Finding Real Value in Real Estate Investing: REITs

Managers Investment Group
By Team
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What if you could find an investment that added to portfolio diversification, generated income, was an inflation hedge and tax efficient? Real Estate Investment Trusts (REITs) fit right into that category. Most investors are unaware of the positive impact an explicit investment in REITs may have on their portfolios. They mistakenly believe that they already have more than enough real estate exposure through home ownership, not realizing that REITs are a distinctly different type of investment. Others may believe that they get sufficient exposure to REITs through their existing equity manager lineup. Yet, typically most portfolios are either underweighted or void of REITs most of the time.

The lack of exposure to REITs is largely a function of the nature of REITs themselves. REITs provide exposure to cash-flow-generating commercial real estate and mortgages, distinctly different investments than residential real estate. Moreover, while REITs are equities, their structure is more complex because of the nature of the underlying holdings—income-generating property. This complexity makes it imperative that a manager be an expert at analyzing stocks and possess a deep knowledge of the real estate market, as well as the ability to analyze the underlying properties held by the REIT.

The breadth and depth of the REIT market, its historical performance record, and the potential diversification benefits REITs can bring point to an asset class that may assist investors in achieving their long-term investment goals.

WHAT IS A REIT?

A REIT is either a publicly traded real estate company or a private trust that generally holds a geographically or sector-diversified portfolio of professionally managed real estate assets and related real estate businesses. Investors in REITs gain exposure to both the capital value of the assets and the income stream derived from the properties and operating businesses. The REIT industry has a diverse profile, which offers many investment opportunities. REITs are often classified in one of three categories:

1. Equity REITs generally own and operate income-producing real estate. They typically engage in a wide range of real estate activities, including leasing, maintenance, development of real property and tenant services. REITs must acquire and develop their properties primarily to operate them as part of their own portfolio, rather than to resell them once they are developed. Their revenues come principally from the rent charged on their properties.

2. Mortgage REITs primarily lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of real estate-backed loans. Their revenues are generated primarily by the interest that they earn on the mortgage loans.

3. Hybrid REITs own both properties and makes real estate-backed loans to real estate owners and operators.

WHAT MAKES REITS DISTINCT?

Congress created the legislative framework for REITs in 1960 to enable public investors to benefit from investments in large-scale, incomeproducing properties. A corporation must meet a host of requirements in order to be designated a REIT. By satisfying these requirements, the REIT gains status as a pass-through entity, an important distinction. A pass-through entity does not have to pay corporate, federal or state income tax—it passes the responsibility of paying these taxes onto its shareholders. This avoids double taxation—paying taxes at both the corporate and individual levels. As required, a REIT must:

- Invest at least 75% of its total assets in real estate assets

- Derive at least 75% of its gross income from rents charged on real property or interest on mortgages financing real property

- Annually pay out at least 90% of its taxable income in the form of shareholder dividends

WHAT ARE THE BENEFITS TO INVESTORS IN REITS?

There are a multitude of benefits gained by owning REITs in a portfolio. These include:

- Opportunity for investors to gain exposure to a diversified pool of real estate with the benefit of liquidity

- Increased portfolio diversification due to the inherent nature of REITs and, within a broad REIT portfolio, geographic and propertytype diversification

- A higher-than-average dividend payout when compared to the general equity market

- Inflation hedge

- Tax efficiency

SOME RISKS TO INVESTING IN REITS

Like all equities, REITs do bring some risk to investors:

- REITs may be impacted by economic or market events

- Concentrated REITs may face unique risks associated with that sector

- The underlying real estate valuations may be subject to such factors as changing general and local economic, financial, competitive and environmental conditions

AN EXPOSURE TO REITS CAN FURTHER DIVERSIFY AN INVESTMENT PORTFOLIO

REITs have historically provided higher risk-adjusted returns and lower correlation compared to other equity investments. Impressively, REITs have produced an annual average return of 11.2% over the last 20 years (Source: NAREIT Equity REIT Index as of 10/31/11). This was 3.1% better than the S&P 500 on an average annual basis. REITs do come with some risk, however. In recent years as REITs' popularity has exploded, they have attracted the attention of hedge funds and other short-term investors, which has increased daily trading volumes. This has caused more volatile swings in performance results and increased the correlations of REITs to equities. However, even after controlling for risk over the long-term, the Sharpe Ratio is still higher than that of most major asset classes. (Figure 1)

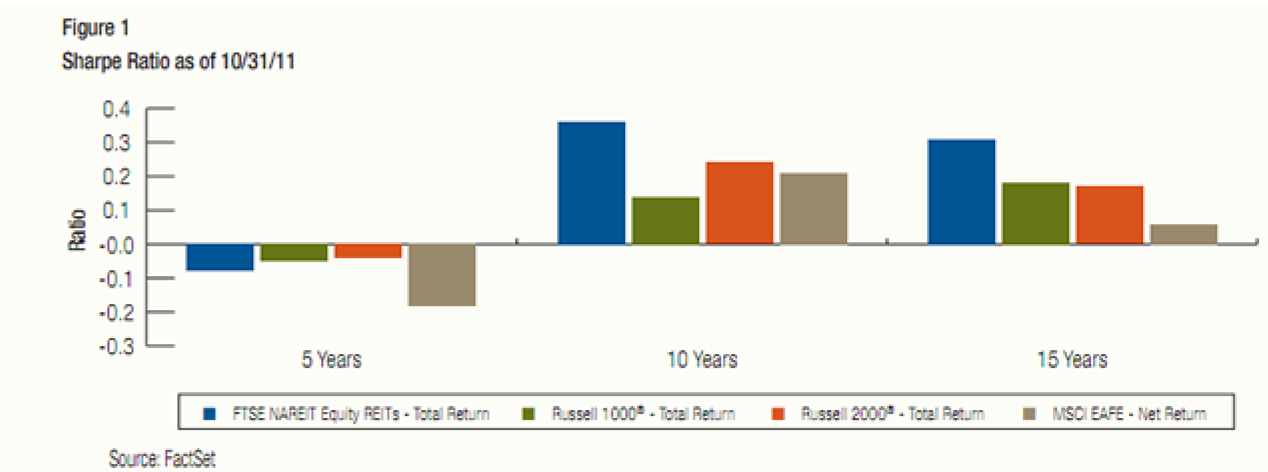


Figure 1
Sharpe Ratio as of 10/31/11

Correlations among traditional equity asset classes have historically been very high—between .80 and 1.0. However, REITs maintain a much lower correlation to other equities because their valuations are affected by different fundamentals. Over the short-term, REITs tend to be similar to equities because they react to earnings announcements and economic news. During the shaky economic cycle of the last few years, REITs have had a higher correlation to equities than they have had historically. Nevertheless, over the long-term, return patterns have behaved more like real-estate investments and less like equities. This is evident in the difference between the three- and ten-year correlations depicted in Figure 2. The Russell 1000® Index has a correlation coefficient of 0.83 to the FTSE NAREIT Equity REIT Index over the last three years. Over the prior ten years, however, the coefficient is noticeably lower at 0.73. REITs' historically lower correlation, combined with higher long-term risk-adjusted returns, can make an impressive one-two punch for your portfolio.

Figure 2

Correlations to FTSE NAREIT Equity REIT Index (10/31/11)

	3 Year	10 Year
Russell 1000®	0.83	0.73
Russell 2000®	0.86	0.78
MSCI EAFE	0.80	0.69
MSCI Emerging Markets	0.73	0.61
Barclays Capital U.S. Aggregate	0.02	0.14
Barclays Capital U.S. Aggregate Credit	0.32	0.33
Barclays Capital U.S. Aggregate Credit - High Yield	0.74	0.68

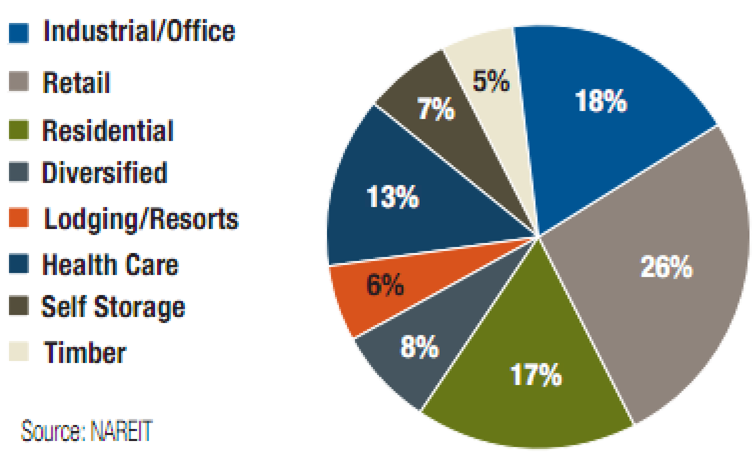
Source: FactSet

REIT PORTFOLIOS CAN BE BROADLY DIVERSIFIED

REITs can own and manage a diversified portfolio of property types that include shopping centers, apartments, warehouses, office buildings, hotels and more. (Figure 3) However, most REITs specialize in a specific property type, such as apartments or self-storage facilities. A key element of REITs is their holding of income-generating property. Rent prices and vacancy levels, therefore, are two critical elements influencing results. REIT performance tends to be cyclical because rents and vacancies are often closely tied to the supply and demand relationship in the prevailing economic environment. Some sectors, however, can be counter-cyclical. Generally speaking, offices, shopping malls and hotels struggle during bad times since the economy is shrinking and demand decreases. On the other hand, apartment properties can prosper when investors choose to rent rather than own. Active management of a diversified REIT portfolio can provide a significant benefit in evaluating these factors.

Figure 3

Listed REITs Invest In All Property Types



Source: NAREIT

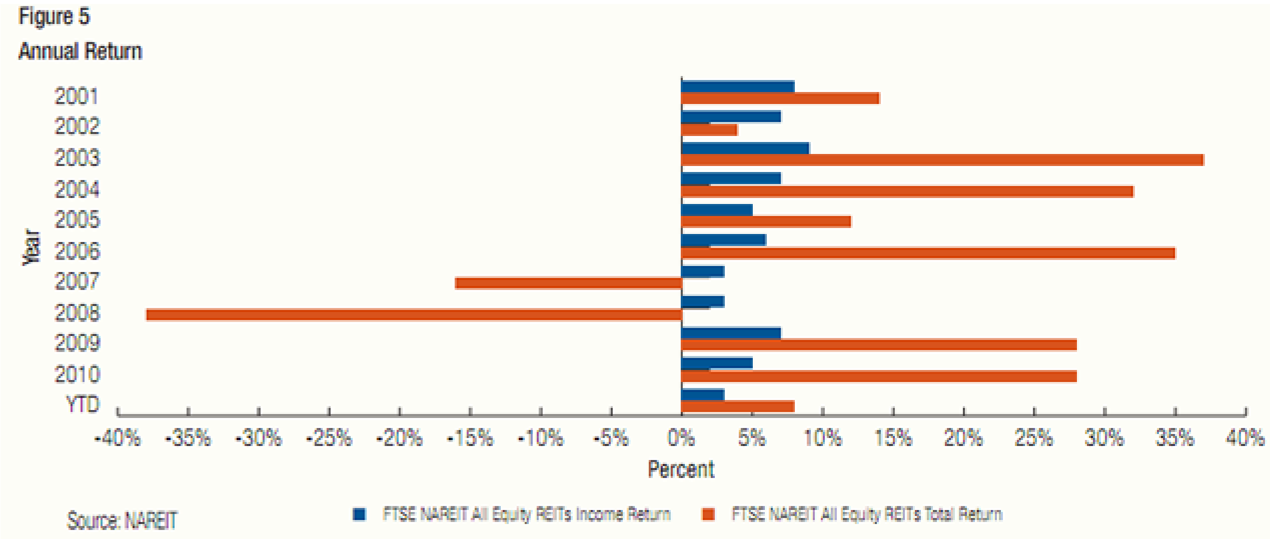
Figure 4 shows total returns for select sectors of the market over the last 10 years. This is a good example of the huge divergence in returnsthat can occur among REIT sectors from year to year. Residential REITs (apartments & multi family housing) underperformed the retail sector in four of the five years from 2001-2005. This trend reversed when the economy began to sour in 2007, and residential REITs have solidly outperformed the industrial and retail sectors since then.

Figure 4
Selected REITs Sector Returns

Timing the market is difficult, if not impossible. Since many REITs are specifically sector focused, choosing active management such as that offered by a mutual fund can help navigate the market when it may be necessary to remain flexible. For instance, when economic conditions are favorable, active managers can shift their portfolio into more aggressive positions with sensitivity to shorter-term leases, such as hotels and apartments, which might be expected to perform better than longer-term leases. If the environment worsens, as we have seen in the recent past, active managers can quickly shift their portfolio toward a defensive posture with longer-term leases and higher-quality properties that may protect better on the downside.

REITS OFFER COMPETITIVE DIVIDEND YIELDS

REITs are required to pay at least 90% of their taxable income in the form of dividends. The effect of the dividends has a tremendous impact on the total return earned by investors. Figure 5 provides a breakdown of REIT total returns by calendar year for the last 10 years. The blue section indicates the portion of the total return that is attributable to dividends. Equity REITs delivered an annualized total return of 11% over the last 10 years, of which 51% is attributable to dividends and the remainder from price appreciation (Source: NAREIT Equity REIT Index). The effect of dividends is even more pronounced during down markets. When prices are falling, the effect of the dividends may help buoy returns and potentially add downside protection. We believe REIT yields are also sustainable, since REITs are required to pay out 90% of their taxable income.



REITS CAN BE AN INFLATION HEDGE

During the economic recovery of the last few years, we have not experienced much inflation. Nevertheless, we intently watch inflation because rising prices can have a deteriorating effect on investor returns. Inflation usually occurs when the economy is expanding at a rapid pace and prices are increasing to keep up with demand. Commodity investments have long been known as inflation hedges, since they represent a “hard asset” whose price will rise with inflation. Real estate is also a “hard asset” that is sometimes overlooked for its inflation-hedging potential. Price appreciation within REITs can offset the impact of inflation over time, since management has the ability to raise rents to keep up with inflation. For instance, hotels have the ability to raise prices on virtually a nightly basis. Other property types such as apartments can raise prices when leases renew. Additionally, since inflation often occurs during economic expansion, occupancy rates are usually rising in offices and shopping centers, which has a positive effect on rents.

REITS CAN OFFER TAX EFFICIENCY

REITs do not pay taxes on the income that passes through to the investor. Unlike corporations that are double-taxed, once at the corporate level and again at the investor level, only the investor pays taxes on income. For this reason, REITs are historically taxefficient entities with attractive dividend yields and total returns. For the investor, corporate accounting rules allow REITs to deduct an allowance for depreciation that reduces net income. In effect, a portion of the dividends that is paid out is treated as return of capital on the investor’s annual 1099. Return of capital is not treated as ordinary income; rather it reduces the cost basis of the investment, which can serve to defer the taxes owed on capital gains from REIT investments.

REITS OFFER DAILY LIQUIDITY AND TRANSPARENCY

Direct private real estate investment is known for its poor liquidity and high transaction costs. Investing in real estate via publicly traded REITs, however, offers transparent pricing, daily liquidity and low transaction costs relative to direct private investment. Publicly traded REITs are required to file financial statements with the SEC and offer the same transparency as other public companies. Similar to the way that other public companies operate, REITs have a management team and a board of directors. The management team decides on the properties for investment while developing and managing a portfolio of properties. Corporate governance is a distinguishing feature that most REITs possess, since their corporate structure allows management's interests to be more closely aligned with shareholders' interests when compared to other equities. Since REITs pay out most of their income, little free cash flow is usually left for management to exhaust on speculative projects. Consequently, we believe this can serve to reduce the urge of management to find new, potentially unprofitable projects on which to deploy excess cash.

REAL ESTATE OUTLOOK

Like most other investments with significant leverage, REITs were flattened during the financial crisis. Dividends were slashed to preserve capital and some REITs went bankrupt. Investors soon realized, however, that many REITs were oversold; they were actually high-quality stocks and REITs rallied fast early into the recovery, posting a total return of 117% following the market bottom (Source: NAREIT Equity REIT Index for the period 3/10/09 through 12/31/09).

Today, the average REIT debt-coverage ratio is 38%, compared with 66% in March 2009, providing a significant cushion in the event of a double-dip recession (Source: REIT Watch issue Nov 2011, data as of June 2011). Should the economic recovery continue, however, REIT fundamentals should coincide with economic growth. Moreover, because real estate prices are extremely sensitive to supply in the market, valuations are likely to post increases if we see faster-thanexpected economic growth, as commercial real estate development was drastically reduced during the recession. Finally, we expect to see improved dividend growth rates in the future as payout ratios that were slashed during the financial crisis return to their historical levels.

SUMMARY: WE BELIEVE A DIVERSIFIED EQUITY PORTFOLIO SHOULD HAVE AN ALLOCATION TO REAL ESTATE

The impressive returns that REITs have posted over the last several years are very appealing. It is easy to make a case for having an explicit allocation to real estate in your balanced portfolio on that fact alone. In addition to the total return component, REITs also offer diversification that can act as a much-needed counterbalance in the portfolio. REITs have strong income growth potential, sustainable yields and can offset the impact of inflation over the long-term. Liquidity and transparency are other defining factors that make this asset class attractive. If you do not already have an allocation to real estate in your long-term balanced portfolio, consider making room for REITs to take advantage of the many benefits they have to offer.

