PORTFOLIO STRATEGY

Real estate: Put an addition on your holdings

If you're in the market for the long term, it's almost always a good time to invest

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One of the most solid investments you can ever make is right under your feet. It's real estate and few other assets are as functional or appreciate as consistently. Many Canadians have all or most of their real estate holdings in their principal residences but analysts say that may not be enough to create a well-diversified real estate portfolio.

Like any sector, the real estate market has its peaks and troughs, but if you're in it for the long term, it's almost always a good time to invest. According to the Globe Real Estate Peer Index, all forms of real estate have gained in value by an average of 6.5 per cent annually over the past 20 years. More recently, a hot market has advanced the sector by an average 16 per cent annually over the past three years.

The most difficult thing for investors to determine is not when to invest but rather how much of their overall portfolios should be committed to real estate.

"There is no rule of thumb," said Tom Zaks, an investment adviser at RBC Dominion Securities. "It all depends on the individual investor's time horizon, financial goals, tax considerations and risk level." Mr. Zaks says that once an individual determines a comfortable real estate weighting, the key is diversification within the sector -- and a principal residence is just part of that. While we may feel safe and secure in our own homes, he said investors who consider the equity in their homes sufficient could be putting all their eggs in one basket.

A home is only a single asset, in one real estate subsector, in one geographic area. That means it's susceptible to any unique development that could cause it to lose value. That risk level rises when you take into account the degree a principal residence is leveraged through a mortgage.

Many investors looking to diversify their real estate holdings beyond their primary residences purchase secondary properties. Secondary properties have the potential to provide capital appreciation and income through rental fees, which are both subject to taxation -- minus a few deductions. Mr. Zaks said many of his retail clients who venture on their own into the real estate market often regret the decision when faced with the headaches that landlords face with tenants. In addition, secondary properties are often purchased in similar areas and subsectors -- exposing them to the same risk as the primary property.

For the cost of a small management fee, Mr. Zaks suggests investors diversify their real estate holdings through an array of real estate securities including direct stocks, mutual funds, real estate investment trusts (REITs) or exchange-traded funds (ETFs).

There are eight open-ended real estate mutual funds with a track record exceeding five years available on the Canadian market. The top performer is the U.S. dollar-denominated AGF Global Real Estate Equity fund with an average annual return of 18.7 per cent. On the diversification scale it's about as far away as you can get from your home on the range. The fund holds roughly a third of its assets in North America, a third in Europe and the rest in Asia.

The second best-performing real estate fund over the past five years is the Dynamic FocusPlus Real Estate fund. Canadian assets dominate the fund, which has an average annual return of 16.3 per cent.

The CIBC Canadian Real Estate fund ranks third with an average annual return of 15.3 per cent. Fund manager Charles Dillingham sees his fund as a perfect complement to home ownership. "So often, housing and the overall real estate market are an entirely different thing," he said, adding that most of the real estate investments in his fund are leveraged less than 50 per cent compared with home ownership, which often exceeds half.

More than 80 per cent of the $54-million CIBC Canadian Real Estate fund is invested in Canadian real estate holdings. Roughly one-third of the total assets are invested in Canadian real estate investment trusts, a quarter is invested in U.S. REITs and the rest of the fund holds individual real estate stocks.

The fund has a heavy weighting in Alberta. The top holding is Calgary-based **Mainstreet Equity**, which buys and maintains multifamily residential properties. The second-largest holding is Melcor Developments -- an Edmonton-based residential developer with commercial holdings and a couple of golf courses to boot. The fund holds no more than 10 per cent in any one stock. "The diversification and management skill has helped us to find small companies with unique growth potential," he says.

Mr. Dillingham recommends an overall portfolio weighting of 10 to 15 per cent in real estate -- more if the investor has no equity in a home. He cautions that his fund and home ownership share some risks. "They both have that overall economic risk that involves interest rates and inflation."

Management expense ratios (MERs) on real estate funds range from 2.44 to 3.24 per cent. Global real estate funds tend to have higher fees as a result of the added cost of managing a fund on a global level.

Another way to diversify your real estate holdings is through real estate investment trusts. REITs are a type of income trust or mutual fund that trade like a stock. Gail Mifsud, real estate analyst with Raymond James Ltd., agrees that the key to investing in REITs is finding the right mix of holdings. "I think diversification is what the real estate investor should strive for to reduce the natural cyclicality."

According to Ms. Mifsud, one of the best-diversified REITs available is Canadian Real Estate Investment (REF.UN TSX). With $1.6-billion in assets, CREIT is the oldest REIT on the

Canadian market. It holds more than 132 properties in various real estate asset classes across the country. In 2005, investors earned a total return (capital gain plus distributions) of 35.5 per cent.

Another potential portfolio stuffer she singles out is H&R REIT (HR.UN TSX), which has produced an average annual return of 18 per cent over the past 10 years. In addition to spreading risk, she said REITs have the potential to provide better capital appreciation than a residential property. "Home values generally appreciate with inflation, making them more like a long-term bond yield," she said.

Investors looking for a diversified stake in the real estate market without the expense of a managed fund or REIT can purchase the iShares Canadian REIT Sector Index fund sponsored by Barclays Global Investors Canada. The iREIT Fund tracks the S&P/TSX Canadian REIT Index. Two REIT ETFs also trade on the Toronto Stock Exchange: S&P/TSX Capped REIT (RTRE TSX) and iShares S&P/TSX REIT ETF (XRE TRX). It's important for investors to know that the holdings are determined by market weighting only, and there is no manager at the helm to temper a sector downturn.

While real estate is considered a relatively safe long-term investment, there have been some dark clouds forming on the housing horizon. Just this week the U.S. Commerce Department reported that construction of new homes fell in July for the fifth time in the past six months. It was the slowest pace for building new homes since November, 2004, signalling the U.S. housing boom is slowing. The slowdown has been more moderate in Canada but according to Peter Norman, vice-president at Clayton Research, the fundamentals are still strong. "Every cycle has a peak, and real estate is on the downside."

Dale Jackson is a producer at Report on Business Television.

Top performing funds

5-year average annual return

1. AGF Global Real Estate Equity ($U.S.)	18.70%
2. Dynamic FocusPlus Real Estate	16.3
3. CIBC Canadian Real Estate	15.3
4. Mackenzie Universal World Real Estate Cap Class	14.1
5. Sentry Select REIT	14

Top performing REITs

Year-to-date return

1. Boardwalk	38.10%
2. Whiterock	22.7
3. CHIP	21.8
4. Dundee	18.1
5. Crombie	17.1

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