FP INVESTING

Real estate means more than your home

COMMERCIAL SPACES

Office buildings, hotels, offer a way to diversify

By David Pett

Canada's housing market is apparently on the ropes, particularly in major cities such as Vancouver and Toronto where prices appear overvalued. The softening market might lead investors to consider trying to cash in on the rebounding U.S. market. Housing prices stateside are expected to grow in the high single digits this year and nearly 15% next year, after several years of steady declines.

But real estate as an asset class should not be mistaken for just owning one's home or buying a second house or condo as an investment. Instead, it should include commercial properties including hotels, apartments, office buildings and both retail and industrial premises, where there are still huge opportunities on both sides of the border for investors looking to diversify their portfolios.

"While we cannot make a case for speculating in residential real estate based on current rents and prices, we continue to hold and acquire high quality commercial real estate in Canada and the U.S.," said Dylan Reece, a financial advisor at Vancouver-based Nicola Wealth Management Inc., in a recent report to clients.

Some people invest in real estate by directly purchasing properties, but that requires significant capital and specialized expertise, and comes with the headaches of being a landlord. As a result, most real estate investment is done indirectly, either through listed securities such as real estate investment trust (REITs) or through unlisted real estate companies, funds and limited partnerships known as RELPs that usually have direct ownership of the assets.

In Canada, there are dozens of REITs trading publicly in Toronto, as well as several mutual funds and exchange-traded funds that invest in the sector. Private real estate investment options are less prevalent, but growing in number.

Some examples include the **Great-West Life Real Estate Fund**, a segregated fund that invests in more than 100 Canadian properties and **King-Sett Capital**'s suite of real estate limited partnership funds.

Institutional investors, including some the world's biggest pension funds, and high-net-worth individuals are by far the most active participants in this asset class.

For example, members of Tiger 21, a North American networking organization for the wealthy that collectively manages US$18-billion in investable assets, allocate an average of 25% of their portfolios to real estate.

Karl Mergenthaler, an executive director at J.P. Morgan, said real estate has emerged as an attractive investment class following the global recession to help diversify portfolios and hedge against inflation risk. He believes both public and private real estate investment offer opportunities, but due to their different characteristics in risk and return, it may be appropriate for investors to invest in both types.

REITs are perhaps the most popular real estate vehicle for both institutional and retail investors, he said, largely because they offer greater transparency and liquidity, while also providing steady income, usually derived from rents or interest payments due to refinancing.

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Sunlight reflects off the facade of the Lipstick Building at 885 Third Avenue in New York. REITs and private real estate funds allow investors to own commercial properties.

Since stock markets bottomed in March 2009, the S&P/TSX REIT index has climbed 160% compared to just 68% for the S&P/TSX composite over the same period. A similar story has unfolded south of the border.

But REITs have some drawbacks, including their tendency to experience higher volatility than private real estate investments.

"Consequently, it is easier for investors to be affected by euphoria and panic in the broader stock market," Mr. Mergenthaler said. "As a result, asset pricing can more easily diverge from the underlying property value, and downturns in the public real estate realm tend to happen more quickly."

This characteristic was particularly evident during the financial crisis that caused stock markets around the world to lose 50% over their value. From the end of 2007 to Mar. 31, 2009, Canadian REITs fell 44%.

"In many ways, REITs behave like equities in the short term and direct real estate over the long term," he said.

Private real estate funds, by comparison, tend to be less correlated with the broader equity markets and react less to short-term trends or news.

Mr. Mergenthaler said they also provide the prospect of higher returns than REITs and the potential for active improvements and more control over the properties.

On the downside, he said investors are often hesitant to put their money into a private fund because of liquidity and fee concerns, as well as initial investment requirements that can be as high as $1-million.

"Physical properties are rather illiquid, potentially taking months to sell," Mr. Mergenthaler said. "As a result, investments are usually locked for long periods of time, and thus downturns can be more prolonged."

Mr. Reece's firm prefers investing in a combination of private and public real estate and offers clients exposure to both through its Real Estate Fund, which primarily holds REITs, and through SPIRE and SPIRE U.S., its two real estate limited partnerships.

"Our investment approach to real estate has been to allocate a reasonable portion of our clients' wealth and our own personal assets in income-producing real estate such as office, retail, industrial and self-storage properties," he said.

"While we like real estate as a hard asset and a long-term store of wealth, we primarily own real estate for its sustainable and predictable cash flow from rents. Capital appreciation — or growth — is a secondary consideration."

Mr. Reece said commercial real estate generally yields 5% to 8% unlevered and expects that to more or less continue.

Given the choice between the U.S. and Canada, he favours the former where property values have been dramatically cheaper than in Canada, especially considering the 30% appreciation in the Canadian dollar over the past decade.

"Where we are seeing the most opportunity is in U.S. real estate," he said. "Pension plans around the world, including both the Canada Pension Plan and Norwegian Sovereign Wealth fund recently announced that they are making strategic shifts into the U.S. commercial real estate markets."

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