Should I Invest in a Real Estate Syndication or Fund?

[Editor's Note: This post is republished from Passive Income MD and is a great discussion of syndicated real estate investments and real estate funds. I invest in these with up to 15% of my portfolio, but it is a huge chunk of PIMD's portfolio. If you want to learn more about this stuff, consider taking the PIMD Syndicated Real Estate Course. Enrollment is open until July 9th and if you enroll through this link, I'll throw in a signed copy of my new Financial Boot Camp book.]

We get a lot of great questions posted in our Facebook group, Passive Income Docs, and someone asked this recently:

If you were to invest in one type of passive real estate investment, what would it be and why?

The discussion, in essence, came down to whether it is better to invest in a real estate syndication or a real estate fund?

To cut to the chase, there's no perfect answer as each has its pros and cons. You'll see that on the surface, there are more similarities than differences. However, I thought that for this post I'd do a little side-by-side comparison to help you decide.

But let's back up a bit…

What Is a Syndication?

I've talked about this before in greater depth, but in summary, a syndication is the pooling of capital from multiple investors to invest in a single real estate opportunity. This makes otherwise cost-prohibitive investments a lot more accessible for the individual investor. Generally, the funds raised in a syndication are for a specific opportunity or building.

A famous example of this was the syndication led by Helmsley and Malkin. In the 1960s, they led a group of investors that bought the Empire State Building for $65 million. Many of those investors contributed only $10,000 each.

One of my first ventures into real estate investing was a syndication of an apartment complex where I invested $25,000. The total amount raised was ~$2 million. In that situation, a property was identified and the syndicator (the manager of the opportunity, also known as an operator or sponsor) allowed investors to come in as limited partners.

What Is a Real Estate Fund?

There are many different types of real estate funds, but for the sake of simplicity, I'm going to talk about funds that raise money for debt (debt funds) or for equity deals (equity funds).

Debt funds raise capital, then invest it by lending out money for professionals to utilize and return with interest. The investors are essentially "the bank." Who's borrowing these funds? Well, it's typically developers and fix-and-flippers who need the money for the short term.

As for *equity* funds, the sponsors raise money and then go out and acquire multiple properties. The goal is to buy the properties, improve the operations, then sell them for a nice profit down the road. It's more of a blind trust though where capital is raised at the beginning based on the sponsor's vision, track record, and reputation. Properties are added later. (An example of this type of fund is the one I made a $50,000 investment in last year by MLG Capital, a partner of this site.)

Comparing Real Estate Syndications and Funds

When it comes to the question of whether to choose either a syndication or a fund, there are some considerations to keep in mind.

Term (Length of Investment)

Syndications typically have loosely defined terms. This means that the end date (when the property is sold) is given a target range (3-7 years is quite common). However, the exact end date is ultimately up to the discretion of who’s operating the deal. I’ve seen syndications that end in 2-3 years because it was a great opportunity to sell, but I’ve seen ones go 9-10 years.

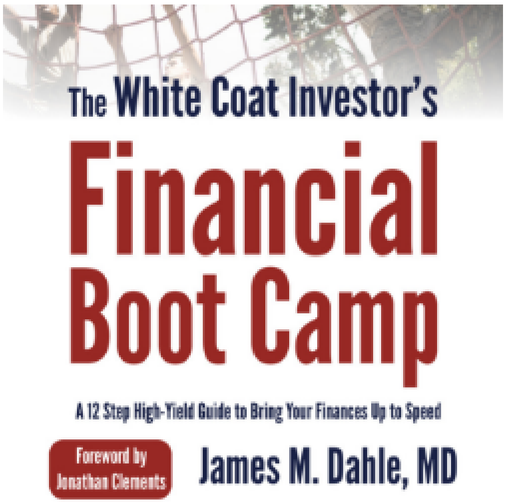
Real estate funds can be either classified as open or closed.

Closed funds have a definitive start date and, like a syndication, the end date again is given as a range (could be anywhere from 3-10 years). Again, the close of the fund depends on when the last property in the fund is sold.

Open funds are ongoing. You can join, get returns, and pull your money out according to their terms. There are usually incentives and disincentives to keep your money in longer and not pull out shortly, especially within the first two years. They might give you an incentive (additional return points) for staying in longer, or they might tack on a fee if you pull out within a certain early period.

Either way, you should make note of those terms before deciding to invest.

Liquidity



The liquidity of a certain investment means how quickly you can get your cash back if needed. It can vary widely for real estate investments based on the terms as mentioned. With a syndication or closed-ended fund deal, you're typically locked in for the entire length of the term with no opportunity to voluntarily remove the capital you invested. Therefore liquidity is considered low.

However, with an open-ended fund, there are usually clearly defined ways to have your capital returned. You may see terms like "redemption period," which means that once you put in the request, there are a certain number of days before you can have that money received. Therefore liquidity is considered much higher in these types of funds.

For example, I see 90-day terms quite a bit, meaning you can ask for the return of your capital, but it may take 90 days to receive it. There might be a limitation on the amount of capital you can withdraw within a certain time period, so make note of it. For example, they might say you can only redeem 50% of your capital within the first two years.

Again, all of this is highly variable based on your particular investment so read the paperwork well and ask about this.

Return Structure

In both syndications and funds, returns are typically offered the same way – you often have something called a preferred return and in addition, you might also receive a split of the profits on top of that preferred return.

For example, the deal might have a preferred return of 8%, meaning they aim to give investors distributions of 8% on your investment each year. Only when the investor receives that 8% does the rest of the profits get split between investors and operators at a set percentage. An example of this split is 70% investors /30% operators.

Do syndications or funds have the potential for higher returns? Well, it’s completely different deal to deal, but oftentimes funds require a little additional management and you may see additional fees as a result. Again, read the fine print.

Vetting

For a syndication, [vetting the deal] involves taking a close look at the sponsor and the property. You get to see who is operating and running the deal, their track history, etc., but also the exact property you’re investing in. Look at the current operations of the property and the future assumptions they make after taking over it. Does it make sense and is it reasonable given the market and their previous history?

For example, for my very first syndication, vetting the property wasn't too difficult. In fact, I think I was able to hurdle that "first investment" fear because the property was less than five miles from my house. I knew the property, I knew the location, and there was a certain comfort level in that. The hardest part was vetting the sponsor because I had never invested with them before. I'll be honest, I didn't know how to vet the sponsor as well as I do now.

For a fund, the vetting focuses purely on the sponsor. Trust is very important because you invest your capital typically not knowing what they'll purchase with your funds. However, they typically give you an idea of the type of properties they're going to target.

However, fundraising for these funds can span a few years so depending on when you invest, you might have a chance to see a few properties that they've already acquired into the fund.

So how do you vet a fund sponsor? Asking them for their track record is a good way to start. How long have they been around? Have any investors lost capital in previous funds? What types of properties are they targeting? How are they mitigating risk? For a full story of how I vetted a fund sponsor, check out this case series.

Investment Minimums

A big consideration, of course, is how much the minimums are to invest.

That amount is highly variable and depends on where you find these opportunities. If they're presented on a crowdfunding site, you might find some lower minimums like $10,000.

However, for most syndications and funds, I find the minimums are typically $25,000 or $50,000. Many are even higher, in the range of $50,000 to $250,000. On average, real estate funds are often larger in size (10-250 million) and therefore they're clearly looking for larger investments (larger minimums).

Taxes

When you invest in a syndication, state tax returns are typically easier – after all, you're only investing in one property in one state. If you're not a resident of that state, you'll typically have to file tax returns both in your home state and the state where the investment is located.

When you invest in a fund, depending on the reporting, you might have to invest in multiple states. If they provide a single K-1, then you might only have to file in one, but make sure to consult your CPA. However, each fund structure is different so carefully consider how taxes will be filed.

Both syndications and funds offer tax benefits such as depreciation and pass them along to investors. Often times, even though you've received distributions, you show a net loss on the K-1 that can offset other passive income you've gained that year.

Just for fun, I've attached an example of a K-1 from a syndication with all confidential information removed. Note the rental income loss in spite of distributions. You can see it here: K-1 example_Redacted

To summarize, both syndications and funds can be tax-efficient investments, but make note of how many tax returns you'd have to end up filing.

Diversification

A syndication is an investment in a single property. So to achieve true diversification, you would need to invest in multiple syndications in different areas with different syndicators. Each time, you would have to meet the minimum requirements, therefore it might be quite a large investment to make overall.

Funds are, by nature, more diversified because they're investments in multiple properties and deals. I like to say that investing in syndications vs funds is similar to investing in stocks vs mutual funds. Mutual funds, because they're a collection of investments, are considered better diversified, and therefore, for the most part, carry less inherent risk. With one minimum investment, you're able to achieve higher levels of diversification than with a single syndication.

Risk

As I mentioned, diversification is one way to mitigate risk.

When it comes to risk management, knowing who's running the deal is the most important factor. You need to find out if your syndicator or fund manager has done this before, what their track record is, and if they know how to handle it if the market softens.

Investing in one property isn't quite diversified, but if you are confident in that one property and the sponsor, it can be a lot better than having multiple properties of which you have no knowledge. Part of that comes down to trust, and that's why I stick to fund operators with a great track history.

Summary

Whether you should invest in a syndication or a fund is a tough decision to make. From the above considerations, you can see that they're similar in many ways.

Both can be great vehicles to create passive income through real estate. After the due diligence portion, you basically wait for updates and for deposits to show up in your bank account.

However, their differences are enough that you should weigh the pros and cons of each.

Personally, I invest in both. I've started to form relationships with certain syndicators that I trust, and if I see a good property that they're raising money for, then I'll invest in it. I also invest in real estate funds with experienced sponsors, and I know that investment will be put to good use.

Whichever you choose to do first, the most important thing is simply your due diligence. Learn how to properly vet sponsors. Learn how to properly vet properties. Learning how to do these things well takes time & experience, so the more you do, the better you'll get. Ask yourself how much risk you're willing to tolerate.

Once that's all done, the hope is that investing in passive real estate opportunities will create the passive income that you're looking for.

Do you invest in syndications, real estate funds, or both? Why or why not? Comment below!

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