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Investment Showdown: Stocks Versus Multifamily Properties

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There is no question that many people have built their wealth over time using multifamily real estate investments. Likewise, many people have amassed significant amounts of money by investing in the stock market. So in a strategic showdown, which investment takes the prize — multifamily real estate investments or the stock market?

I can tell you from personal experience how I fared, because over the years I've invested in both multifamily properties and stocks. Historically, the average return on stock market investments since the 1950s is 7%. Certainly, some years are higher, and some are lower. In contrast, the average internal rate of return (IRR) I've seen on multifamily property investments over the past year was 16% to 18%. Of course, there are pros and cons to each type of investment, so let's take a look at those before deciding the winner.

Liquidity

If I woke up tomorrow and read some negative news about one of the stocks in my portfolio, I could sell the stock before it dropped significantly. On the other hand, if I read some bad news about a real estate market where I own properties, there wouldn't be much that I could do about selling a property in my real estate portfolio in one day — or over a longer period of time, for that matter.

Stocks have the advantage in liquidity. You can buy and sell as you deem appropriate, even on the same day if necessary. Real estate, on the other hand, takes time to list, show to potential buyers and ultimately negotiate a price. This process can take months if the right buyer doesn't come along immediately.

However, if you are a passive investor in a syndication, your investment can be liquid. When you invest in a property as a passive investor, you're actually buying shares in a limited liability corporation (LLC) that holds the property. After the first 12 months of owning those shares, according to SEC regulations, you are able to sell those shares to anybody. It's not as easy as selling shares in the stock market, because you'll need to find buyers, and it also depends on whether the syndicator you work with allows it, but generally speaking, your investment is liquid after 12 months.

Advantage goes to: Stocks

Leverage

With stocks, you can have leverage by purchasing stocks on margin. That means you will buy a stock using 50% of your own cash, and up to 50% of margin that you are "borrowing" from the broker. The minimum amount of a margin account is $2,000. Of course, you will pay interest to the brokerage firm for lending you the margin money.

Let's say you buy 100 shares of XYZ Corp at $100 a share. That's $10,000. But with margin, you can purchase 200 shares, because the brokerage firm will cover the cost of the additional shares with margin at 50%. If the stock goes up, you're fine. If the stock drops, you will get a margin call to bring your account back to the 50% level. If you don't put in cash, they will sell stock to cover the amount. It's a higher-risk proposition than simply purchasing stock for cash.

With multifamily properties, you can use leverage as well. You don't have to come up with 100% of the equity, and you can leverage up to 70-80% of the cost of the asset. When buying a large multifamily property (five units or more), you're eligible for interest rates from governmental agencies with rates as low as 3–4.5%. Leverage is better with multifamily compared to stocks, since you can use greater leverage (70-80% compared to only 50% in stocks).

Advantage goes to: Multifamily properties

Tax Benefits

When you sell stocks, you'll pay 100% of long-term or short-term capital gains (short-term is when you sell a stock within one year). You'll pay short-term capital gains tax based on your ordinary income. And if you have a long-term gain, you'll pay approximately 15% tax.

With multifamily properties, you'll pay very little or even zero tax on profits. Here's why. There are two types of profits for multifamily investors: profits during the hold period (as long as you are the owner of the property), and profits from the sale of your property.

During the hold period, you can get property income, such as rents, which you can deduct against expenses and lower the taxable income. Expenses include utilities, repairs, salaries, etc. You can also use capital expenditures (CapEx) for bigger-ticket items, such as a new roof or HVAC system, to deduct from your taxable income. Finally, there is depreciation, which you're able to accelerate using cost segregation.

Most properties depreciate over 27.5 years, but with cost segregation, assets can be depreciated a lot faster, and you can use that depreciation to offset income. Cost segregation studies examine all of the various parts in the property, including the doors, roofs, floors — in fact, just about everything. Based on the analysis, the depreciation can be accelerated to five, seven or 15 years, versus the 27.5-year depreciation that the IRS places on the building. This way, owners can depreciate a larger amount in a shorter period of time instead of spreading the depreciation over 27.5 years.

When the property sells, you can avoid paying taxes by using a 1031 exchange, which means you can defer paying capital gains taxes on the sale as long as another "like-kind property" is purchased with the profits from the sale of the property and the purchase is completed within 180 days.

Advantage goes to: Multifamily properties

Summary

As you can see, when you add up the leverage and tax benefits available from investing in multifamily properties, they far outweigh the liquidity advantage gained from buying stocks. My personal experience is that over time, building wealth by investing in multifamily properties is much better than playing the stock market.

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