How to make money investing in real estate

A house is the biggest investment most people make, but there are other ways to gain exposure

Brett Gundlock/National Post

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Don Campbell thinks everyone should consider real estate. Of course, you'd expect him to think that given his firm has advised clients on real estate purchases of more than $4 billion. The senior analyst at the Real Estate Investment Network in Vancouver, says every investor should be pondering where they can fit real estate into their overall strategy given the volatilities and uncertainties of the equities market.

[np_storybar title="Five people who are changing the real estate industry in

Canada" link="http://business.financialpost.com/2013/09/05/canada-real-estate-industry-leaders/"%5DReal estate is about more than just houses. We profile five Canadians who are changing the way we should be looking at the industry. Keep reading.
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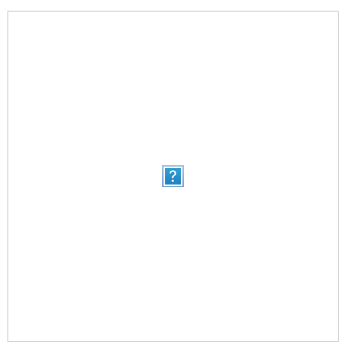
"A portion of your portfolio should be in housing or hard assets," he says. "Our clients lean towards owning their own homes and direct real estate. Our philosophy is that a good piece of real estate is like a blue chip stock. It won't make you rich overnight, but it will perform well."

Many investors already own their own homes or are paying off mortgages, so they have a sizeable portion of their overall net worth tied to a hard asset. But there are several other ways to invest in real estate including secondary properties, real estate income trusts and alternatives such as real estate limited partnerships. The key thing to remember is that no one asset type should take up more than 50% of an investor's portfolio, but how you get to that level can be dramatically different from person to person.

Home ownership and secondary properties

At a time when condo sales in Toronto were reported to have fallen 18% year-over-year, many raised the question of whether residential property, be it a primary residence, second home or vacation place, is actually an investment. Some, like David Kaufman, CEO of Toronto-based Westcourt Capital Corp., simply don't see homes as investment options. "A lot of people treat their primary residence as an investment, but they aren't in a traditional way," Kaufman says. "One of the things people forget is that if you live in an appreciating area, unless you are willing to exit the market and move to some other area, it is hard to make money on it."

Kaufman adds many think they'll always make money off their properties because of the leverage involved and the long-term growth of real estate prices in recent years. "They think real estate will always go up in value ahead of inflation, but that assumption must be fallacious at some point," he says. "The music has to stop when there's no real estate affordable for people to live in."


Tyler Anderson/National Post

But Campbell thinks you can make smart real estate investments by looking at trends in the area you are buying into. He says buyers must look at more than current real estate values and investigate other issues such as job growth in the region, GDP growth and economic development to determine whether those factors will positively impact prices. "If you are going to buy, buy where job growth and GDP growth is," he says. "Don't buy cheap, but where long-term demand is good."

As for vacation properties, Wayman Crosby, CEO of Nicola Crosby Real

Estate Asset Management Ltd. in Vancouver, says although prices have dramatically risen in the past decade, expenses have also increased and need to be considered. “Costs associated with vacation properties are often greater than a primary home,” he says, adding that funding the costs associated with these properties are done in after-tax dollars. “My belief is that the market for recreational properties may have peaked and, given the costs, no longer represents the kind of investment opportunity of the past.”

Some pundits claim personal real estate isn’t a very liquid investment, and is limiting for those who may need access to capital. Campbell disagrees. “If you need to sell a piece of property, you can,“ he says. “But if you want to squeeze the last nickel out of it, it might appear illiquid. Canadians have this incredible emotional attachment to property. But once you get by that and recognize you can pay someone 7% for looking after the place and that there aren’t that many issues that come up anyway, then you can put it in your portfolio like your other investments.“

The REIT Conundrum

Real estate income trusts have long been considered a safe way for the average investor to gain exposure to the property market. Experts, however, see REITs as investment vehicles that are linked to the volatility of the overall stock market. Yes, REITs offer liquidity, but they come with a series of potential pitfalls, Kaufman says. His company is concerned REITs can be readily affected by equity market trends as well as by interest rates. For example, many Canadian REITs were hit hard by rising interest rates in May, with several showing declines of more than 5% in the months that have followed. Kaufman isn’t sure the damage is complete.

“We have fears that we will witness that the publicly traded REIT market could face volatility that vastly exceeds the volatility of the stock market because it has three elements affecting value,” he says. “There’s the net asset value, there’s the stock market and the effect of rising interest rates that operate independently of the stock market. You could have a double whammy.”

Crosby agrees REITs are linked to market sentiments, and at some points in recent history represented a discount to the underlying real estate values. However, many REITs more recently have traded above the value of the underlying property as investors chased distributions.

Campbell says you have to do your research if you chose to invest in REITs: Find out where and what they are buying. What is the strategy? Are they speculating on higher-risk turnarounds or relatively safe investments such as apartments and commercial properties? “Why would I dramatically increase my risk for the small chance of a greater return? You need to understand where they are putting your money,” he says.

The RELP Opportunity

Investment advisors looking to open up real estate possibilities for clients are increasingly pondering the option of real estate limited partnerships, which are essentially privately-held versions of REITs. Some provinces have rules that make it easier to invest in these real estate options, but in Ontario you have to be an "accredited investor" with assets exceeding $1 million or a household income of more than $350,000 to invest in RELPs.

Kaufman likes the RELP opportunity because it isn't tied to the public markets, thereby limiting the volatility that commonly plagues REITs, while still typically offering a total return in the 10% range. "The reason some pooh-pooh them is because they say these REITs aren't publicly traded," he says. "I say I don't care. If I'm able to redeem at the net asset value rather than some price set by some day trader in his pajamas from his basement, then that's what I care about. I'll give up 29 days of liquidity for the lack of ridiculous volatility."

Liquidity is an issue, says David MacNicol, president and portfolio manager at Toronto-based MacNicol & Associates Asset Management Inc. MacNicol started offering real estate investments to his clients five years ago, and now many come seeking them specifically. He says RELPs have less liquidity — his clients can typically get out after two years without penalties — but adds these investments aren't for people looking to make a quick buck. Instead, they are aimed at those looking for longer-term returns. "We have more and more people looking for direct investment into real estate — 10% per year with 2-3% volatility," he says, noting the volatility of the public markets can be four times higher.

Some investors are scared of RELPs because they feel private investment is where frauds are more likely to occur. But Kaufman says many put too much faith in a prospectus, a document that doesn't offer any real protection against fraud. And Campbell says the notion of malfeasance in the RELP market is overdone, and certainly no worse than what has happened in the publicly-traded sector. "The checklist for RELPs is easy," Campbell says. "Where are they buying and who is doing the buying? What's their track record? Are they quality investors?"

He recommends digging deep into the history of those running the RELP before plunking down any cash. He also says to look for companies with management experience in the real estate market and past successes. "I'm not a fan of putting money into the first time someone does an LP," he says. "Just because they have a high profile doesn't make them great investors. I see people write $150,000 cheques because they like the investor. I'd rather people checked out the investor and their track record."

MacNicol says one of the good things about owning alternative real estate investments is that they have limited the peaks and valleys that the public markets have experienced in recent years. The TSX in 2011 was down about 11%, while his company's real estate fund was up 3.5%.

"That's what our investors are looking for," he says. "They don't want to be up 20% one year and down the next. In the old days, a balanced portfolio got you through the highs and lows of the equities market. That won't cut it any more. To try to achieve a 3-4% cash flow return like you might be able to in a bond portfolio, we can do that in a half-weighting position in our real estate portfolio."

In the end, Campbell says the fundamentals work for all forms of real estate investments, regardless of whether they are a personal acquisition of a vacation home, a stake in a publicly-traded REIT or looking at the RELP market.

"No matter what you are analyzing, go back to the basics: where and who is involved, and is there a good solid future?" he says. "I've done this for 21 years and these things have never changed. I'm looking for a place with a future and not a past."

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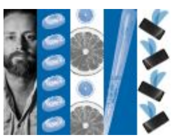

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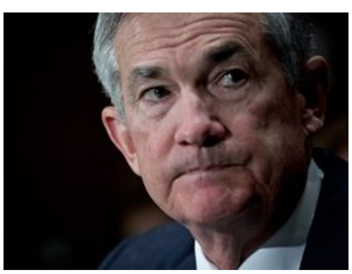

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