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4 Ways to Add Real Estate to Your Asset Mix

From direct options like flipping a home to indirect like REITs, individual investors have a host of ways to gain exposure to the property sector

ILLUSTRATION: THOMAS FUCHS

Individual investors who want to diversify into real-estate investing have no shortage of options—from the direct, like purchasing a property to flip or rent

out, to the indirect, such as real-estate investment trusts or crowdfunding syndicates.

Now may be a good time to consider it. Demand for residential property remains strong, according to the National Association of Realtors. Home prices also are expected to rise, according to housing-finance firm Fannie Mae, even as the cost of lumber and other construction materials gyrates thanks to tariffs.

But financial advisers say that picking the best strategy depends on your appetite for risk, your tolerance for dealing directly with properties and tenants, and the size of your overall portfolio. Potential real-estate investors should also understand the factors that determine property valuation, appreciation and cash flow, advisers say, as well as the tax considerations that affect all three.

Don't just apply your observations about your neighborhood's real-estate trends to potential investments, says Brian Spinelli, a certified financial planner with Halbert Hargrove, as the rising costs of insurance, maintenance and home-improvement supplies can upend your calculations for returns.

Here are some things to know about real-estate investing options.

1. REITs

Publicly traded real-estate investment trusts, or REITs, are a low-cost way for individual investors to gain access to a variety of property sectors—including residential, commercial, office, warehouse and institutional. You can invest in REITs directly or through mutual funds or exchange-traded funds.

One important distinction among REITs: an "equity REIT" owns and manages properties, while a "mortgage REIT" buys mortgages secured by real estate. An equity REIT's return is delivered by rent and property appreciation, while a mortgage REIT's returns come from the interest on the mortgage payments.

What's more, REITs must distribute at least 90% of their taxable income to shareholders annually, making them popular with income-hungry investors. REIT dividends usually are taxed as ordinary income, which means that REIT investors can't claim some of the tax advantages of more-direct forms of real-estate ownership, such as depreciation.

Investors should be aware that sometimes fees are opaque. It can be hard to figure out exactly how much REITs are charging for managing the properties and transactions, say advisers. And REITs that hold commercial, industrial and distribution properties are subject to the whims of the sectors they serve, which injects another dynamic for capturing consistent returns.

Publicly traded REITs are a low-cost, low-barrier on-ramp to learning how professionals manage and value real-estate investments, says Spinelli. You can delve into the factors that professional investors use to extract income, tax advantages, asset appreciation and valuation.

2. Stocks

Another way to gain exposure to the real-estate sector without buying a property is to invest in publicly traded home builders, construction companies, suppliers and even home-improvement or furniture retailers. You can get in on these companies by buying their stock directly or by investing in sector mutual funds and ETFs.

One upside of this approach: Some stocks' returns can be strong even if physical property sales and prices are stagnant. Financial advisers point out that the market for single-family houses is cyclical, meaning stocks in related sectors can be subject to the same ups and downs. But when home sales are slow, renovation often picks up, which lifts adjacent sectors like home improvement and makers of fixtures, paint, tile and carpet.

Of course, when the stock market is down as it has been recently, real-estate-related stocks can get caught in the same downdraft. While dividends may be able to offset a decline in value, there is no guarantee that a stock will rebound.

Another point of caution: Advisers suggest taking a look under the hood of your holdings in broad-based funds as builder stocks and related sectors already may be represented. If so, single stocks might increase the proportion of real estate in your overall portfolio more than intended.

3. Shared ownership options

Partnerships and syndicates allow investors to share the risk and returns of direct ownership without having to get their hands dirty.

One way to get involved in a shared-ownership opportunity is by creating a legal entity for buying and managing properties with other like-minded investors such as friends or relatives. With this option, you will need appropriate legal arrangements to define the investment, ownership, responsibilities and an exit plan.

Unless someone from your group has the time or ability to manage the property, you will have to hire a management firm. Or if one of your investors agrees to manage the property, you will need to quantify that person's compensation in the partnership agreement.

Tim Carr, deputy chair of the real-estate department at the University of Wisconsin, says another option is to invest through online platforms that offer slices of ownership of large properties to investors, a process known as syndication. Two popular platforms—BiggerPockets and RealtyMogul—offer a variety of properties, deal structures and potential returns.

These platforms allow nonaccredited investors—those with net worth under $1 million, excluding their primary residence, or income under $200,000 for individuals or $300,000 for couples—to get in on syndicated deals that previously had been open only to accredited investors.

But advisers say it is important to get familiar with the terms. When will the private syndicates pay investors? How are payments determined? How much does the platform charge, both for its services and for any property management and other associated fees? Investors should also confirm the qualifications, licenses and track records of these platforms.

4. Private ownership options

Buying a property to fix and flip or to rent is a common, yet high-risk and potentially high-return, endeavor.

For one thing, capital appreciation or steady rent checks look great on paper, but any rise in property value is offset to some extent by improvements, maintenance, property taxes and insurance.

"The appeal of direct holding is the asset appreciation plus potential cash flow," says Spinelli, but with the rising costs of ownership, "it's a lot harder to make the cash flows work."

Another risk from direct ownership: natural disasters.

“You need to understand the implications of where you buy,” says Peter Krull, partner and director of sustainable investing with Earth Equity Advisors. That means scrutinizing the climate risk of your investments—and not concentrating risk by, say, buying several properties in a flood-prone neighborhood.

On the other hand, direct ownership gives you maximum control over the quality of improvements, tenant selection and maintenance. And there are tax breaks often available only to direct property owners.