

P A R T
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MEET THE REIT

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CHAPTER 1

REITs: What They Are and How They Work

“Buy land. They ain’t makin’ any more of the stuff.”

—Will Rogers

What’s your idea of a perfect investment? That’s a trick question—there is no perfect investment! Greater returns come with greater risk. But those looking for above-average current returns, along with reasonably good price appreciation prospects over time—and with only modest risk—will certainly want to consider apartment communities, office and industrial buildings, shopping centers, and similar investments. In other words, commercial real estate that can be leased to tenants to generate reliable streams of rental income.

Sure, you might say, but only if there were an easy way to buy and own real estate, where an experienced professional could handle the business of owning and managing it well and efficiently, and give you the profits. And only if you could sell your real estate—if you wanted to—as easily as you can sell a common stock like General Electric or Intel. Well, read on. This is all possible with real estate investment trusts, or REITs (pronounced “reets”).

REITs have provided investors everywhere with an easy way to buy major office buildings, shopping malls, hotels, and apartment buildings—in fact, just about any kind of commercial real property you can think of. REITs give you the steady and predictable cash flow that comes from owning and leasing real estate, but with the benefit of a common stock's liquidity. Equally important, REITs usually have ready access to capital and can therefore acquire and build additional properties as part of their ongoing real estate business.

Besides that, REITs can add stability to your investment portfolio. Real estate as an asset class has long been perceived as an inflation hedge and has, during most market periods, enjoyed fairly low correlation with the performance of other asset classes.

REITs have been around for nearly 50 years, but it's only been in the past 20 that these appealing investments have become widely known. From the end of 1992 through the end of 2010, the size of the REIT industry has increased by more than 20 times, from just under \$16 billion to \$389 billion. But the REIT industry, having so far captured only about 10 to 15 percent of all institutionally owned commercial real estate, still has plenty of room left for growth.

Stan Ross, former managing partner of Ernst & Young's Real Estate Group, defined REITs by saying, "They are real operating companies that lease, renovate, manage, tear down, rebuild, and develop from scratch." That helps define a REIT, but investors need to know what they can expect from it in terms of investment behavior. That's really what this book is about.

REITs provide substantial dividend yields, which have historically exceeded the yields of most publicly traded stocks, making them an

REITs Are a Liquid Asset

A *liquid asset* or investment is one that has a generally accepted value and a market where it can be sold easily and quickly at little or no discount to that value. Direct investment in real estate, whether it be a shopping mall in California or a major office building in Manhattan, is not liquid. A qualified buyer must be found, and even then, the value is not clearly established. Most publicly traded stocks *are* liquid. REITs are real estate-related investments that enjoy the benefit of a common stock's liquidity.

ideal investment for an individual retirement account (IRA) or other tax-deferred portfolio. Their actual dividend yields tend to be somewhat correlated with—and generally higher than—yields on 10-year U.S. Treasury bonds. But, unlike most high-yielding investments, REIT shares have a strong likelihood of increasing in value over time as the REIT's properties generate higher cash flows, the values of their properties increase, and additional properties are added to the portfolio.

**TIP**

REITs own real estate, but when you buy a REIT, you're not just buying real estate, you're also buying a business.

When you buy stock in Exxon, for example, you're buying more than oil reserves. And with REITs, you own more than its real estate. The vast majority of REITs are public real estate companies overseen by financially sophisticated, skilled management teams who have the ability to grow the REIT's cash flows (and dividends) at rates in excess of inflation. Adding a 4 percent dividend yield to capital appreciation of 4 percent, resulting from 4 percent annual increases in operating cash flow and property values, provides for total return prospects of 8 percent annually.

A successful REIT's management team will accept risk only where the odds of success are high. REITs must pay out most of their earnings in dividends to shareholders, and thus must be very careful when they invest retained earnings. REITs operate their properties in such a way that they generate steady income; but they also have an eye to the future and are interested in growth of the property portfolio, its values and its cash flows, and in taking advantage of new opportunities.

Types of REITs

There are two basic categories of REITs: equity REITs and mortgage REITs.

An equity REIT is a publicly traded company that, as its principal business, buys, manages, renovates, maintains, and occasionally sells real estate properties. Many are also able to develop new properties

when the economics are favorable. It is tax advantaged in that it is not taxed on its income and, by law, must pay out at least 90 percent of its net income as dividends to its investors.

A mortgage REIT is a REIT that makes and holds loans and other debt instruments that are secured by real estate collateral.

The focus of this book is equity REITs rather than mortgage REITs. Although mortgage REITs have higher dividend yields and can, at times, deliver spectacular investment returns, equity REITs are less vulnerable to changes in interest rates and have historically provided better long-term total returns, more stable market price performance, lower risk, and greater liquidity. In addition to that, equity REITs allow the investor to determine not only the type of property he or she invests in, but also, quite often, the geographic location of the properties.

General Investment Characteristics

Performance and Returns

Although the long-term performance of equity REITs varies with the measurement period used, they have, during most time horizons, compared quite well with that of broader stock indices such as the S&P 500 index. For example, according to data provided by the National Association of Real Estate Investment Trusts (NAREIT), shown in Figure 1.1, during the 35-year period ending December 31, 2010,

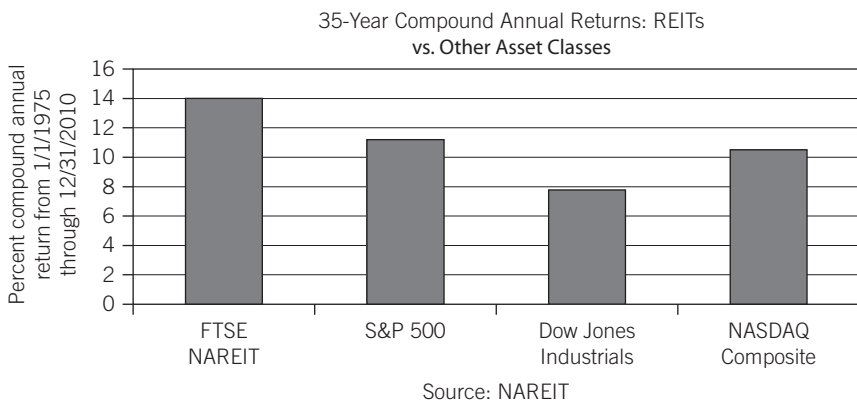


Figure 1.1 35-year Total Returns for REITs vs. Other Asset Classes

Source: NAREIT REITWatch January 2011.

equity REITs delivered an average annual total return of 14.0 percent. This compares quite well with the returns from various other indices during the same time period.

However, if REITs' performance was merely comparable to the Standard & Poor's (S&P) 500, you wouldn't be reading a book about them. And the performance of many high-risk stocks has substantially exceeded the returns provided by the broad market. Here's the difference: REITs have provided total returns comparable to the S&P 500 index despite having benefits not usually enjoyed by stocks that keep pace with the market, including only modest correlation with other asset classes, less market price volatility, more limited investment risk, and higher current returns. Let's look at each of these.

Lower Correlations

Correlations measure how much predictive power the price behavior of one asset class has on another to which it's compared. In other words, if we want to predict what effect a 1 percent rise (or fall) in the S&P 500 will have on REIT stocks, small caps, or bonds for any particular time period, we look at their relative correlations. For example, if the correlation of an S&P 500 index mutual fund with the S&P 500 index is perfect, that is, 1.0, then a 2 percent move in the S&P 500 would predict that the move in the index fund for the same period would also be 2 percent. Correlations range from a perfect +1.0, in which case the movements of two investments will be perfectly matched, to a -1.0, in which case their movements will be completely opposite. A correlation of 0.0 suggests no correlation at all. Correlations in the investment world are important, as they allow financial planners, investment advisers, and individual or institutional investors to structure broadly diversified investment portfolios with the objective of having the ups and downs of each asset class offset one another as much as possible. This, ideally, results in a smooth increase in portfolio values over time, with much less volatility from year to year or even quarter to quarter.

According to NAREIT, as summarized in the graph in Figure 1.2, REIT stocks' correlation with the S&P 500 during the period from December 1980 through December 2010 was just 0.55. Thus, price movements in REIT stocks have had only a 55 percent correlation

| Comparative Total Return Investment Correlation | | | | | | |
|---|-----------------------|------------|---------------------|------------------|--------------------------|----------------------------|
| | FTSE NAREIT Equity | S&P 500 | NASDAQ Composite | S&P Utilities | Dow Jones Industrials | ML Corp/Govt Bond Index |
| FTSE NAREIT Equity | 1.00 | 0.66 | 0.53 | 0.38 | 0.61 | 0.10 |
| S&P 500 | | 1.00 | 0.91 | 0.56 | 0.96 | −0.10 |
| NASDAQ Composite | | | 1.00 | 0.40 | 0.83 | −0.17 |
| S&P Utilities | | | | 1.00 | 0.55 | 0.14 |
| Dow Jones Industrials | | | | | 1.00 | −0.12 |
| ML Corp/Govt Bond Index | | | | | | 1.00 |
| December 2000 through December 2010 | | | | | | |

Figure 1.2 REIT Stock Correlations

Source: NAREIT REITWatch, January 2011.

with the broad market, as represented by the S&P 500, during that period. Accordingly, in markets where stocks are rising sharply, REITs’ relatively low correlation suggests that they may lag relative to the broad stock market indices. This happened in 1995, when REIT stocks underperformed the popular indices—but still provided investors with total returns of 15.3 percent—and in 1998 and 1999, when REITs’ returns were actually *negative* despite strength in the technology-led S&P 500. Conversely, during many bear markets in equities, such as in 2000 and most of 2001, lower correlating stocks such as REITs tend to be more stable and may suffer less. And yet there are some markets, as in 2008 and 2009, when virtually *every* investment, including REITs, will drop by similar amounts. When investors decide to unload everything, there is no place to hide!

A study of correlations by Ibbotson Associates completed in 2001 and updated in 2003 concluded that the correlation of REITs’ stock returns with those of other equity investments has declined significantly when measured over various time periods since 1972, when NAREIT first began to compile REIT industry performance data. Nevertheless, correlations will vary over time—particularly during short time frames—and REIT stocks have been more closely correlated with other stocks during the market turmoil of the past

few years. However, because commercial real estate is a distinct asset class, and due to the unique attributes of REIT investing as discussed in this chapter and elsewhere in this book, it is reasonable to expect that REIT stocks will maintain fairly low correlations with other asset classes over reasonably long time periods.

Lower Volatility

A stock's "volatility" refers to the extent to which its price tends to bounce around from day to day, or even hour to hour. My observations of the REIT market over the past 35 years have led me to the conclusion that REIT stocks are, most of the time, simply less volatile, on a daily basis, than other equities. Although REITs' increased size and popularity, particularly over the past 5 years, has brought in new investors with different agendas and shorter time horizons, and thus created more volatility, REIT stocks should remain less volatile than their non-REIT brethren.



TIP

REITs' higher current yields often act as a shock absorber against daily market fluctuations.

There is a predictability and steadiness to most REITs' operating and financial performance from quarter to quarter and from year to year, and there is simply less risk of major negative surprises that can stoke volatility.

Another factor that should help to dampen the volatility of REIT stocks is their higher dividend yields. When a stock yields next to nothing, its entire value is comprised of all future earnings, discounted to the present date. If the perceived prospects for those earnings decline just slightly, the stock can plummet quickly. Much of the value of a REIT stock, however, is in the REIT's current dividend yield, so a modest decline in future growth expectations will have a more muted effect on its trading price. The volatility of REIT stocks spiked from 2007 through 2009, due to concerns about REITs' balance sheets and our nation's space markets, but

those issues were pretty much resolved by 2010, and a reasonable assumption for REIT investors is that REIT stock volatility will, in the future, as in most of the past, be lower than that of other equities.

This is important because our biggest investment mistakes tend to be the result of fear. When our stocks are going up, it's human nature to ignore risk in our pursuit of ever greater profits. But, when our stocks are dropping, we often tend to panic and dump otherwise sound investments because we're afraid of ever greater losses. When is the "right" time to sell or buy? There is no easy answer to this question, but prudent investors have learned through experience to control their emotions; low volatility in a stock can make patient and disciplined investors of us all.

Sometimes our financial decisions are not based on long-term investment strategy but on some unexpected personal event that requires that we liquidate some of our holdings. That can be very unpleasant if it occurs during a sizeable market downturn. But if we own ample amounts of REIT shares, chances are we can sell some of them at prices that are reasonably close to where they were trading a week or a month ago, even in soft markets.

Less Risk

There's just no way to avoid risk completely. Even simple preservation of capital carries its own risk—inflation can impact the real value of even seemingly low-risk investments such as investment grade bonds. Real estate ownership and management, like any other business or commercial endeavor, is subject to all sorts of risks. Mall REITs are subject to the changing spending habits of consumers; apartment REITs are subject to changes in the popularity of single-family dwellings and declining job growth in the areas where their properties are located; and health care REITs are subject to the politics of government cuts in health care reimbursement, to cite just a few examples. In general, all REITs are subject to an increased supply of rental properties and demand-weakening recessions.

Yet, despite this, owners of commercial real estate can limit risk, including the risk of tenant bankruptcies—if they are diversified by sector, geographic location, and tenant roster. For example, if some tenants are doing badly, there are usually other tenants who are doing fine. This has happened repeatedly in the history of the retail industry,

and the retail REITs have remained resilient; they continually find new tenants to replace those that must close their doors.

Holders of most common stocks must contend with yet another type of risk, related not to the fundamentals of a company's business but to the fickle nature of the financial markets. Let's say you own shares in a company whose business is doing well. The earnings report comes out and the news is that earnings are up 15 percent over last year. But because analysts expected a 20 percent increase, the price of the stock drops precipitously. This has been a common phenomenon in the stock market in recent years, but REIT investors have rarely suffered from this syndrome.



TIP

Analysts who follow REITs are normally able to accurately forecast quarterly results, within one or two cents, quarter after quarter.

This is because of the stability and predictability of REITs' rental revenues, occupancy rates, and real estate operating costs. Long-term leases enjoyed by most commercial real estate owners provide earnings stability and make this asset class more "bondlike." The risks, therefore, are reduced.

Few REITs have gotten themselves into serious financial difficulties over the years. Those few instances of severe financial stress have generally been caused by risky balance sheets, for example, General Growth Properties, or poor allocation of their investment capital. Remember, there is no such thing as zero risk. If you're investing primarily in the higher-quality REITs (we'll review the nature of "blue-chip" REITs in a later chapter), the long-term risk of REIT investments is far lower than that of most other common stocks.

Higher Current Returns

As we'll see in Chapter 3, REITs must, by law, pay out at least 90 percent of their pretax income to shareholders in the form of dividends. As a result, REITs' dividends tend to be higher than those of other companies as a percentage of their free cash flows, and REIT shares normally trade at higher dividend yields (see Figure 1.3).

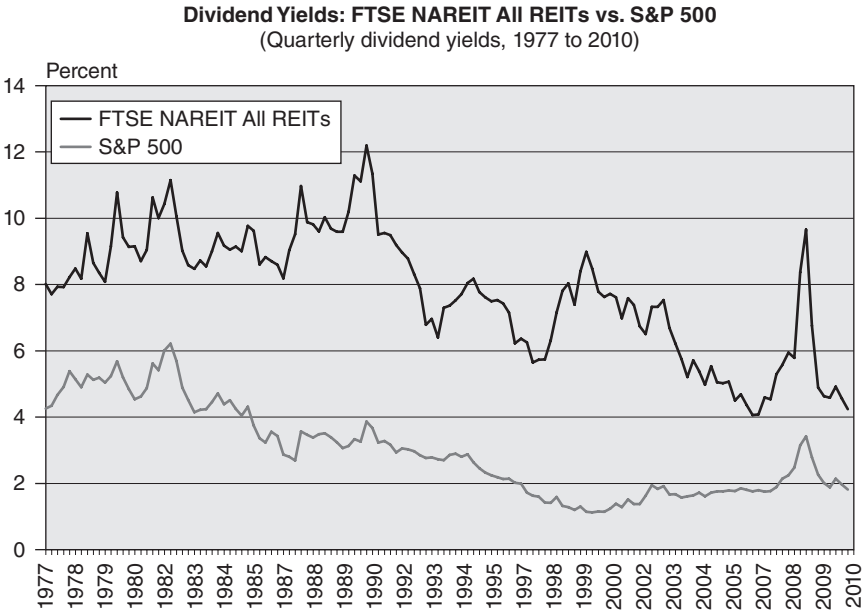


Figure 1.3 REIT Yield Comparison vs. S&P 500

Source: NAREIT REITwatch, January 2011.

Although many academics claim that it shouldn't matter to shareholders how much of its net income a corporation pays out in dividends, many argue that dividends really do matter with respect to shareholders' total returns. According to Ed Clissold, an equity strategist at Ned Davis Research (as referred to in a *Barron's* article of September 20, 2010), the S&P 500 index has delivered average annual price appreciation since the end of 1929 of 4.92 percent, but its average annual total return has been 9.16 percent. Thus, dividends have provided approximately 46 percent of those total returns. Dividends *do* count.

Perhaps another benefit of owning REIT stocks, relating to REITs' dividend payment requirement, is that its shareholders are legally entitled to 90 percent of the REIT's income each year. This allows the shareholder to participate in income reinvestment decisions. He or she can plow the dividend income back into the REIT by buying additional shares (albeit on an after-tax basis if owned in taxable accounts), investing elsewhere, or spending it on a vacation in Hawaii. Shareholders in non-REIT companies don't have this

advantage, and must accept the decisions of the company's board of directors with respect to dividend policy.

Another key advantage to owning higher-yielding investments is that they provide a steady income even during the occasional bear market. This can often prevent the investor from becoming discouraged enough to sell out at bear market lows. With REITs, we get "paid to wait."

REIT stocks' current dividend yields are often below those of many corporate bonds. However, bond interest payments do not increase, while the REIT industry has a long-term track record of increasing dividends on a regular basis. Although this track record was marred during the recent traumatic period commonly referred to as the "Great Recession," as many REITs reduced their dividends in response to weak and uncertain space and capital markets, REITs have been able, over time, to increase their dividends at a rate above the rate of inflation (Figure 1.4).

Finally, there's an intangible psychological benefit in seeing significant dividends roll in each month or each quarter. If, like most of us, you have to work to earn a salary, seeing a check come in for several hundred dollars—without your having to show up at the office—provides substantial comfort regardless of whether you intend to spend it or reinvest it.

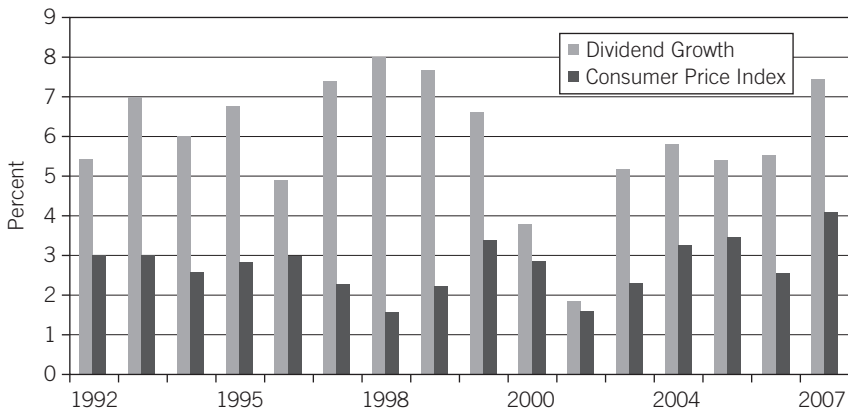


Figure 1.4 Equity REIT Dividend Growth vs. CPI

Source: www.reit.com.

Note: Data as of December 31, 2007.

Do High Current Returns Mean Slow Growth?

It doesn't take a PhD to figure out why many investors like REITs' substantial dividend yields. But what effect does the high payout ratio have on a REIT's growth prospects? With investors receiving at least 90 percent of pretax income, a REIT can retain only modest amounts of capital with which to expand the business and, therefore, to grow its future operating income. Thus, to the extent that stock price appreciation results from rapidly rising earnings growth, a REIT's share price should normally rise at a slower pace than that of a non-REIT stock. However, the REIT investor doesn't mind that; he or she expects to make up much, or even all, of the difference through higher dividend payments over time, and thus maintain a high *total* return.

And it isn't even clear that paying out most of a REIT's income in dividends condemns it to slower growth. A study appearing in the January/February 2003 issue of *Financial Analysts Journal*, entitled "Surprise! Higher Dividends = Higher Earnings Growth," by hedge fund manager Cliff Asness (AQR Capital Management) and academic Robert Arnott (Research Affiliates) concluded that earnings growth rates of companies with above-average dividend payments are actually higher than those of companies with lower dividend payments. These results tend to defy logic, but the implication is that many companies with low payout ratios may not be doing a very good job of reinvesting their retained capital, perhaps investing it in poorly conceived acquisitions. One may therefore speculate whether the higher dividend payments required by the tax laws applicable to REITs, by creating a situation of "opportunity triage," has been a key element in REIT stocks' excellent relative performance over the years.

Regardless of the conclusion of Asness and Arnott or the relevance of dividend payout rates to growth rates, there are ways other than retaining earnings by which REIT organizations can drive growth. If management wants to expand the REIT's growth rate, it can do so through additional stock and debt offerings, by exchanging new shares or partnership units for properties, or by selling mature properties and reinvesting in higher-growth properties. There are some times when such capital is freely available to a REIT, sometimes when it dries up altogether, and still other times

when it is available but at a price that is dilutive to the existing shareholders. Generally, however, high-quality REITs can expect to have reasonably good access to expansion capital during most market environments.

**TIP**

When selecting REITs for investment, remember that it is the strong ones that can attract additional capital—and this provides the greatest long-term growth potential.

Because being able to attract reasonably priced capital is an important advantage for a REIT, those companies with excellent reputations in the investment community and strong balance sheets have a potent tool at their disposal.

Nevertheless, let's be conservative. The need to raise additional capital to fund significant external growth opportunities, such as acquisitions or developments, normally means that REITs will be slower-growing investment vehicles. In the mid-1990s, however, some REITs were acting in a very un-REITly way, growing by 10 to 20 percent annually. It was as if tortoises were actually sprinting faster than hares. What happened? The phenomenon can probably be explained by the fact that many REITs during that period combined their capital-raising capabilities with many institutions' need to liquidate their real estate investments, and thus many REITs created rapidly growing cash flows through numerous property acquisitions. This trend ended in 1998, and REITs' growth rates returned to the more normal single-digit range thereafter.

Some have speculated that the gut-wrenching recession that began late in 2007 and ended in the middle of 2009—the Great Recession—and related problems in the U.S. real estate markets, along with the vast amounts of mortgage loans whose principal amounts were greater than the values of the underlying properties, might create similar acquisition and growth opportunities for REITs over the next few years. While this could happen, there has been much competition among buyers for “distressed real estate,” and it is unlikely that REITs will be able to generate double-digit earnings growth by buying huge volumes of cheap properties.

Of course, investors in REITs shouldn't assume that these organizations will be able to grow earnings each and every year. Cash flow growth went negative for many REITs in the early years of the twenty-first century, due to weak office, industrial, and apartment rental markets, but these markets later stabilized, and modest cash flow growth resumed in late 2005. Then, beginning in 2008, when many of our leading investment banks either failed or had to be rescued by the federal government and a deep recession ensued, REITs' cash flows declined due to lower occupancy and rental rates. Property markets began to stabilize, yet again, in 2010. Real estate is a cyclical industry, and there will be down years. However, rental rates *do* grow over time, and REITs' cash flows will grow also. But REIT investors would be wise not to expect more than mid-single-digit growth over relatively long time frames.

This chapter has suggested some long-term advantages of owning REIT shares as part of a broadly diversified investment portfolio. By the time you finish this book, you will understand what REIT stocks are capable of and why. There is, indeed, a great deal to like; however, I am not promising instant riches or even perpetual investment tranquility. As noted earlier, commercial real estate, like virtually all global markets, is cyclical, and so are the markets for real estate space and property valuations. Furthermore, investment trends, like fashion trends, change quickly and are not easily predictable. In some years, REIT stocks will simply become unpopular due to the oft-fickle nature of investors. Also, the rise of hedge funds, sometimes with very short time horizons, has added another wild card to the deck; REIT stocks have, at times, become the sandbox in which these funds like to play. As a result, REIT stocks will often be more volatile than warranted by the stability and predictability of their property cash flows. We must remember that REITs are a unique blend of equity and real estate.

The bottom line here is that REIT stocks are not without risk, particularly for those with short time horizons; unexpected economic events and changes in investor preferences can, and do, affect REIT prices from time to time. But that does not detract from REITs' value as excellent long-term investments, as we'll see throughout the rest of this book.

Summary

- REITs own real estate, but when you buy a REIT, you're not just buying real estate—you're also buying a business run by an experienced management team.
- REITs' total returns, over reasonably long time periods, have been very competitive with those provided by the broader market.
- The vast majority of REITs offer the liquidity provided by public equities markets.
- REITs provide diversification to your portfolio because their price movements, during most periods, are not highly correlated with the rest of the market.
- REITs' higher current yields frequently act as a shock absorber against daily market fluctuations.
- Analysts who follow REITs are normally able to forecast quarterly results within one or two cents, quarter after quarter, year after year, thus minimizing the chances for "negative surprises."
- REITs' higher yields raise the overall yield of the portfolio, thus reducing volatility and providing stable cash flows regardless of market gyrations.
- REIT stocks are equities, as well as real estate, and thus are subject to the prevailing winds that blow across the investment world.

