Why Commercial Real Estate Is An Important Investment Class

The perfect investment — one that is highly profitable and completely secure, with numerous tax advantages and stability — is, like the unicorn, a mythical beast. Investment has always, from its very beginning, entailed the idea of some risk.

When many investors think of a well-diversified portfolio, they often only think in terms of investments like stocks and bonds, or maybe a mutual fund or ETF. Savvy investors understand the importance of having a diversified portfolio. Diversification protects you against losses. If one investment class performs poorly, you can still reap gains from others. It's a balancing act that works. A truly diverse portfolio will go beyond just investing in stocks and bonds and also include assets like commercial real estate (CRE).

Even when market cycles fluctuate for one reason or another, CRE remains a desirable investment thanks to its stable nature. That steady nature makes commercial real estate a great way to diversify a portfolio. In addition, investing directly in CRE offers assets that can appreciate and provide cash flow.

Let's look a little more in-depth at the advantages of investing in commercial real estate.

Solid Returns Over Time

In general, most investors understand that it is better to hold an asset over time than to jump in and out chasing gains. In this respect, CRE can provide solid, predictable returns. Investors in commercial real estate typically receive steady cash flow for their investments, with income generally distributed annually, quarterly or even monthly. That's because high occupancies and predictable rents often provide the steady cash flow that most investors are looking for.

The average annual return of commercial real estate over 20 years is roughly 9.5%, nearly 1% greater than the S&P 500's average annual return of 8.6% over the same period of time. Those types of returns add stability to an investment portfolio.

An Escape From Correlated Returns

Correlated returns mean that one investment's return is linked to the performance of another. The returns for those investments, either positive or negative, tend to move in the same direction at the same time. Commercial real estate, by contrast, is a noncorrelated investment. Its performance is not typically linked to that of the stock or bond markets.

Real Estate Is A Tangible Asset

For many people, real estate is attractive because it is a tangible asset. It's an asset class that investors can see and touch. You can visit a property yourself to learn more about its size, condition, location and other factors that can affect earnings. If something happens to a structure on an investment property, the land is still there for rebuilding or for sale.

For some people, that's more reassuring than buying shares in companies that may not survive. However, it should be noted that real estate has some risks that other investments, such as stocks and bonds, do not. For example, unoccupied properties may cost an investor money over time. Additionally, real estate is a fairly illiquid asset. That makes it an investment that is best for those who are in for the long haul rather than those who may need their money on short notice.

Leverage

Not only is CRE likely to appreciate, but most owners also carry mortgages on their property. This allows them to leverage their investment dollar, while at the same time building equity in the property.

For example, a property that is purchased with 20% equity and 80% debt only has to go up 20% in value for the invested equity to have a return of 100%. However, that leverage comes with additional risk — the risk of foreclosure if the property can't make its monthly mortgage payments. Therefore, the key is to make moderate use of debt ensuring there is enough cash flow from rents to service the monthly mortgage payments.

Tax Advantages

No discussion about the value of commercial real estate as an investment would be complete without mentioning some tax benefits in owning CRE. When you invest in stocks and bonds, you can expect to put aside a portion of your earnings to pay capital gains taxes. Unless the investment is part of a qualified plan or retirement account, these taxes are hard to avoid.

By contrast, with commercial real estate, there are a number of ways to reduce or eliminate capital gains. If you have purchased well-located properties, those properties should go up in value over time. Yet, for tax purposes, you can depreciate the value of the buildings over time, which helps to reduce yearly taxable income. The net effect is you are depreciating for tax purposes what should turn out to be an appreciating asset for investment. Not many asset classes provide this benefit.

Additionally, profits when you sell may be postponed completely through what is known as a 1031 tax-deferred exchange. A 1031 exchange allows you to defer taxable gains if you invest in something similar within a prescribed amount of time.

It's An Inflation Hedge

An advantage of commercial real estate is that it can offset the long-term impact of inflation. A major factor is the fact that property rents can be adjusted with inflation, which is often the result of strong economic growth. This is quite different from investments such as stocks or bonds, in which inflation can yield diminishing returns.

Conclusion

Is commercial real estate the right investment for everybody? Probably not. But the benefits of investing in CRE include noncorrelated, predictable returns over time, along with tax advantages and an inflation hedge. That makes it close to the mythical unicorn in offering superior investment returns.