Crowdfunded Private Equity vs. REITs – Pro/Con Series

[Editor’s Note: Today’s debate participants are Jilliene Helman, of Realty Mogul, advocating for crowd-funded Private Equity (the business she is in) and myself advocating for publicly traded REITs for providing diversification into real estate for your portfolio. We have no financial relationship.]

PRO – Crowdfunded Private Equity Is Better Than REITs

The recent movement toward online “crowdfunding” has begun to make private real estate investment opportunities more accessible to investors. Diversification remains a key concern, however, and the real estate investment trusts (REITs) that would seem to solve that problem for “average” investors continue to be given short shrift by the larger financial institutions. What gives?
REITs operate pools of many different properties and their shares offer at least a degree of liquidity. Yet recent surveys estimate that institutional investors continue to place between 80% to 95% of their real estate allocations into private real estate investments, rather than publicly traded REITs. Crowdfunding sites tend to similarly focus on private opportunities.

Many market participants insist that there are simply some things that private real estate investments can do better than public REITs. Some of these purported advantages are:

- Public REITs are driven partly by underlying market sentiment, rather than real values
- REITs are limited by asset class or geography; but cycles don’t always track either of those groups, so private opportunistic buying makes more sense
- Private equity is better managed and investor-aligned because sponsors are highly invested, and so focused on achieving high returns
- Private equity is disciplined by its focus on achieving a successful exit
- The liquidity of public REITs is illusory (only the biggest REITs are liquid)
- Private equity can be nimble, with more ability to buy at the bottom of the market and sell at the top
- Private transactions use a bit more leverage, so should be able to outperform public funds

It seems that part of the issue with REITs lies with their
essential nature. Basically a creation of the Internal Revenue Code, a REIT is a real estate company or trust that has elected to qualify under certain tax provisions to become a pass-through entity that distributes to its shareholders substantially all of its taxable earnings, in addition to any capital gains generated from the sale or disposition of its properties. To qualify for this tax treatment, a REIT must follow several legal requirements, probably the most significant of which is that distributions to shareholders must equal or exceed 90% of the REIT’s taxable income.

This requirement would seem to be beneficial to investors, but it can prove to be a handicap. Because they must distribute nearly all of their income, both mortgage and property REITs must regularly sell equity in order to grow, i.e. acquire more assets. Institutional investors holding REIT shares are continually being approached to increase their existing positions, a circumstance that can worsen liquidity issues at smaller REITs whose shares are already largely held by just a few institutional holders.

Refinancing risk includes not only the risk associated with the cost of debt, but also that relating to the availability of capital. In 2008, the subprime mortgage crisis resulted in a very severe credit crunch in which many REITs were unable to refinance corporate or property-level debt when it came due, regardless of operating performance. The focus of discussion became “survivability,” and there was a massive sell-off in REIT shares. One very high-profile REIT, General Growth Properties – which had been one of the largest REITs in existence – sought bankruptcy protection.

REITs also face other issues that tend to reduce their attractiveness to some investors. They tend to focus only on the highest “Class A” assets, and are often unable to take advantage of “core-plus” or “value-added” properties needing some remodeling or more extensive renovation to get their cash
flows up to desired levels — but which also offer greater potential returns. Another drawback is that the value of REIT shares can fluctuate constantly, just like any other stock. If one purpose of real estate is to provide true asset class diversification, some people argue that REITs fail that test simply by being publicly traded. Private real estate investments are somewhat insulated from — or at least not closely correlated with — the equity markets.

The debate over whether private real estate investments or publicly-traded REITs are better overall investments will surely go on for some time. REITs suffered greatly during the recent recession but have lately come back strongly, with many institutional investors taking a greater stake in them than in earlier years. Nevertheless, most large institutions — and crowdfunding sites — remain focused on private investments, for reasons of reduced volatility, exposure to a broader range of opportunities, and true asset class diversification.

CON — REITS Have Their Benefits

What you have read above was submitted to me as a guest post for the site. I felt it lacked balance, which isn’t surprising given the occupation and business interest of the author(s). As Upton Sinclair famously said, “It is difficult to get a man to understand something, when his salary depends upon his not understanding it.” I find myself much more ambivalent on the subject of public REITs vs Crowdfunded Real Estate, so I’ll be arguing from the Con perspective. There are several reasons why an investor may opt for using REITS over private equity of any kind for his portfolio, and these should not be discounted. Keep in mind while reading this that I am NOT defending privately-traded REITS, which are an investment which is sold, not bought. Here I give 7 reasons why publicly
traded REITs are better than crowd-funded Private Equity.

1. Historically Low Correlation With the Stock Market

Critics of REIT investing describe REITs as real estate flavored stocks. Like any company traded on the stock market, REIT share prices can and do go up and down with the general market, particularly on a short term basis. However, so does the price of any piece of real estate, whether privately or publicly held. The value of your home goes up and down every single day, whether you like it or not. Just because the value isn’t published in the Wall Street Journal or broadcast across CNBC doesn’t mean it isn’t changing. The idea that the value of a private real estate investment isn’t as volatile as a public real estate investment is an illusion. Besides, the only prices that matter are the price on the day you buy and the price on the day you sell. If those dates are decades apart, then for all intents and purposes, the volatility simply doesn’t matter.

REITs do provide a diversification benefit. Correlations vary over time, and the lower the better. Current correlations among stock asset classes are quite high compared to historical norms. Adding REITS to a portfolio isn’t like adding an asset class like bonds (current R squared= -0.49), but REITS (0.85) have a lower correlation with the overall market than both international stocks (0.91) and small value stocks (0.96). Rick Ferri’s All About Asset Allocation has a nice graph showing the rolling 36 month correlation between a REIT Index and a US Stock Index. It varies from -0.10 to as high as 0.90. REITS might have dived just as badly (actually worse) than the overall market in 2008, but they certainly fared better in the Tech Stock Crash and did far worse in 2013. They might not always zig when the market zags, but they do sometimes.

2. Available From A Household Name
One huge benefit of owning publicly traded REITs over crowdfunded private real estate is that you can buy REITs from a firm that is a household name, like Vanguard, Fidelity, or T. Rowe Price. Vanguard has been around since the 70s and manages trillions of dollars a year. If you want to crowdfund real estate, you’ll need to go to a small start-up most investors have never heard of to do so. I only know of one company doing this, and it is the company which submitted the article above on it. Unproven would be a nice way to describe the concept. I don’t need to go run a background check on Jack Bogle and Gus Sauter before buying a fund at Vanguard, but you’ll need to spend some time and money doing due diligence before investing with any private real estate firm.

3. Easily Diversified

If you go to Vanguard and buy their REIT index fund, you’ll own 126 individual REITS, each of which owns dozens or even hundreds of properties. When you buy a crowdfunded or syndicated investment, you get a single property. That’s it. Thousands of properties versus one property. Talking about all your eggs in one basket. At $5-100K per property, even a physician investor is going to have a hard time getting real diversification.

4. Exceedingly liquid

My debate opponent criticizes many public REITs for not being very liquid. While that may be true, that’s Vanguard’s problem, not mine. The fund is highly liquid. You can buy or sell your entire holding in the fund or any portion thereof any day the markets are open, commission-free. While an investor doesn’t need to have instantaneous liquidity for his entire portfolio, pretending there is no value in liquidity is
foolish. If you’ve ever had to sell your house, you know the meaning of an illiquid investment. Many private real estate investments lock your money up for years. If the only people who can buy your investment from you are accredited investors, don’t count on being able to get out of it quickly, at least not without offering “fire sale” prices.

5. Available At Very Low Cost With Low Minimums

Most private equity real estate investments will require you to invest $50-100K in the investment. Realty Mogul is unique in that it only requires $5K. But even that is $4930 more than the Vanguard REIT ETF requires. Fees are also significantly different. Vanguard charges 10 basis points for their admiral shares. Private real estate charges an acquisition fee averaging 179 basis points, an asset managing fees averaging 185 basis points, property management fees ranging from 2.25% to 8.5%, and disposition fees averaging 225 basis points. Plus, after you receive your preferred return of 5-10%, 20-50% of your additional return goes to the sponsor. Every dollar you pay in fees comes directly out of your return. I’m not saying a private real estate syndicator can’t find deals that are sufficiently good to overcome these fees, but that’s not an insignificant hurdle to overcome.

6. Easily Leveraged

My opponent suggests that private equity has higher returns because it is more highly leveraged on average. That may or may not be true, but it isn’t like you cannot leverage up your REIT returns. You can always buy them on margin, or even a somewhat safer method like using a home equity loan. But keep in mind that leverage works both ways, magnifying both gains and losses.

7. Excellent Returns

Public REIT returns have been historically excellent. The
NAREIT Index has average annual returns of 11.96%. The Vanguard fund, begun in 1996, has average annual returns of 10.45%. Returns will probably be lower in the future, but it is anyone’s guess how much lower. I have no idea what the long term returns of any given “crowdfunder” or “syndicator” might be. Chances are good that a solid audited return couldn’t be provided even if you asked. Although you can probably get data on a single investment, you are unlikely to be able to obtain the long-term overall data for a small firm. If you do, be sure it is an “after-fee” amount.

Overall, REITS have their problems. It is a tax-inefficient and volatile asset class. Real estate is an illiquid, inefficient market. There is a great deal of room for a talented investor to add value. Crowdfunded or other private real estate investments have the potential to boost your portfolio returns and provide valuable diversification. I’m very excited to see what Realty Mogul is doing for real estate investing. But let’s not overstate the case. REITS provide diversification and liquidity with little hassle.