CHAPTER 2

# Why Invest in REITs?

Many investors buy REITs solely for the attractive dividend yields they offer relative to government bonds and other investments. However, there are many more, equally compelling reasons to include REITs as part of a well-balanced portfolio. Two such reasons are that REITs typically have delivered total returns that exceed those of the S&P 500 Index and that their dividends generally increase faster than inflation (as measured by increases in the Consumer Price Index [CPI]), making REITs an effective hedge against inflation. A third and equally important reason is that REITs are a diversification tool; a wealth of research has proven that investing in REITs helps lower risk and increase returns on a portfolio of stocks and bonds.

## Double-Digit Total Returns

Investor total returns on any stock investment are calculated as the sum of dividends received plus any appreciation (or less any declined) in stock price during the time the stock is owned. Due in part to their attractive current yields, REITs have tended to deliver annualized total returns to investors of 10 to 12 percent over time. As shown in Table 2.1, equity REITs delivered average total annual returns of 12.0 percent from 1972 to 2015—or 170 basis points more than the 10.3 percent total return achieved by stocks in the S&P 500 Index over the same period. (A basis point [bps] is equal to 1/100 of a percentage point; for example, 1 percent equals 100 bps.)



*The Intelligent REIT Investor: How to Build Wealth with Real Estate Investment Trusts*,
Stephanie Krewson-Kelly and R. Brad Thomas
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Table 2.1 Comparative Compounded Total Annual Returns

| Timeframe* | All REITs | All Equity REITs | S&P 500 | NASDAQ† | DJIA |
|---|---|---|---|---|---|
| 2015 | 2.3% | 2.8% | 1.4% | 7.0% | 0.2% |
| 3-Year | 10.3% | 10.6% | 15.1% | 19.8% | 12.7% |
| 5-Year | 11.6% | 11.9% | 12.6% | 14.9% | 11.3% |
| 10-Year | 6.9% | 7.4% | 7.3% | 9.7% | 7.8% |
| 15-Year | 10.8% | 11.1% | 5.0% | 4.8% | 5.8% |
| 20-Year | 10.3% | 10.9% | 8.2% | 8.1% | 8.8% |
| 30-Year | 9.4% | 10.7% | 10.4% | 9.6% | 8.4% |
| 40-Year | 12.0% | 13.7% | 11.4% | 11.0% | 7.8% |
| 1972 – 2015 | 9.8% | 12.0% | 10.3% | 8.9% | 7.0% |

*Compounded annual total returns for the number of years ended December 31, 2015. Shaded areas represent time periods when equity REITs outperformed the S&P 500 Index.
†Price appreciation only. Compounded annual returns from 1972 to 2015 are calculated from the NASDAQ Composite's inception date of December 31, 1973.
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## Dividends

Dividend income is one of the primary reasons to invest in REITs, in large part because their yields represent an attractive premium to yields offered by other investments. As of December 31, 2015, the average dividend yield from REITs in the FTSE NAREIT All REITs Index was 4.3 percent, or approximately 200 basis points higher than the 2.3 percent yield on 10-year U.S. Treasuries and the 2.2 percent yield from the S&P 500 Index.

REITs are an attractive investment for people seeking current income, provided that the REIT has a conservatively leveraged balance sheet and well-located assets that are competitively managed. When a REIT possesses these qualities, it generally can sustain—and preferably grow—the dividend it pays to shareholders. Chapter 3 discusses the characteristics of REIT dividends and dividend yield, as well as quick calculations investors can perform to assess the sustainability of a REIT's dividend.

## Liquidity

Publicly traded REITs offer investors the ability to add real estate returns to their portfolios without incurring the liquidity risk that accompanies direct real estate investment. This is because REITs that are publicly traded on stock exchanges can be bought or sold in

an instant, like other stocks, through a financial advisor or online trading services. (Nontraded and private REITs do not offer similar liquidity; these structures are discussed in Chapter 6.) In contrast, direct investments in real estate can take several months or even years to sell. Publicly traded REITs, therefore, enable investors to participate in real estate–based investments in a liquid manner.

## Portfolio Diversification

REITs are a proven diversification tool for portfolio management, a fact that has been demonstrated in multiple studies by various prominent investment advisory firms using different techniques, data sources, and time periods. In simplistic terms, diversification means that adding a particular investment to a portfolio increases the overall expected returns of that pool of investments while also reducing risk. Note that risk is also referred to as *volatility*.

The reason for this diversification benefit is because real estate and, by extension, REITs represent one of the three fundamental investment asset classes, the other two being stocks (also called *equities*) and bonds. As Figure 2.1 shows, U.S. investment real estate (which excludes single-family homes) is estimated to represent $17 trillion, or 21 percent of the $79 trillion investable assets in the United States. Because real estate has its own unique drivers and cycle that are separate from that of other equities and bonds, real estate investments promote portfolio diversification. (Chapter 7, REIT Performance, discusses the real estate cycle in detail.)

In the past decade, six major studies have been performed to determine what allocation to REITs will maximize their diversification benefits. (*Allocation* speaks to what percent of the total portfolio amount is invested in an asset class. For example, an individual may invest 20 percent of his or her portfolio in REITs, 40 percent in equities, and 40 percent in bonds.) Figure 2.2 summarizes their findings.

### Fact

A $1,000 portfolio invested in a combination of equities, bonds, and equity REIT shares will produce greater returns and exhibit less risk than a $1,000 portfolio that does not include an allocation to equity REITs.

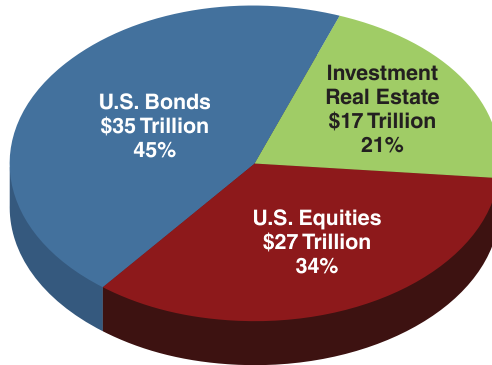


Figure 2.1 Investment Real Estate Is the Third Largest Asset Class in the United States.

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Although many investors believe investing (or allocating) between 5 and 10 percent of their portfolio in REITs is "about right," these six studies have shown that the optimal allocation to REITs is as high as 20 percent—which is proportionate with the size of the investment real estate market shown in Figure 2.1.

For example, the 2016 Wilshire Associates study commissioned by NAREIT, *The Role of REITs and Listed Real Estate Equities in Target Date Fund Asset Allocations* (the "2016 Wilshire Report," reference in Figure 2.2), found that the optimal portfolio allocates up to 17 percent of assets to REITs. The study showed that a diversified portfolio that included REITs had nine less basis points of risk (and generated 33 basis points of additional return) than a similar portfolio that did not include REITs. Although 0.33 percent may not seem meaningful on the surface, over time the additional return adds up.

A portion of this outperformance can be attributed to the robust dividend yields and above-average returns REITs offer, but an equally important factor is the low correlation with which REITs trade relative to bonds and other stocks. A correlation of +1 between two investments means that they trade in complete lockstep with one another; conversely, a correlation of –1 means they trade proportionally in opposite directions. The 2016 Wilshire Report showed that from 1975 through 2015, REIT share prices moved with a 0.58 correlation with the Wilshire U.S. Large Cap Index and a 0.65 correlation with the Wilshire U.S. Small Cap Index.

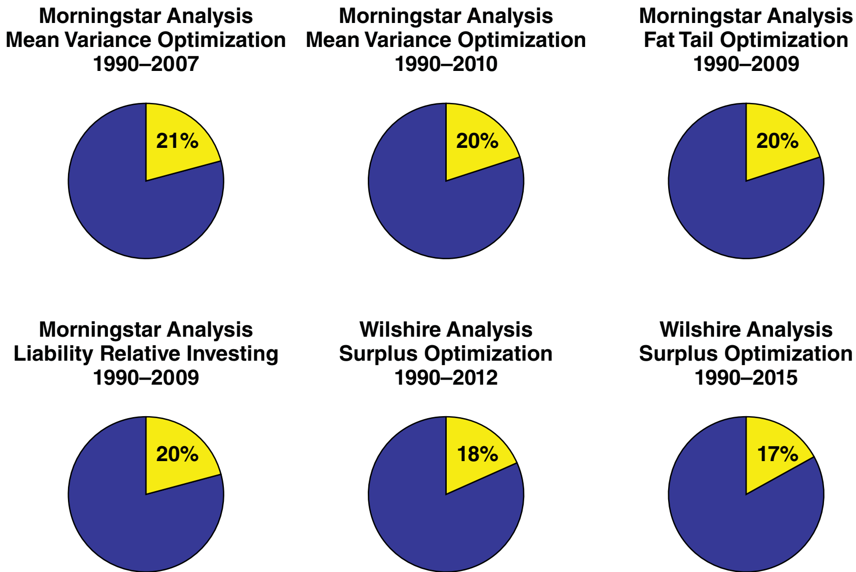


Figure 2.2 Portfolio Allocations to Global Real Estate (different researchers, methodologies, and time periods)

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As a final note, a groundbreaking study completed recently by CEM highlighted the advantages of owning publicly traded REITs rather than private real estate. According to a summary of the CEM study provided by NAREIT, the study tracked returns from over 200 public and private pension plans with combined assets of over $2.5 trillion. The results, which are summarized in Figure 2.3, clearly demonstrated that publicly traded REITs had the highest return (net of expenses), with an annualized total return of 11.31 percent. Private real estate returned just 7.61 percent.

## Hedge Against Inflation

Equity REITs rent their properties to tenants according to leases, the terms of which tend to protect the REITs' margins from the effects of inflation. As discussed in Chapter 4, most leases provide

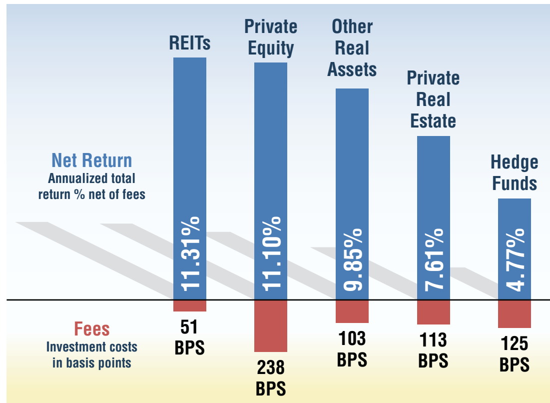


Figure 2.3 CEM Benchmarking Study: U.S. Defined Benefit Pension Plan Performance

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that landlords will bill tenants for various costs (utilities, taxes, insurance, landscaping, etc.) after they have been incurred. In the case of triple-net leases, the landlord does not pay any of these operational costs; instead, tenants pay the costs directly. Apartment landlords typically have one-year leases, and generally can increase their rents (also called *marking-to-market*) to keep pace with inflating costs. The ability to pass along increases in operating costs enables REIT revenues to keep pace—albeit with some lag—with rising prices in times of inflation. The result is that REITs generate inflation-adjusted earnings, which makes their stocks attractive investments during times of inflation.

Table 2.2 is excerpted from the 2016 Wilshire Report referenced earlier in this chapter, and shows how often different investments—namely REITs, commodities (as represented by the S&P GSCI Total Index), the S&P 500 Index, and Treasury Inflation Protected Securities (TIPS)—generated total returns that exceeded inflation. The higher the percentage shown, the more effective the investment was at protecting (or *hedging*) against inflation. From 1975 through 2015, REIT total returns exceeded inflation 74 percent of the time on a rolling 6-month basis, and 75 percent of the time on

Table 2.2 Percent of Rolling Periods in Which Total Return Met or Exceeded Inflation: 1975–2015

| | FTSE All Equity REITs Index | S&P GSCI Total Index | S&P 500 Index | Barclays Capital U.S. TIPS Index* |
|---|---|---|---|---|
| 6-month rolling returns | 74% | 56% | 69% | 69% |
| 12-month rolling returns | 75% | 57% | 72% | 74% |

*Barclays Capital U.S. TIPS Index inception was October 1, 1997.
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a rolling 12-month basis. REITs' ability to produce total returns that were greater than inflation was comparable to owning TIPS, which exceeded inflation 69 percent of the time over a 6-month period and 74 percent of the time over a 12-month period. Although it is not surprising that REITs' inflation protection exceeded that of stocks in the S&P 500 Index (69 percent and 72 percent on 6- and 12-month rolling returns, respectively), it may surprise investors to learn that REITs also were a much more effective hedge against inflation than commodities, where returns exceeded inflation only 56 percent of the time on a rolling 6-month basis and 57 percent of the time on a 12-month basis.

## Transparent Corporate Structures

The REIT industry is highly transparent in part because, as publicly traded firms, each company faces a high degree of scrutiny every quarter. There are over 30 firms in the United States. that provide equity research on REITs. Additionally, based on data provided by S&P Global Market Intelligence, 80 of the 223 REITs in the FTSE NAREIT All REITs Index at the end of 2015 were investment-grade rated and another 24 were rated but below investment grade, for a total of 104 rated REITs. (Please see Appendix D, *REITs with Credit Ratings*.) These 104 companies represent approximately 80 percent of the industry's equity market capitalization and have at least one fixed-income analyst also scrutinizing their quarterly results. If a management team pursues a questionable business practice, such as using short-term variable rate debt to finance growth, one of these analysts is bound to report on it, alerting investors and likely causing that REIT's valuation to suffer. Against the backdrop of accounting

scandals like the Enron Corporation (former NYSE: ENE) in 2001 and Ponzi schemes like that of Bernie Madoff, which was revealed in 2008, investors increasingly take comfort in REITs because of the daily scrutiny they endure from the analyst communities.

Secondly, REITs are compelled to pay out at least 90 percent of their otherwise taxable income, and many pay out 100 percent or more. REITs also pay their dividends in cash (though the IRS has, in the past, allowed REITs to issue new stock to pay their dividends) and, therefore, operate with limited retained earnings. As a result, they generally issue new public equity every other year in order to finance growth. Whichever Wall Street firm a management team selects to underwrite a stock issuance will subject the REIT to yet another level of scrutiny as part of the investment bank's due diligence. As the accounting irregularities discovered at American Realty Capital Properties' (formerly NYSE: ARCP) in 2014 proved, the REIT industry is not immune to scandal. However, incidents of fraud are few and far between in the REIT world. The difficulty REIT management teams would have in hiding accounting irregularities for any extended period of time, without disrupting their ability to pay dividends or without being found out by the analyst community or underwriters, minimizes the risk of fraud. The heavy scrutiny under which REITs operate, as well as the discipline the dividend payout requirement imposes on management, combine to make REITs a highly transparent investment class that investors increasingly turn to for steady appreciation and attractive yield.