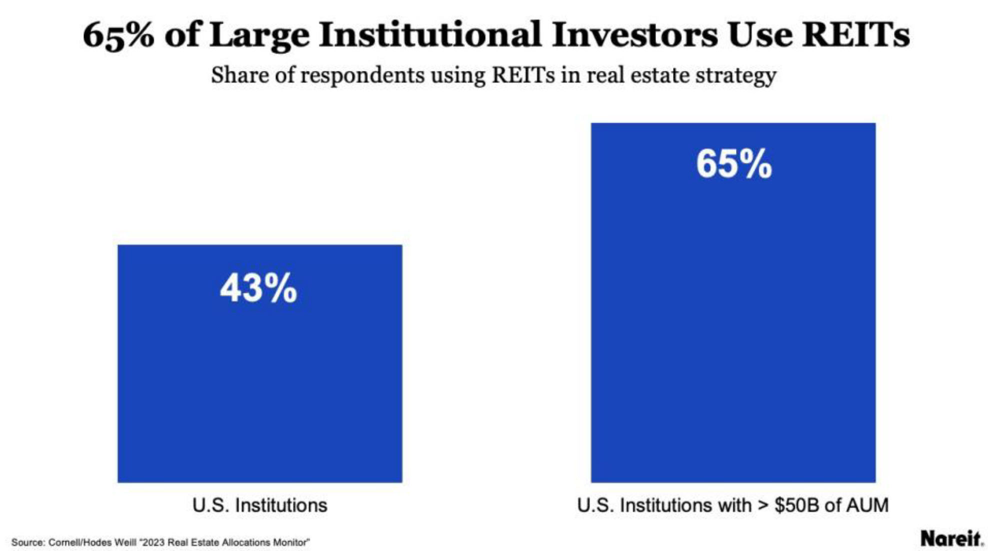
And if you want to own real estate, commercial real estate should be a part of that portfolio given its overall size in the US economy:



Even the majority of large institutional investors like pension funds, university endowments and insurance companies own REIT stocks:



Conclusions

Direct investing feels more real, but REITs require a lot less mind space, carry lower risk, and offer higher returns over the last 25 years. Like every property, each REIT has its own unique set of business risks **and** they are a more efficient investment vehicle today for the average investor.