REITS EXPLAINED

Understanding Real Estate Investment Trusts

REITs, or Real Estate Investment Trusts, are companies that own and typically operate a portfolio of income-generating commercial real estate such as apartment buildings, hotels, office space, and retail shopping centers.

REITs were first created by Congress in 1960 in order to enable small investors the ability to reap the benefit of the investment returns associated with commercial property.

REITs receive income from the various properties in their portfolios and pay out at least 90% of their taxable income to investors as dividends. As such, REITs have become quite popular with investors due to their high yields, particularly in low interest rate environments. Because of the low correlation with other asset classes, such as equities and fixed income, the inclusion of REITs in a diversified portfolio can reduce overall portfolio volatility and improve risk-adjusted returns.

There are three major types of REIT securities: private equity REITs, publicly traded REITs, and public non-traded REITs. In addition, there are also REIT mutual funds and ETFs (Exchange-Traded Funds) which allow investors to diversify over a larger portfolio of REITs.

Types of REITS

REITs can be further divided into equity REITs, mortgage REITs, and hybrid REITs. The key distinction between the different types is that equity REITs are actively involved in ownership and operation of income-producing assets (buildings and property), while mortgage REITs are involved with real estate debt such as

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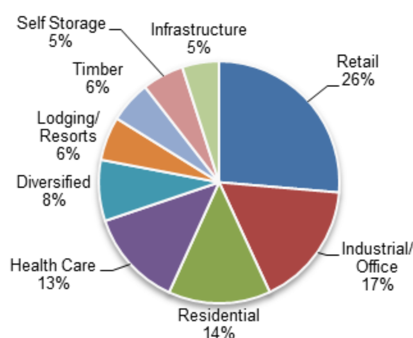
mortgages and real estate loans. Hybrid REITs, as the name implies, can own both real estate assets and real estate debt.

Equity REITs are by far the largest single type of REIT, accounting for over 90% of all listed REITs according to NAREIT[1].

Equity REITs invest in real estate across a number of different sectors including retail (shopping centers), industrial (office parks), residential (apartment buildings), health care (hospitals), and lodging (resorts).

Mortgage REITs typically focus on commercial real estate debt although a small number of mortgage REITs invest in residential mortgages and home loans.

Chart 1



Source: NAREIT

Types of REIT Securities

Publicly traded REITs are similar to stocks in that they trade on a national stock exchange and are required to file both a prospectus and regular financial reports with the SEC.

Public non-traded REITs are similarly required to file with the SEC. However, non-traded REITs are not listed on an exchange, and there is a very limited secondary market. Because of the limited secondary market, non-traded REITs typically have a finite investment life, at the end of which the REIT will either list on an exchange or liquidate.

In addition, there is typically a minimum (one-year) holding period before investors can redeem their shares in non-traded REITs. Redemptions may also be limited to 3-5% of the weighted average number of shares outstanding during the previous year. While sales prior to a liquidity event may be allowed, the redemption price in these instances is often set below the purchase price.

Because non-traded REITs are designed to be held by investors for a long period of time, the shares are not marked to market on a daily basis. Instead, the price is set at $10 per share at offering and that price holds for the first 18 months after the REIT stops raising money. This allows the REIT to use the proceeds from the offering to invest in a portfolio of real estate. After the first 18 months, the REITs are valued based on the net asset value of the portfolio.

Private placement REITs are not registered with the SEC and do not trade on any exchange. In addition, the ability to redeem shares is often quite limited and often restricted to liquidity events. Private placement REITs are only available to “sophisticated investors” who meet certain requirements related to net worth and annual income.

[1] National Association of Real Estate Investment Trusts

Advantages of REITS

REITs have several advantages for investors. First and foremost, REITs have historically exhibited a low correlation with other asset classes, providing diversification benefits. The benefit of low correlations between assets in a portfolio is that the overall volatility of the portfolio can be reduced. The lack of correlation between two securities means that the daily movement of one security will not be mirrored by the movement of the other. To take the simplest example, imagine that stocks and bonds have a correlation of -1. This means that on days when stocks move up, bonds move down and vice versa. A portfolio that owned a mix of stocks and bonds would exhibit less combined volatility than one that held just stocks or bonds as a result of this negative correlation. This is the founding insight of Modern Portfolio Theory – that imperfect correlation between assets makes it possible to construct portfolios that exhibit lower risk at a given level of return than the individual assets alone. The low correlation between REITs, Equity and Fixed Income[2] investments over the past ten or twenty years (shown in **Table 1**) illustrates the advantage of holding a portfolio which contained a combination of those assets.

Often, portfolio construction follows a familiar pattern of allocation between equities and fixed income with the allocation to each being adjusted over time, according to the age and risk tolerance of the client. The fixed income component of the portfolio is usually represented by bonds, the average duration of which is again matched to the needs of the client. However, in the fixed income section of the portfolio, REITs are often underutilized (or excluded entirely) because the investment advisor either believes they are more appropriately included in the equity allocation or lacks even a basic understanding of the product area and thus prefers to use only bonds.

In making these allocation choices it is important to know that REITs can be a successful substitute for bonds and can serve to dampen overall portfolio volatility in a way that bonds cannot. Specifically, REITs tend to respond better than bonds in a rising interest rate environment. Because interest rate increases often coincide with periods of increased economic activity, after the initial rate increase-induced selloff, investors will reconsider the ability of REITs to thrive as a result of the positive benefit this increased activity has on REIT operations. Since characteristics of bonds such as the coupon, maturity date, call date, issuer and maturity value are fixed, bonds can only respond to interest rates changes with a change in price. In the absence of default risk, investors will generally not consider the underlying business prospects of a bond issuer (and in the case of Treasuries, this factor is never considered) and will subsequently buy and sell bonds based on their interest rate outlook and the ensuing need to adjust average duration in response to perceived interest rate risk. REITs can provide more flexibility while providing income that is in many cases superior to bonds and can provide at least the possibility

[2] REITs are represented by the FTSE NAREIT All REIT Index, Equity by the S&P 500 Total Return Index and Fixed Income by the BarCap US Aggregate Bond Index.

of capital gains in a rising rate environment, which bonds cannot. Income from REITs can also be reinvested in additional shares, allowing an investor to average costs, a feature that is usually very difficult to duplicate in a bond investment, unless a bond fund is utilized, which comes with a whole separate set of portfolio risks. The tradeoff for some of the advantages of utilizing REITs instead of bonds is the lack of a maturity date (making average duration calculations difficult) and the lack of a fixed coupon, since REITs can and do adjust their dividends as funds from operations rise and fall. REITs also do not carry with them a promise of payment, as bonds do, so REIT investors lack the certainty of the eventual return of their principal. For these reasons and others, it is unlikely that REITs will ever totally supplant bonds as the preferred fixed income alternative, but there still remains plenty of opportunity to utilize REITs alongside bonds in a properly constructed, well-diversified portfolio.

Table 1

Correlation 1992-2012

	REIT	EQUITY	FIXED INCOME
REIT	1.00	0.57	0.14
EQUITY	0.57	1.00	0.06
FIXED INCOME	0.14	0.06	1.00

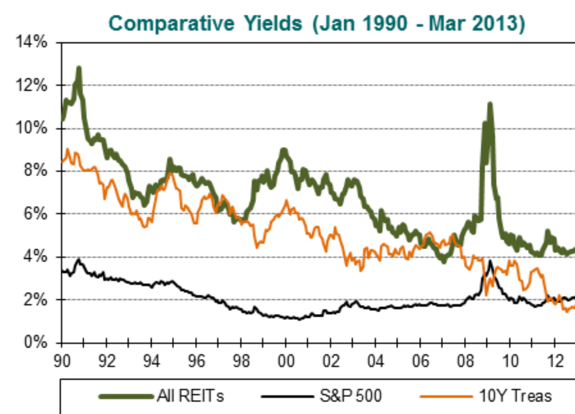
Correlation 2002-2012

	REIT	EQUITY	FIXED INCOME
REIT	1.00	0.72	0.16
EQUITY	0.72	1.00	-0.07
FIXED INCOME	0.16	-0.07	1.00

Source: NAREIT, Bloomberg, BarCap Live

Another advantage that REITs offer to investors is the ability to pay out higher yields than equities and fixed income. Because REITs must distribute 90% of their taxable income to investors, the average yield on REITs can be 3.9% higher than for equities or 1.8% higher than Treasury bonds.[3] The comparative yields for all three are shown in **Chart 2** below.

Chart 2

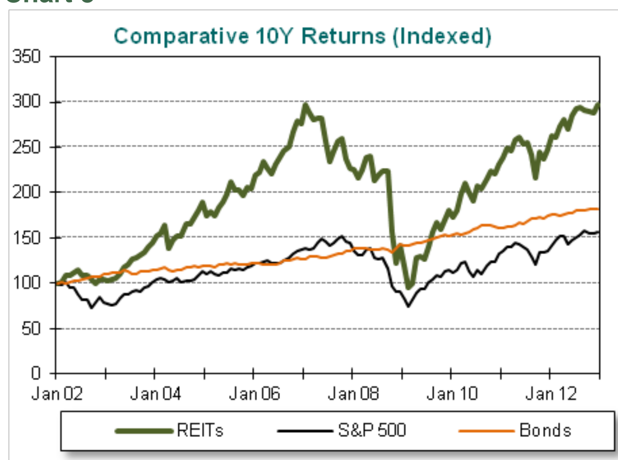


Source: NAREIT, Bloomberg

[3] Based on monthly yields for the FTSE NAREIT All REIT index, the S&P 500 Total Return Index and 10 year Treasury yields from January 1990 – March 2013.

In terms of total return, which includes capital appreciation and dividend yields, REITs have historically outperformed most types of equities while exhibiting lower volatility. Over the most recent 10 year period ended December 31, 2012 REITs have returned 197% to investors. This compares to 57% for stocks as represented by the S&P 500 Total Return Index and 81% for bonds as represented by the BarCap US Aggregate Bond Index. This performance is illustrated in **Chart 3** below.

Chart 3



Source: NAREIT, Bloomberg, BarCap Live

Table 2

1990-2012	Avg Return	Avg Risk	Sharpe
REIT	12.3%	15.8%	0.36
EQUITY	10.2%	16.9%	0.29
FIXED INCOME	7.0%	3.9%	0.42

Source: NAREIT, Bloomberg, BarCap Live

From 1990 to 2012, REITs have performed well in terms of average annual returns on both a gross and risk adjusted basis. During this period they returned more on average than did equities, at slightly lower volatility. The Sharpe ratio presented in **Table 2** above captures returns in excess of the risk free rate, divided by the volatility of those excess returns[4]. It shows that per unit of risk undertaken, REITs performed better than equities, while lagging marginally behind bonds. It is important to remember that the statistics for bonds during this time period are greatly skewed by their outperformance subsequent to the Credit Crisis, and the underperformance of other asset classes during the crisis aftermath[5].

REIT Risk Factors

Although all REITs do have exposure to the real estate market, and in particular, the commercial real estate market, there are differing risk factors among the various types of REIT securities.

Publicly Traded REITs

REITs are susceptible to downturns in the economy, as slower growth could negatively impact the income REITs receive from various properties as well as property values.

Although publicly traded REITs have historically exhibited less volatility than stocks, price volatility is still present. Additionally, REITs can

[4] Excess annual returns are calculated by subtracting the yield on a ten-year Treasury bond from the annual return generated by each index. The average of these excess annual returns is then divided by the standard deviation of excess annual returns in order to generate an annualized Sharpe ratio for the period for each index.

[5] For example, the Sharpe ratios for the time period 1990-2006 are 0.51, 0.38, and .030 for REITs, Equity and Fixed Income respectively. Bonds enjoyed strong returns and low volatility after the crisis, as investors sold out of other asset classes in a 'flight to safety'. This dramatically improves the Sharpe ratio for the asset class when extended through 2012.

experience volatility in share price unrelated to the underlying net asset value of the REIT.

Public Non-traded REITS

As the name implies, non-traded REITs are not listed on a national securities exchange and there may be a very limited secondary market in which to trade the securities. As such liquidity is a major risk factor for these types of securities. It bears noting, that these securities are designed to be held for a minimum holding period of five to seven years.

Because non-traded REITs are not actively traded on an exchange, there is not a market value for the securities. Instead, valuation is initially set at $10 per share for the first 18 months. After that time period, valuation is set based on a number of factors including type of real estate portfolio, property values, current and future income projections, asset/liability mix, and other factors.

REITs are frequently constructed with a focus on a particular type of commercial project, like office buildings. The focus on one particular type of commercial property leaves them vulnerable to any downturn in that market space. Similarly, to the extent that the REIT is focused on property located in one particular geographic region, it will be vulnerable to specific regional downturns as well.

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