

## Dollars &amp; Sense

## Should You Invest in Real Estate?

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Just about everyone who invests does so in major asset classes including stocks, bonds, and cash equivalents. When it comes to real estate, though, you'll find widely divergent opinions about its importance in an investment portfolio. There are some well-respected people and institutions who say that real estate investing is unnecessary, and there are others who will tell you it should

be your primary asset class. I've recently debated whether I should start investing more heavily in real estate, so I wanted to lay out the basic arguments for and against real estate investing.

### What is Real Estate?

The answer to this question is not simple because real estate investing comes in many forms. There are relatively passive ways of investing in real estate, such as Real Estate Investment Trusts (REITs). According to Investopedia, a REIT is "a type of security that invests in real estate through property or mortgages and often trades on major exchanges like a stock." In other words, you can simply invest in a REIT like you do any other stock, mutual fund, or exchange-traded fund (ETF).

Just send your money to your investment company, and you own a little slice of passive real estate.

There are more active methods of investing in real estate, such as fixing and flipping. You purchase a property, you make improvements to it, and then you sell it to someone, hopefully for a profit. As you can imagine, this would take quite a bit more work than investing in a REIT.

There are probably over 100 other ways you can invest in real estate. This abbreviated link (<https://goo.gl/A6Gaiv>) will take you to an article on Bigger Pockets, one of the largest websites about real estate investing, entitled "The Top 100 Ways to Make Money in Real Estate." Check that out if you are interested.

### Arguments Against Investing in Real Estate

Regular readers know that Vanguard is my go-to source for both advice and my own investments. Vanguard considers real estate an alternative

investment, and according to them "alternatives usually come with more risks and higher costs." They believe that a diversified portfolio of stocks and bonds provides enough diversification and that alternative investments are unnecessary. Only "sophisticated investors" should consider alternatives, and they see direct real estate investment as "expensive and time-consuming." Most people have exposure to real estate in the equity in their house and diversified stock/bond funds than often include REITs, real estate companies, and mortgage-backed securities. For these reasons, Vanguard doesn't think additional investment in real estate is necessary.



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Another argument against real estate investing is that it can quickly become a second job. While you can hire property managers, they are probably not going to provide the level of service most Type A, detail-oriented physicians desire. Most of us are already fully employed and don't need a second job. If we did, we could very easily get paid \$200/hour or more to do one. This opportunity cost is difficult for real estate to compete with. In addition, owning investment properties can create additional legal risk.

When you purchase an individual property, it is like buying a single stock. You are taking what is called

an uncompensated risk. Larry Swedroe defines an uncompensated risk as, "Risk — that is, the risk of owning single stock or sector of the market — that can be diversified away. Since the risk can be diversified away, investors are not rewarded with a risk premium (higher expected return) for accepting this type of risk." Essentially, you are putting all your eggs in one basket that is not diversified by location or property type. Investing in real estate via a REIT can avoid this problem because REITs invest in properties that are diversified (Swedroe, 2008).

Real estate is an illiquid asset class with high transaction fees. While I can sell my stock or bond mutual funds or ETFs in seconds online and pay extremely low expenses to do so, it will take me weeks or months to buy or sell a property. In addition, I'll likely pay 5-10 percent of the price in transaction costs.

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## Arguments for Real Estate Investing

Real estate is easily acquired, most often by purchasing your own single family house or condominium. You have to live somewhere, and there are several tax advantages to owning where you live. Interest payments on your mortgage and property taxes are tax deductible. If you sell your property, capital gains of up to \$250,000 if you're single or \$500,000 for couples are tax-free. In addition, paying a mortgage forces you to save by making regular payments, some of which pay off the principle balance of your loan. That is money you'll get back when you sell.

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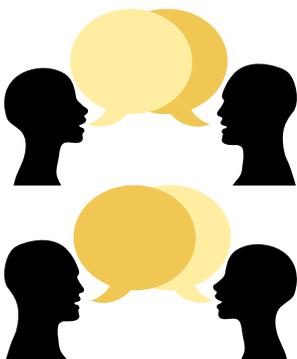
One of the goals of diversification is to have investments that are not correlated with each other. In other words, when investment A drops in price you have investment B that does not. When compared to stocks and bonds, real estate is not perfectly correlated with other investments and therefore provides diversification.

You can use leverage or "other people's money" to increase investment returns. Instead of buying a property for \$120,000, you could buy three \$160,000 properties with a \$40,000 down payment on each. This can increase your returns, but in a down market it can also dramatically increase your losses. As many found out during the housing market crash, leverage is a double-edged sword.

Real estate is an inflation hedge. Burton Malkiel says, "A good house on good land keeps its value no matter what happens to money" (Malkiel, 2015). Rents and property values tend to rise as prices rise, preserving your purchasing power. Since your mortgage payment doesn't change with inflation, while rents are going up your mortgage payment remains the same. Stocks do hedge inflation somewhat, but the companies they represent and the stocks themselves tend to get hurt as the prices of raw materials rise.

## The Bottom Line

There are a lot of different ways to invest in real estate, passively investing in REITs, fixing and flipping, owning rental properties, and all sorts of other investment opportunities. Like Vanguard, I don't think it is necessary to invest in real estate, but it is something to consider if you think you will either enjoy it or believe the value it adds to your investment portfolio is worth the effort.



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## Bibliography

- Malkiel, B. G. (2015). *A Random Walk Down Wall Street*. New York: W. W. Norton & Company.
- Swedroe, L. E. (2008). *The Only Guide to Alternative Investments You'll Ever Need*. New York: Bloomberg Press.

If you have ideas for future columns or have other resources you'd like to share, email me at [jschofer@gmail.com](mailto:jschofer@gmail.com).

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