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How Humdrum Self-Storage Became the Hottest Way to Invest in Real Estate.

You've run out of room to stash that old cherrywood table, your high school sports trophies, Grandma's wedding dress and those bulging boxes of tax records. What to do? Rent a 10-by-15-foot storage unit, for about $100 per month, and stick all the excess stuff in there. Even if your home doesn't come with an attic, you have one now.

As commercial property goes, self-storage has none of the sex appeal of a gleaming office building or a ritzy shopping mall. There are more than 50,000 self-storage facilities in the U.S. — nondescript warehouses filled with cubicles where Americans keep the belongings that don't fit into their homes. But even though self-storage is about as unassuming an industry as you can get, it turns out to be a pretty solid investment — often better than other kinds of real estate.

self-storage_2000Readers of this column know that I often take note when wealthy, savvy investors figure out new, unconventional ways to get a good investment return. For several years, their favorite kind of real estate investment was the apartment property. But in the last several months, they've shifted to self-storage, a property type that seems a little humdrum.

Why? It is recession-resistant. There are other interesting factors that I'll explain. But first, here's some good news. Though some of the most exciting types of self-storage investments are restricted to only the wealthiest investors, anybody can get in on this trend. Ordinary investors can participate in the self-storage real estate market by purchasing shares of a real estate investment trust, or REIT, that concentrates on this industry. And even very wealthy investors can learn a lot about the sector by studying self-storage REITs and taking a cue from Forbes 400 member B. Wayne Hughes, who built his $2.4 billion fortune on self-storage.

The biggest REITs own vast pools of commercial property, such as offices, shopping centers or, in some cases, self-storage facilities, sometimes strewn across the country. (Other kinds of REITs are collections of mortgages; the type we're talking about are called equity REITs.) Their publicly traded shares usually offer nice dividend yields, paid for by tenants' rent. Unlike buying and selling a building or a stake in a self-storage property partnership, a cumbersome process involving deeds and brokers and lawyers, trading in and out of REIT shares is as easy as buying and selling stock on a stock exchange.

Of course, nothing in the investing world is invulnerable. Like any other asset, real estate values can fall, particularly in a recession. That's true of your home: Housing values, as measured by the S&P/Case-Shiller index, still haven't completely recovered from their plunge during the financial crisis. Back then, most REITs got walloped, too. The FTSE NAREIT All Equity REIT index lost almost 40% in 2008, even worse than the Standard & Poor's 500 index of stocks.

BUT NOT SELF-STORAGE.

In 2008, according to the industry's trade group, NAREIT (that's short for National Association of REITs), self-storage was the only REIT sector to post a positive total return of 5%, including dividends. That's quite a distinction, sort of like being the last contestant standing on The Voice.

The reason is that, in good times and bad, there is a need for these convenient repositories of clutter that no one can bear to toss out because, well, they might need it someday. In 2015, a flat year for stocks in general and a so-so one for REITs — equity REITs as a whole were up just 2.8% — self-storage had a boffo performance, up 40%, blowing away all other REIT sectors. This year, self-storage is in third place for returns among REITs.

In case you're wondering, as an investment class, equity REITs have done very well historically. Over five, 15, 20 and 25 years, equity REITs have outdone the S&P 500, the standard benchmark for stocks. Over 10 years, REITs trailed by a tiny amount, an annual 7.5%, compared to 7.7% for the S&P. So standing out in such a well-performing industry is a tribute to self-storage.

Now, let's be clear: I'm not saying that self-storage is a magical wealth-creating machine. This is not a glamorous business, and occasionally self-storage REITs have a negative year. Just not often, and hardly ever in recession years. If they do dip amid a recession, historically it has been small and followed by a strong comeback.

Let's look at the largest self-storage REIT, Public Storage PSA -3.98% (PSA). Founded in 1972 by B. Wayne Hughes, the company has 2,200 locations in the U.S. and Europe, with 142 million square feet of rentable space. (Hughes still serves as the company's "chairman emeritus," and his two children serve on its board of directors.) Public Storage slumped 20% in 2008, when the entire world economic system almost collapsed. Then in early 2009, it exploded, up fivefold — far better than the S&P 500, for sure. It pays a 2.5% dividend yield, better than the 2% from the S&P.

Potential self-storage yields can range even higher, if you opt for a private REIT, which means its shares can't be purchased on an exchange. The goal of these nontraded REITs is to be bought, either by another REIT or by a private equity firm. Take SmartStop Self Storage, which pays out 6%. Extra Space Storage (EXT), a public REIT, purchased it last year for $1.3 billion. SmartStop CEO H. Michael Schwartz has launched a second private REIT, SST II, and raised $300 million thus far. He says he sees an endpoint in three to five years.

Publicly traded REITs are probably the safest bet for most investors. That's because analysts closely follow them and they're transparent. Plus, there's no up-front fee to purchase them. For wealthier investors, nontraded REITs, which do charge up-front loads (but not necessarily if your advisor is fee-based only), are potentially interesting. After all, they're smaller and can pick away in sharpshooter fashion at a niche in the market that a behemoth like Public Storage can't be bothered with. Later, once a well-managed small REIT has assembled a significant portfolio, it can sell itself to a bigger player at a hefty premium.

With a private REIT, you can't cash out your investment instantly, as you can with a public REIT. You typically are locked in for a set period, maybe up to 10 years, although some allow you to withdraw piecemeal after a while. That confers some meaningful advantages. For example, the REIT doesn't have to worry about having to sell off properties to cover redemptions in a market panic. So if you're a wealthy, patient investor who values the idea of being involved with others like you, there may be a play here for you.

The self-storage sector has a lot of good news around it. Its key demographic driver will be strong for some time: the retirement of baby boomers, which is leading to a lot of home downsizing. After they sell the rambling four-bedroom house, they want to hang on to their beloved possessions, maybe to give them to their kids or to ship to a vacation home once they buy one.

Another ramification is a large and continuing migration to the Sun Belt, for both workers and retirees, and moves always mean households find how much excess they have. Further, in the wake of the recession, small businesses have awakened to self-storage as a great place to house excess inventory for less money than maintaining a warehouse.

One of the advantages of self-storage is that it involves little capital outlay, as compared to other kinds of commercial real estate, such as malls or offices or apartments. It also needs precious little upkeep. When an occupant moves out, management doesn't have to repaint or fix the plumbing. All that's needed is to sweep out the now-empty unit. Break-even for self-storage is just 45% occupancy, far below that of other sectors.

Self-storage is a classic mom-and-pop operation, owing to the low level of upkeep and capital spending required. That means it is ripe for consolidation by REITs. REITs bring economies of scale, with more money for marketing and thus better recruitment of space renters. Since 2012, NAREIT figures show that net acquisitions in the self-storage realm have surged by $8 billion, with $2 billion of it last year.

The hot play among REITs lately has been in apartments, which benefit from their own demographic trend. Nevertheless, self-storage may be a superior investment for the long term. The reason is interesting.

The millennial generation is powering the surge in apartment REITs. Last year, this group became the most populous in the U.S., containing 75 million people. With single-family-home prices high and climbing, apartments are the habitat of choice for the young set. Hence, there's been a burst of growth for apartment REITs over the past five years. Once they can afford it, young adults leave their parents' place and head for apartments. And they keep renting for a long time. According to real estate site Zillow, first-time homebuyers these days rent for six years before buying; back in the 1970s, it was 2.6 years. That all suggests that more demand for apartments is coming.

Trouble is, all this crowding into rented housing has set off a boom in apartment construction. In 2016's first quarter, rents dipped 4% and vacancies nudged up. Thus, research firm Green Street Advisors projects a tapering of growth in revenue per available foot between now and 2020. It cites elevated supply and slowing of job expansion

While more self-storage units are also under construction, this is not a frenzy. Why? They have difficulty gaining town governments' approval, says Green Street analyst Ryan Burke. To residential neighbors, who vote, self-storage seems tacky. Also, town councils rightfully see that a new self-storage locale won't be a job spur. The projects are easy to build, meaning no bonanza for local contractors, and only need a couple of guys to run the place. And they don't pay huge property taxes.

Could self-storage REITs be getting frothy, too? Sure. And there is some evidence that, at least with the top-tier self-storage REITs, valuations may be getting a bit rich. Green Street says that the biggest three self-storage REITs change hands at a 40% premium to net asset value.

The kingpin of self-storage REITs, Public Storage, with a $47 billion market cap, has a price-earnings multiple of 28 (where earnings are defined as funds from operations, which adds in depreciation and amortization expenses). On the other hand, the company has an enormous cash position and its 2.5% yield, while not stellar, is well-protected, meaning it has the financial resources to keep paying the dividend.

In short, self-storage REITs don't look ready to slow down anytime soon. That makes them truly a store of value.

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