

## 15.1: Real Estate Investments

### Learning Objectives

1. Distinguish between direct and indirect investments in real estate.
2. Identify the four main ways to invest in real estate indirectly.
3. Explain the role and the different kinds of REITs.
4. Discuss the role and uses of mortgage-backed securities.

When you buy a home, even with a mortgage, you are making a **direct investment**, because you are both the investor and the owner who holds legal title to the property. For most people, a home is the single largest investment they ever make.

As an investor, you may want to include other real estate holdings in your portfolio, most likely as an **indirect investment** in which you invest in an entity that owns and manages real estate. Studies have shown that real estate is a good diversifier for financial investments such as stocks and bonds. Jack Clark Francis and Roger G. Ibbotson, *Contrasting Real Estate with Comparable Investments, 1978–2004* (Ibbotson Associates, 2007), <http://corporate.morningstar.com/ib/asp/detail.aspx?xmlfile=1409.xml> (accessed June 24, 2009).

### Direct Investments

Sonia is looking to buy her first home. After graduating from college, she decided to stay on because she liked the town and found a job as an elementary school teacher. She loves her job, but her income is limited. She finds a nice, two-family house in a neighborhood close to the college. It needs some work, but she figures she can use the summer months to fix it up—she's pretty handy—and renting to students won't be a problem. The tenants will pay their own utilities. Sonia figures that the rental income will help pay her mortgage, insurance, and taxes, and that after the mortgage is paid off, it will provide a nice extra income.



Figure 17.2.1 . © 2010 Jupiterimages Corporation

Many real estate investors begin like Sonia, buying a rental property that helps them to afford their own home. If you actively manage the rental property, there are tax benefits as well. Of course, you have to provide maintenance services and arrange for

repairs, and, in Sonia's case, perhaps give up a bit of privacy. A second or vacation home can be used as a rental property as well, although the tax benefits are less assured. In both cases, the investor is making a direct investment in the property.

The advantages to a direct investment are the additional rental income and tax benefits. The disadvantages are that real estate is relatively illiquid, and the investment concentrates your portfolio in one asset class—residential real estate. Conventional wisdom was that real estate was a good hedge against inflation, but the recent burst of the housing bubble—not only in the United States but also worldwide—has cast a shadow on that thinking. Also, to realize the tax benefits, you must actively manage the rental property, and being a landlord is not for everyone.



Figure 17.2.2 : © 2010 Jupiterimages Corporation

Other direct real estate investments include **commercial property**, or property exclusively for rent, and undeveloped land. Developers buy property or land and seek to profit from quickly improving and reselling it. Both are more speculative investments, especially if purchased with debt financing. They may also prove to be illiquid and to concentrate assets, making them inappropriate investments for investors without a large and diversified portfolio.

## Indirect Investments

Investors who want to add a real estate investment to their portfolio more often make an indirect investment. That is, they buy shares in an entity or group that owns and manages property. For example, they may become limited partners in a real estate syndicate.

A **syndicate** is a group created to buy and manage commercial property such as an apartment, office building, or shopping mall. The syndicate may be structured as a corporation or, more commonly, as a limited partnership.

In a **limited partnership**, there is a general partner and limited partners. The general partner manages the entity, while the limited partners invest in partnership shares. The limited partners are only liable for the amount of their investment; that is, they can lose only as much as they have put in. Limiting liability is particularly important in real estate, which relies on leverage or debt financing. Investors find syndicates valuable in limiting liability and in providing management for the property.

Another form of indirect investing is a **real estate investment trust (REIT)**—a mutual fund of real estate holdings. You buy shares in the REIT, which may be privately held or publicly traded on an exchange. The REIT is a fund invested in various commercial properties. Some REITs specialize, concentrating investments in specific kinds of property, such as shopping malls, apartments, or vacation properties.

To qualify as a REIT in the United States (for the allowable tax benefits), a fund must

- be managed by directors as a corporation or trust,
- offer transferrable shares,
- not be a financial institution,
- have at least a hundred shareholders,

- have at least 95 percent of income from interest, dividends, and property,
- pay dividends that are at least 90 percent of the REITs taxable income,
- have at least 75 percent of its assets invested in real estate,
- get at least 75 percent of gross revenue from real estate.

An equity REIT invests in property, while a mortgage REIT provides real estate financing. A hybrid REIT does both. REITs do for real estate what mutual funds do for other assets. They provide investors with a way to invest with more liquidity and diversity and with comparatively lower transaction costs.

Another way to invest in the real estate market is to invest in the real estate financing rather than the actual real estate. **Mortgage-backed securities (MBS)** are bonds secured by pools of mortgages owned by large financial institutions or agencies of the federal government.

It is difficult to price mortgage-backed securities—to gauge their present and future value and their risk. Like any bond, mortgage-backed securities are vulnerable to interest rate, reinvestment, and inflation risk, but they are also particularly vulnerable to economic cycles and to default risk. If the economy is in a recession and unemployment rises, mortgage defaults will likely rise. When mortgage defaults rise, and the value of mortgage-backed securities falls.

Because they are complicated and risky, mortgage-backed securities are appropriate only for investors with a large enough asset base and risk tolerance to support the investment. MBS investors are usually institutional investors or very wealthy individuals.

### Key Takaways

- Direct investments in real estate involve controlling ownership and management of the property.
- Indirect investment involves owning a share of a company that owns and manages the real estate.
- Indirect investments may be structured as
  - a syndicate,
  - a limited partnership,
  - a real estate investment trust (REIT).
- A REIT is designed as a mutual fund of real estate holdings.
  - An equity REIT invests in property.
  - A mortgage REIT invests in real estate financing.
  - A hybrid REIT does both.
- Mortgage-backed securities are another way to invest in a real estate market by investing in its financing, but they are considered too risky for individual investors.

### Exercises

1. View the video “Top Eight Real Estate Investment Mistakes” at [www.5min.com/Video/Top-Eight-...takes-24084962](http://www.5min.com/Video/Top-Eight-...takes-24084962). According to the speaker, based on eight common mistakes that real estate investors make, what eight things should you do to succeed? The same speaker gives advice on how to be a landlord at [www.5min.com/Video/What-Does-...dlord-27579055](http://www.5min.com/Video/What-Does-...dlord-27579055). What five points does she identify as most important?
2. What have been your experiences as a landlord or as a tenant? Collaborate with classmates to develop two lists: advantages and disadvantages of direct investing in rental property and of being a tenant in a residential or commercial space. Have you had any experience with developing or “flipping” property for resale? What is your opinion of direct investing in foreclosed homes to flip for profit? For perspectives, see the 2009 Money Talks videos on this subject, such as “Vulture Investing” at [www.youtube.com/watch?v=rXF1d...fs&feature=fvw](http://www.youtube.com/watch?v=rXF1d...fs&feature=fvw). According to the MSN article “Flipping Houses Is Harder than It Looks” at <http://realestate.msn.com/article.aspx?cp-documentid=13107725>, why is flipping houses so challenging?
3. Are you already invested in real estate? Record in My Notes or your personal finance journal information about your investment and/or your strategy for including real estate in your investment portfolio. Will you invest directly, indirectly, or both? What is your plan and timetable for executing your strategy? Choose one of the REITs listed at “In Reality” at [www.inrealty.com/restocks/linmrt.html](http://www.inrealty.com/restocks/linmrt.html) to track and to consider hypothetically as an investment. What might be some advantages and risks of investing in this or another REIT as part of your investing strategy?

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