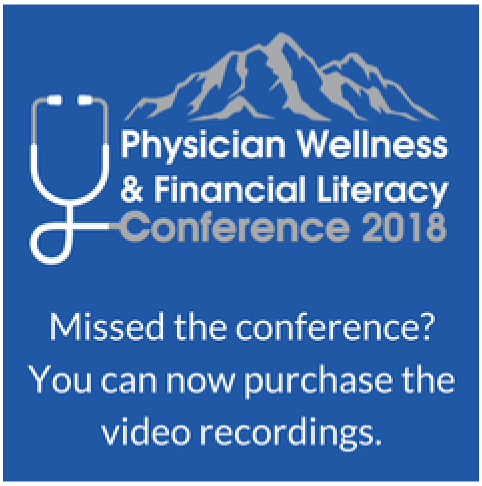
Real Estate Vs Stocks – An Investing Showdown

I've noticed a strange but interesting theme among investors. Real estate investors like to denigrate stock investors as speculators who buy "paper assets" subject to market crashes. Stock investors bash real estate investors as "people who want a second job," "get rich quick schemers," and "people who can't accurately calculate a return." As with most stereotypes, there is some truth to them. Both types of investments have their pluses and minuses. You can do both of them poorly, but done well, both are likely to lead to wealth. I have at times found myself in two separate arguments at the same time, one in which I am defending real estate investing and one in which I am pointing out its flaws. In this post, I'll discuss some of the advantages of each, as well as ways in which they are far more similar than the extremists like to admit.



8 Ways to Compare Real Estate vs. Stocks Investments

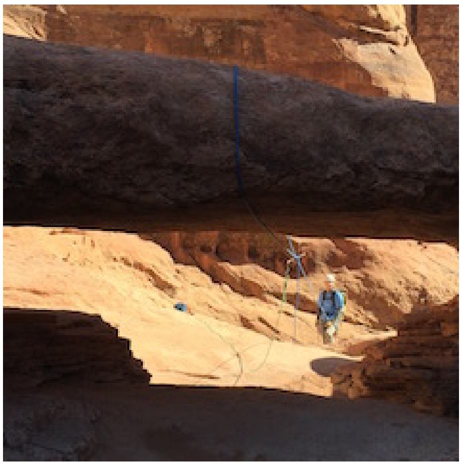
1. Generating Profit From Business Ownership

Real estate investors seem to forget what a stock is. A share of stock is partial ownership of a business. Believe it or not, GE, Exxon, Apple, and Disney all make money. If you own a share of these companies, you share in the profits. These profits come as dividends and as capital gains. A share of stock is not like a piece of gold, where it's value is purely speculative. Future cash flows can be discounted to the present and a real value assigned to the company. While there is a significant speculative component to short-term returns, this cancels out over the long term, leaving the stock investor with a fundamental return derived primarily from how well the business is run. This is far different from buying a barrel of oil or a painting and hoping the value goes up.

Well-run real estate is also a profitable business, with a fundamental return derived primarily from rents. Increased rents, in turn, increase the value of the property. Both investments involve placing your capital into a business that has the expectation of generating a profit on that capital. Those who have done better in real estate like to say real estate has higher returns and vice versa. But as near as I can tell, if you're accurately calculating unleveraged returns and taking into account the value of your time, the returns are very similar with both asset classes over the long run.

Advantage: Tie

2. Generating Passive Income



Granary Canyon bridge rappel, Moab, UT

Stock investors, particularly buy and hold index fund investors, pride themselves on portfolios that take literally minutes a year to maintain and deride real estate investors for failing to take their time into account when calculating their returns. Some real estate investing, of course, requires so much active input from the investor that it becomes a career. Consider a house-flipper for instance. He spends days searching for a property, hours and hours purchasing it, a few more days fixing it up, and hours and hours selling it for a profit. This investor might be very proud to say "I bought it for $75K cash and sold it for $115K just 3 months later!" That's a 332% annualized return! However, if he includes the $25K he put into it, that return drops to a 63% return and if you include the 120 hours of time he poured into it the return drops to 10% annualized (perhaps 6-7% after tax), and there was significant risk of that return being a lot worse.

Next on the spectrum of passivity is the real estate investor who does his own property management and maintenance. Experts estimate that, on average throughout the rental cycle, each unit you own will require 5 hours a month to manage and maintain. Even if you buy and hold this property for years, and hire a property manager to do most of the management tasks, many hours of work above and beyond what it would take to maintain a portfolio of index funds are required. There are yet more passive ways to invest in real estate. We've discussed real estate syndication on this blog numerous times. There is some initial time required to do due diligence, but after that, there is little ongoing time requirement. The more passive you wish to be, of course, the more ongoing expenses you have. Finally, you can invest in "real estate flavored stock", such as the Vanguard REIT index. While most experts agree REITs are a separate asset class from the overall stock market, the correlation with an index fund portfolio will be far higher than an investment in an apartment building in your city. Real estate is generally a much more active investment when compared to stock index funds, but there are ways to minimize the active involvement.

A real estate proponent also has the counter-argument that while it is possible to invest in stocks in a very passive manner, there are a whole lot of people out there doing it actively. That ranges from picking actively managed mutual funds and reviewing them from time to time to day trading. The more active your investing, the more you need to take into account the value of your time in calculating returns. For a busy high income professional able to trade time for money at a very high rate, maintaining passivity in his investments is very important.

Advantage: Stocks

3. Generating Income And Capital Gains

Far too many investors fall into the "income investing" trap. Dividend stock investors are the classic example, but real estate investors are even worse. It is important to understand the concept of total return investing to avoid this trap. A dollar spends just the same whether it came from income or from capital gains. Neither is necessarily any better. Both stocks and real estate have both an income and a capital gain component. 10% returns are not unusual for either investment, but with a stock you are much more likely to get 8% from capital gains and 2% from dividends whereas with real estate you are more likely to get 8% from income and 2% from capital gains. If you fall into the income investing trap, you would think that real estate is somehow the better investment because the income is higher, but in reality returns are returns. Real estate investors like to argue that total return stock investors are "eating the goose that laid the golden egg" but in reality the stock goose grows faster and lays smaller eggs when compared to the real estate goose. They both provide the same amount of food in the end.

Real estate investors love to talk about "becoming financially free" and "replacing their income" with the income from their properties. There is nothing magical about real estate in this respect. The money you spend doesn't care where it comes from. Safe withdrawal rate (SWR) studies show that you can take a certain amount of inflation-adjusted money out of a portfolio each year and expect it to last. If you're just spending the income, the portfolio will last forever, but you'll end up with a lower standard of living than you could have had with a total return SWR approach. You can just "spend the income" with both stocks and real estate.

However, one benefit of real estate over stocks is that because real estate returns come more from income than capital gains they are less volatile. If you have the same return from a less volatile portfolio, you can have a higher safe withdrawal rate from it. Plus, the process is more automated with real estate. The capital gains component tends to move along at the rate of inflation, automatically increasing income each year with inflation, so you can just take the inflation-adjusted income each year and spend it without any complicated calculations.

Advantage: Real Estate

4. Tax Advantages

Real estate investors love to talk about the tax advantages of real estate. There are many, but there may be even more with stocks. Real estate investors are able to deduct their expenses, including mortgage interest, from their income. Businesses (stock shares), of course, get to do this too. Real estate investors get to depreciate their assets, but so do businesses. The stock investor may not be as aware of all these benefits, but he is reaping their benefits all the same.

Real estate investors like to point out that they can avoid capital gains taxes by exchanging from one property to another and then at their death the heirs inherit it with a stepped-up basis. However, if you inherit stock shares, you also get a step up in basis. You can also tax loss harvest both assets. Stocks enjoy more favorable tax treatment of their returns. Long-term capital gains and dividends are taxed at a favorable tax rate whereas real estate income (the lion's share of returns) is taxed at your full marginal tax rate. Exchanges do cost stock investors taxes, but not if done within a retirement account. Real estate investors like to point out that they get "paper losses" for the first few years of ownership. Unfortunately, for a high-income investor like a physician, those paper losses can't be used to offset earned income.

Stocks are also easily invested in using retirement accounts. 401Ks and other tax-deferred accounts save taxes with an up-front tax break, tax-protected growth, and a tax-bracket arbitrage at the time of withdrawal. Roth accounts don't provide that up-front tax break but do provide tax-free growth and withdrawals for you and your heirs. Aside from REITs, it can be a big pain to invest in real estate in retirement accounts, and even if you do so, you lose some of the tax benefits, like depreciation, that you would otherwise get.

Advantage: Stocks (Slight)

5. Ability to Use Leverage

One of the biggest advantages of real estate investing is the ability to use leverage in a safer manner. It is possible to invest in stocks using leverage through a margin account, although most investing experts recommend against it. The main issue, aside from increased volatility and variable interest rates, is margin calls. In a big bear market (which will come as it always does) the investor will be forced to come up with cash to cover the margin call. Mortgages, however, are generally long-term loans, are fixed at low-interest rates, are collateralized with the property itself, and are non-callable. It is possible to use mortgage money to invest in stocks, but you are then putting your home or other property at risk, rather than just the investment. Leverage, of course, works both ways, and there are plenty of real estate investors who were ruined in the recent housing market downturn due to using too much leverage, but as a general rule, it is far safer to use in real estate investing than in stock investing.

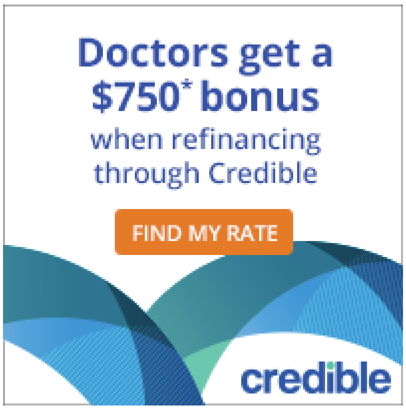
Advantage: Real Estate

6. Liquidity

One of the biggest downsides of traditional real estate investing is that it is highly illiquid. Roundtrip transaction costs may be up to 15% of the value of the property, 5% to buy and 10% to sell. Plus, it may takes months to do so. In contrast, a portfolio of publicly traded stocks can be liquidated under normal conditions in minutes. While there can be some illiquidity issues with stocks in a down market, they pale in comparison to the issues with real estate, where there may be no buyers for a property at any reasonable price for years. It is also far easier to rebalance a more liquid portfolio to maintain an appropriate risk level.

Advantage: Stocks

7. Efficiency



The publicly traded stock market is highly efficient. It might not be perfectly efficient, but compared to the real estate market it might as well be. There are many opportunities to both outperform and underperform in real estate depending on your skill level. If you are skilled at assessing, purchasing, and selling property and talented at managing it, you will be rewarded with high returns. If you try to manage your own rental property but aren't good at screening tenants and feel badly raising rents to the market rate, your returns will stink. With stock investing, especially using a buy-and-hold static asset allocation of low-cost index funds, your talent and skill will have little effect on your returns, for better and for worse.

Advantage: Real Estate (slight)

8. Volatility

Nobody gets their rental property assessed every month, much less every minute of every day the markets are open. That doesn't mean the value of the property doesn't fluctuate wildly. The value of a property is whatever someone is willing to pay for it. However, the owner only thinks about the property value on rare occasions; perhaps once a year when the tax assessment comes and when he buys and sells it. Since he isn't confronted with a talking head on CNBC every afternoon screaming "buy buy buy" and "sell sell sell" he is unlikely to sell except when his life circumstances change. Stock investors should also be like that, but who are we kidding. The vast majority struggle to stay the course in market downturns, so much so that they often have to mix stocks with an asset that has a lower expected return (like bonds) to lower volatility to the point they can sleep at night. Stocks are risky investments with high expected returns. Real estate is also a risky investment with high expected returns. Bonds, however, are relatively lower risk with corresponding lower expected returns. The more bonds you have to hold to lower volatility, the lower your return is likely to be over the long term. Real estate's lower volatility, whether real or just perceived, allows investors to tolerate a riskier portfolio, boosting expected returns.

Advantage: Real Estate

Overall Winner

Looking at these eight aspects of investing, I see real estate winning 4, stocks winning 3, and a tie. That is essentially a draw in my mind. The truth, however, is that you don't have to choose between these two great asset classes. You can have both. I have a large percentage of my net worth invested in stocks. I also have a significant percentage tied up in real estate, including my principal residence, a rental property, shares of the LLC that owns the building housing my business office, and REITs. Both assets provide great returns and diversify each other. You may favor one asset class over the other in your portfolio, and that's fine, but you can reap big benefits by avoiding an extreme position in this debate.

What do you think? Stocks? Real Estate? Both? Sound off in the comments section!