

REITs: What They Are and How They Work

“The true investor . . . will do better if he forgets about the stock market and pays attention to his dividend returns and to the operation results of his companies.”

—Benjamin Graham

What’s your idea of a perfect investment?

That’s a trick question, for the record, since there is no such thing. Greater returns come with greater risk, while lesser risk comes with lower returns. You’re just not going to find a stock that offers intense gains and intense safety at the same time.

Even so, those looking for above-average current returns, reasonably strong long-term price appreciation, and only modest risk should definitely consider commercial real estate that can generate reliable streams of rental income.

In the past, real estate investing was only available to wealthy entrepreneurs with deep pockets and the ability to acquire and actively manage portfolios of properties. Real estate investment trusts, or REITs (pronounced “reets”), were born out of that environment with the intent to allow small investors the same kinds of benefits.

Congress officially recognized REITs in 1960, patterning them after mutual fund laws. In the beginning, they were severely restricted, mostly meant to just provide investors with a non-taxed, passive flow-through form of income. The REIT vehicle received a dividend-paid deduction from corporate tax for every dollar distributed. And income was taxed only at the shareholder level instead of being double-taxed like most corporations.

They've since evolved into a highly attractive overall package that's very much worth considering: an uncomplicated way to buy and own real estate run by experienced professionals who give you some of the profits anyway. REITs offer access to reaping income from major office buildings, shopping malls, hotels, and apartment buildings. In fact, they work with just about any kind of commercial real property you can think of. Better yet, this all comes in an easily traded common stock like Apple or Amazon.

Perhaps best yet, they do all this while giving you the steady and predictable cash flows that come from owning and leasing real estate – and on a much larger scale than a mere individual can handle. Essentially, REITs put their corporate-strength access to public equity and debt capital into acquiring and building additional properties to grow their businesses. Combined, these features can add stability to their investors' portfolios.

Real estate as an asset class has long been perceived as an inflation hedge that, during most market periods, enjoys fairly low correlation with the performance of other categories.

As mentioned in the introduction, REITs have been around for 60 years now, though it's only been in the past 30 that they've become widely known. That's true because of several pivotal moments in their evolution, some of which were out-and-out crises at the time. We'll discuss those in more detail in Chapter 3, but suffice it to say for now that REITs evolved in very positive ways as a direct result of those experiences.

From the end of 1992 through the end of 2019, the size of the REIT industry has increased by more than 75 times, rising from a market cap just under \$16 billion to almost \$1.33 trillion. Since that's only about 10–15% of all institutionally owned commercial real estate, this extremely attractive sector is filled with vertically integrated operating companies that still have plenty of room to grow.

REITs Are Liquid Assets

I've already mentioned that REITs are easy to buy and sell. But you're excused if you'd like to point out how unwieldy commercial real estate can be.

A liquid asset or investment is one with a generally accepted value and accommodating market, where it can be sold easily and quickly at little or no discount to that value. In which case, direct investment in real estate – whether a shopping mall in California or a major office building in Manhattan – is far from liquid. People aren't exactly lining up outside of such buildings ready to buy them at the drop of a hat.

Most publicly traded stocks, however, are liquid, a rule that holds true for REITs. They're real estate – owning investments that enjoy the benefit of a common stock's public market trading and liquidity. So when you buy into them, you're not just buying properties; you're also buying the businesses they belong to. It's like when you buy stock in Exxon; you're buying more than oil reserves.

The vast majority of REITs are public real estate companies overseen by financially sophisticated, skilled management teams with the ability to grow their companies' cash flows (and dividends) at rates higher than inflation. It's not uncommon to get total annual returns of 8%. All you need is a 4% dividend yield and 4% capital appreciation resulting from 4% annual increases in operating cash flow and property values.

As we'll discuss in a later chapter, management and good corporate governance are critical to those kinds of results. Like other operating companies in the public market, REIT shares have a strong likelihood of increasing in value over time as their properties generate higher cash flows, the values of their properties increase, and they grow their portfolios – all of which management can, should and, in most cases, does add active value to.

Running a REIT isn't always a stress-free job (especially in the face of a global pandemic and subsequent shutdowns). But there are teams of men and women out there nonetheless who knock it out of the park. They operate their properties to generate steady income, only accepting risk where the odds of success are high. Because they recognize REITs' unique ins and outs, most of them are exceptionally careful when and where they invest retained earnings.

They search out ways to grow their property portfolios, values, and cash flows by taking advantage of new opportunities as they come along.

Types of REITs

There are two basic categories of real estate investment trusts to consider. An equity REIT, for one, is a publicly traded company that buys, manages, renovates, maintains, and sometimes sells real estate properties as its principal business. Many also develop new properties under favorable economic conditions. Meanwhile, mortgage REITs (mREITs) make and hold loans and other debt instruments that are secured by real estate collateral.

The focus of this book, it should be stated, is on the former. That's mainly because, while mREITs have higher dividend yields and can deliver spectacular investment returns at times, equity REITs are less vulnerable to changes in interest rates. And they've historically provided better long-term total returns, more stable price performance, lower risk, and greater liquidity.

In addition, equity REITs allow the investor to determine the type of property he or she invests in and often even the geographic location of the properties in question. Most equity REITs today are specialized, best-in-class operating companies that invest in only one or two property types. This makes them concentrated experts in their fields of business, which gives investors greater chances to reap significant benefits over time.

General Investment Characteristics

Performance and Returns

Although equity REITs' long-term performance varies depending on the exact timeline used, they typically relate very well with those of broader stock indices such as the S&P 500. Data provided by the National Association of Real Estate Investment Trusts (Nareit) shown in Figure 1.1 show that, during the 40-year period through June 2020, REITs delivered an average annual total return of 11.38%. This compares closely with other indices' returns during the same period.

FTSE Nareit All Equity REITs

Monthly Indexed Total Return

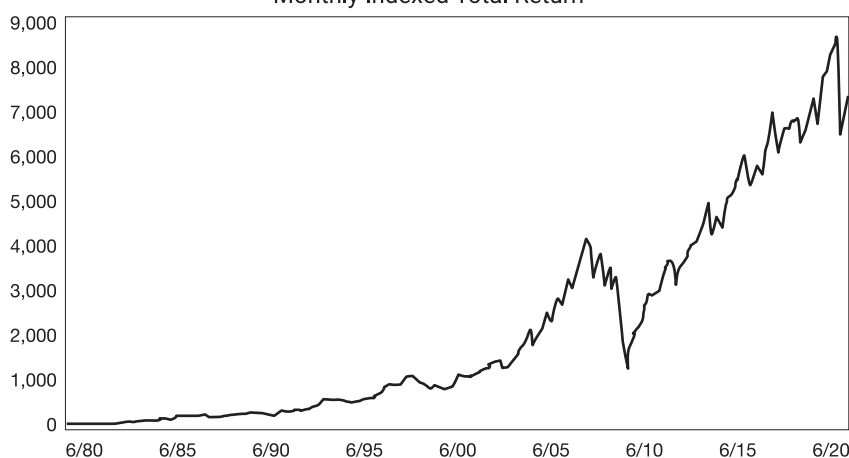


Figure 1.1

Source: Nareit website.

Admittedly, that makes them sound indistinguishable. So here's the difference: REITs enjoy largely unique benefits that include merely modest correlation with other asset classes, less market price volatility, more limited investment risk, and higher current returns – each of which we'll look at next.

Lower Correlations

Correlations measure how much predictive power the price behavior of one asset class has compared to another. So if we want to predict what effect a 1% rise (or fall) in the S&P 500 will have on an investment category – REITs, stocks, small caps, bonds, and so on – 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 (written out as 1.0), then a 2% move in the S&P 500 would predict a 2% move in the index fund as well. On the opposite end of the range, correlations can trend down to -1.0, in which case their movements are completely opposite. And in between is 0.0, which suggests no correlation at all.

This concept is important in the investment world, since it allows financial planners, investment advisers, and individual or institutional investors alike to structure broadly diversified investment portfolios with the objective of having the ups and downs of each asset class offset each other 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.

Cohen & Steers Senior Vice President and Global/U.S. Portfolio Manager Laurel Durkay – along with Senior Vice President and U.S. Senior Portfolio Manager Jason Yablon – gave some interesting insights on the subject in their September 2020 publication, “How REITs Benefit Asset Allocation.”

They noted, “REITs have historically served as effective diversifiers, as they tend to react to market conditions differently than other asset classes and businesses, potentially helping to smooth portfolio returns.”

They also wrote that “share aspects of both stocks and bonds – responding to economic growth like equities, but with yields and lease-based cash flows that give them certain bond-like qualities.” In addition, they’re “subject to real estate cycles based on supply and demand, with the added stability of commercial leases. And they tend to be more sensitive to credit conditions due to the capital-intensive nature of real estate.”

The co-authors add that “these distinct performance drivers” have actually resulted in “low long-term correlations with stocks and bonds. Since 1991, U.S. REITs have had a 0.57 correlation with the S&P 500 and a 0.21 correlation with U.S. bonds (see Figure 1.2). Global REITs have also exhibited diversifying correlations, albeit to a more modest degree, due largely to higher correlations of Asia’s real estate market with both [Asian] and U.S. equities.” (See Figure 1.3.)

Accordingly, in markets where stocks are rising sharply, REITs may lag relative to the broad stock market indexes. This happened in 1995, when REIT stocks underperformed comparatively speaking while still providing investors with 15.3% total returns. And it happened again in 1998 and 1999, when their returns were actually negative. Conversely, during many equity bear markets – such as 2000–2001 – lower correlating stocks such as REITs tend to be more stable and may suffer less.

Differentiated Behavior

U.S. REITs

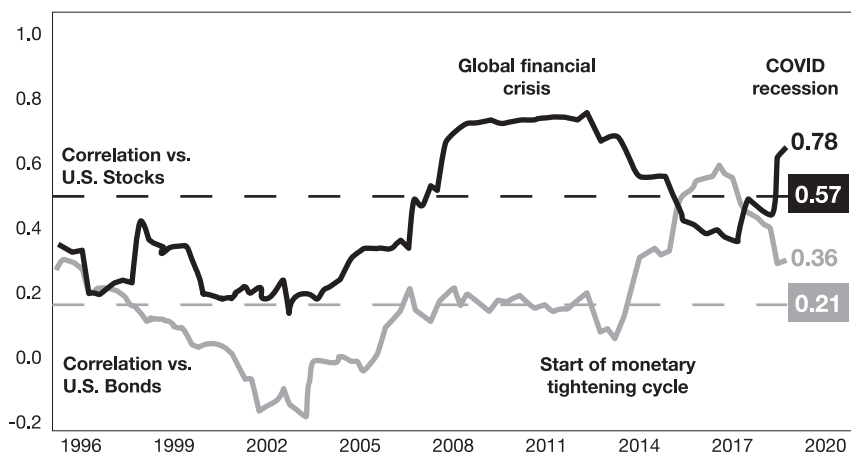


Figure 1.2

Source: Cohen & Steers.

Differentiated Behavior

Global REITs

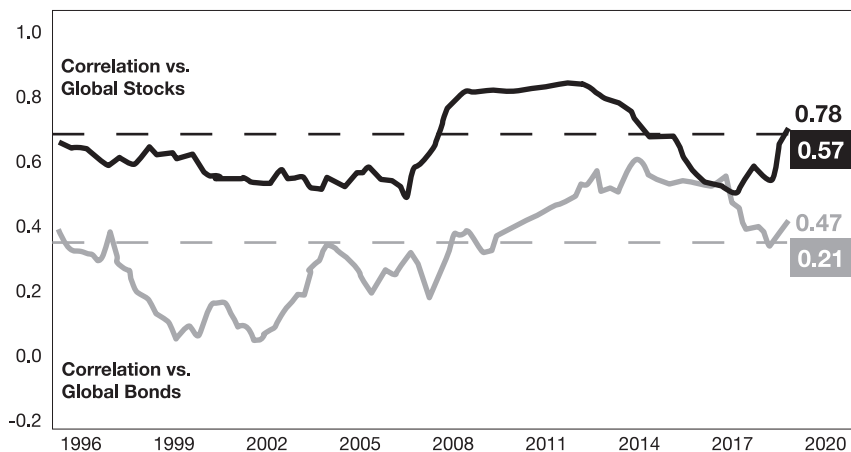


Figure 1.3

Source: Cohen & Steers.

Durkay and Yablon add that “sudden changes in bond yields can have a meaningful influence on short-term REIT performance. However, such periods tend to be temporary. In the long run, REIT returns are driven primarily by the distinct cash flows and growth profiles of the underlying property markets and the added stability of leases [that provide] the potential diversification benefits of an allocation to real estate.”

Bottom line: Correlations will vary over time, particularly during short time frames. However, because commercial real estate is a distinct asset class with distinct attributes, it’s reasonable to expect REITs to maintain fairly low relativity to other asset classes over reasonably long time periods.

Lower Volatility

A stock’s volatility refers to how much its price tends to bounce around from day to day or even hour to hour. Over the past four decades or so, REITs have proved to be less volatile than other equities on a daily basis. This has even been despite their increasing size and popularity, which has brought in new investors with different agendas and shorter time horizons.

Another factor that usually helps tamp down on such issues is REITs’ 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 even just slightly, the stock can plummet. However, much of a REIT’s value is in its current dividend yield. So a modest decline in future growth expectations will have a more muted effect on its trading price.

It’s true that their volatility spiked from 2007 through 2009 due to concerns about their balance sheets and the American economy. And in 2020, the Covid-19 pandemic also caused significant REIT volatility, though shares still didn’t fall as hard as they did in 2008. This is because most of them were already reducing leverage and building up access to capital to strengthen their liquidity, which helped them immensely.

On the larger issue of volatility, Cohen & Steers adds, “At its Core, real estate exists to support basic needs of individuals and businesses, providing shelter and facilitating commerce.” And there

will always be demand in that regard. It's only a matter of whether those needs are "housed in a different form or location," or reflect "current preferences, such as residents moving from multifamily apartments in dense cities to suburban single-family homes."

Investment trends can change quickly and unexpectedly. In some years, REIT stocks will be very popular; in others, they'll be all but ignored. Admittedly, some "trends may be more permanent: accelerated e-commerce adoption driving demand for industrial/logistics at the expense of retail." Some examples include "greater reliance on digital infrastructure benefiting data centers and cell towers" and "increasing acceptance of work from home affecting office utilization."

The rise of hedge funds – including those with very short time horizons – has added another wild card to the deck. REITs can sometimes become the sandbox in which these funds like to play, bringing more volatility with them than there otherwise would, or should, be.

The reason I bring this up is because it's important to know what can cause volatility in the stocks we purchase, REITs or otherwise. When our stocks go up, it's too easy to ignore risk in our pursuit of ever-greater profits. And when our stocks drop, we too often tend to panic, dumping otherwise sound investments because we're afraid of ever greater losses.

Consider missed market expectations, which can play havoc on otherwise stable stocks. Let's say you own shares in a "regular" company that reports a 15% year-over-year increase in earnings. Yet because analysts expected a 20% increase, the stock drops. That scenario has played out more than once.

Fortunately, REITs are superior to most common stocks in this regard. Analysts who follow these companies are normally able to accurately forecast quarterly results, within one or two cents, quarter after quarter. This is because of the sheer predictability of the operations at work, especially when it comes to any property type that uses long-term leases (which is most of them). That provides earnings stability that can't be found very easily elsewhere, further reducing both risk and volatility.

As a result, relatively few REITs have gotten themselves into serious financial difficulties over the years. Those that did were generally poorly managed and/or burdened by risky balance sheets.

Less Risk

Make no mistake: There are times to buy and sell. But prudent investors control their emotions, oftentimes by filling their portfolios with low-risk positions like REITs.

As we already established, there's no way to avoid risk completely. Even simple preservation of capital carries its own risk, with inflation taking its typical toll on almost everything. So it should come as no surprise that real estate ownership and management comes with potential problems too.

The previously referenced Cohen & Steers report already broached the subject. It's easy to see that retail REITs are subject to the changing spending habits of consumers and that rising online capabilities are affecting offices. But every other property type comes with its own set of potential pitfalls. For instance, apartment REITs have to deal with varying popularity of single-family dwellings and/or declining job growth. And the healthcare subsector constantly battles government decisions concerning healthcare reimbursement.

Again, there is no perfect investment. I can't stress that enough. The global pandemic and consequent government shutdowns certainly put significant stress on many REITs, especially already struggling malls, which we'll discuss in Chapter 5. Even so, the unique blocks these investments are built on do make them very worthwhile considerations.

The fact that they simultaneously provide a steady income of dividend payments even during the occasional bear market doesn't hurt either. They literally pay us to wait.

Higher Current Returns

Chapter 3 discusses the actual creation and evolution of REITs. For now, just understand that they pay out at least 90% of their pretax income to shareholders in the form of dividends. The result is typically higher dividends as a percentage of their free cash flows (FCF) and higher dividend yields to boot.

In addition, to stay compliant with the law, REITs usually have to increase their payouts as rents rise over time, historically resulting in steady dividend growth.

Some academics claim shareholders shouldn't care how much of a company's net income is paid out this way. But others argue

that dividends really do matter with respect to shareholders' total returns.

In September 2010, *Barron's* quoted Ed Clissold, an equity strategist at Ned Davis Research. His research showed that the S&P 500 had delivered average annual price appreciation of 4.92% since the end of 1929. But its average annual total return had been 9.16%. In other words, dividends provided approximately 46% of those total returns, indicating that they do indeed count. A lot. And we haven't seen any evidence of that principle changing in the last decade.

Another related benefit is that REIT shareholders can participate in income reinvestment plans, plowing their dividend income back into their holdings by buying additional shares. Or, should they so choose, they can invest it elsewhere or spend it on a vacation in Hawaii. Other shareholders don't have this advantage. They have to accept whatever decisions the board of directors puts in place in this regard.

Skeptics may point out that REITs' featured dividend yields are often below those of many corporate bonds. However, bond interest payments don't increase, whereas the REIT industry has a long-term track record of increasing dividends on a regular basis. The Great Recession and 2020–2021 Covid-19 pandemic both interrupted that run, it's true. But over time, their dividend action has still proven to outpace inflationary forces.

Back to Cohen & Steers again: "Real estate has inherent inflation-hedging qualities that we believe can help investors defend against erosion in buying power resulting from the rising cost of living." This includes how an inflationary environment can restrain new developments by pushing up the price of everything from land to materials and labor. As a result, landlords are in a better position to raise rents.

The article also mentions this: "Many commercial leases even have explicit inflation links, with rent escalators tied to a published inflation rate. As a result, REITs have historically benefited from inflation surprises, contrasting with the adverse reaction from broad stocks and bonds." Covid-19 did halt inflation for a time, but the long-term trend tells us that will change soon enough.

On a slightly separate note, there's also an intangible psychological benefit in seeing significant dividends roll in so

consistently. Seeing a check come in for several hundred dollars every quarter – without the usual effort on your part – can provide substantial comfort . . . regardless of whether you intend to spend it or reinvest it.

High Current Returns Versus Slow Growth

Many people understandably wonder if those high dividends have a negative effect on REITs' growth prospects. After all, their 90% pretax-income payouts mean they can only keep so much money to build on.

Stock prices do indeed appreciate from rising earnings growth. Therefore, REIT shares do usually rise at a slower pace than non-dividend-paying companies. However, this is perfectly acceptable to their investors, who expect to make up much – or even all – of the difference through higher dividend payments over time.

Consider the study presented in the January/February 2003 issue of *Financial Analysts Journal*. Entitled “Surprise! Higher Dividends = Higher Earnings Growth,” it was written by hedge fund manager Cliff Asness of AQR Capital Management and academic Robert Arnott of Research Affiliates. Together, they concluded that the earnings growth rates of companies with above-average dividend payments are actually higher than those with lower offerings.

These results tend to defy logic, I know. But the latter kind of company doesn't always do a good job of reinvesting its retained capital. Why should it? There's not the same incentive to be careful in this regard.

Regardless, REITs do have other means of obtaining growth (yet another to-be-discussed topic, this time in Chapter 10). They can make additional stock and debt offerings, exchange new shares or partnership units for properties, or get creative with buying and selling strategies.

With all that said, when dealing with most subsectors, it's often best to have relatively conservative expectations. In most cases, investors would be wise not to expect more than mid-single-digit growth over the long term. And when those conservative expectations are blown out of the sky, you'll want to do your due diligence.

It's not an automatic warning flag when a REIT's stock just keeps climbing. Some sectors perform better than others at varying times,

which only makes sense. Real estate is a cyclical industry, so there will be down years. But rental rates do grow over time, meaning that healthy REITs' cash flows will grow as well.

These assets don't promise instant riches or even perpetual investment tranquility. But the sector does make for excellent long-term investments nonetheless. I've seen it happen too many times for myself and my readers to doubt that fact.

