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WEALTH MANAGEMENT

About REITs as an Investment Alternative

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Real estate has historically delivered attractive investment returns through a combination of current income and price appreciation. Many investors want to include real estate as a piece of a well-diversified portfolio. However, adding real estate to a traditional investment portfolio consisting of stocks, bonds and cash was a challenge. The Real Estate Investment Trust (REIT) structure was created to mitigate many of the challenges individual investors can have when attempting to invest in institutional grade commercial real estate.

The Basics

A REIT is formally known as a Real Estate Investment Trust. REITs are pooled investment vehicles similar to a mutual fund that allow retail investors to access the benefits of large commercial real estate investments. REITs own, operate, or finance income-producing real estate. Congress originally passed legislation in 1960 allowing the creation of REITs. This law was refined with the passage of the 1986 Tax Reform Act. This allowed REITs to manage and operate real estate, while the prior legislation had limited REITs to simply owning and financing real estate. The enhanced ability to own and manage real estate created the foundation for the existing REIT investment landscape.

The Modern REIT era began in 1986 and accelerated during the 1990s as real estate companies transformed their businesses into qualified REITs. The major driver of this transformation was the attractive tax benefits offered. Investors in corporations are effectively taxed twice. The company pays the corporate income tax, then when dividends are paid to shareholders, these dividends are taxed again. REITs offer a solution to help manage this double taxation. REITs are able to avoid paying corporate income tax by meeting specific criteria.

How to Qualify as a REIT[1]

A company must have the bulk of its assets and income connected to real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends. A company that qualifies as a REIT is allowed to deduct all of the dividends that it pays out to its shareholders from its corporate taxable income. Because of this special tax treatment, most REITs pay out at least 100 percent of their taxable income to their shareholders and, therefore, owe no corporate tax.

There are a number of other qualifications required that generally fall under the category that the corporation is substantially involved (75% or more) in real estate assets and that the gross income is derived from real estate sources including rents and interested paid on mortgages. This framework has allowed the creation of three major types of REITs: Equity, Mortgage, and Hybrid.

1. **Equity REITs**

   The majority of REITs are equity REITs. These are vehicles that own and manage income-producing real estate. These REITs earnings are primarily derived by tenants paying rent, not the buying and selling of the underlying real estate.

2. **Mortgage REITs (mREIT)**

   Mortgage REITs utilize the income earned on debt to produce dividends. Mortgage REITs may invest in mortgage back securities (MBS), purchase existing mortgages, or lend directly to borrowers. Mortgage REITs profitability is often determined by the difference between the mREIT borrowing costs and the amount earned via their investment in mortgages. This dynamic can make mortgage REITs subject to risks from rising interest rates.

3. **Hybrid**

   Hybrid REITs utilize investments in both Equity and Mortgage areas.

Key Benefits of REITs

REIT investments provide exposure to the institutional real estate market. This is an area that has historically produced attractive returns. These returns have traditionally provided differentiated returns from the stock market which can create attractive opportunities for investment diversification.[2]

REIT-Stock Correlation by Property Type

Apr 2008	Apr 2009	Apr 2010	Apr 2011	Apr 2012	Apr 2013	Apr 2014	Apr 2015	Apr 2016	Apr 2017	Apr 2018
Self Storage 39%	Self Storage 37%	Self Storage 48%	Self Storage 53%	Self Storage 53%	Infrastructure 28%	Infrastructure 32%	Health Care 28%	Health Care 25%	Data Center 31%	Health Care 25%
Health Care 46%	Health Care 47%	Health Care 55%	Health Care 53%	Health Care 57%	Health Care 51%	Health Care 34%	Infrastructure 34%	Self Storage 32%	Self Storage 33%	Retail 27%
Residential 51%	Residential 55%	Residential 65%	Residential 61%	Residential 59%	Residential 51%	Residential 39%	Self Storage 38%	Infrastructure 35%	Infrastructure 35%	Data Center 29%
Retail 51%	Retail 65%	Industrial 68%	Retail 69%	Industrial 71%	Self Storage 54%	Self Storage 45%	Residential 39%	Retail 36%	Health Care 36%	Self Storage 32%
Industrial 53%	Industrial 67%	Retail 73%	Industrial 70%	Timberland 71%	Diversified 71%	Retail 51%	Retail 47%	Residential 36%	Retail 43%	Infrastructure 35%
Diversified 56%	Diversified 67%	Diversified 75%	Diversified 72%	Retail 73%	Timberland 71%	Diversified 52%	Diversified 48%	Industrial 45%	Residential 45%	Residential 39%
Office 57%	Lodging 73%	Lodging 75%	Lodging 75%	Diversified 74%	Industrial 72%	Office 60%	Office 52%	Office 50%	Industrial 59%	Diversified 46%
Lodging 61%	Office 74%	Office 78%	Office 77%	Lodging 76%	Retail 72%	Industrial 63%	Industrial 53%	Diversified 50%	Diversified 66%	Industrial 51%
				Office 77%	Lodging 75%	Timberland 71%	Lodging 71%	Lodging 64%	Lodging 66%	Office 57%
					Office 76%	Lodging 74%	Timberland 71%	Timberland 71%	Office 67%	Lodging 63%
									Timberland 71%	Timberland 71%

Source: Nareit – 5/22/18 Return Correlations between REITs and the Broad Stock Market by Property Type

Real estate has historically been able to produce positive returns in inflationary periods potentially creating an inflation hedge in investment portfolios. The ability of real estate to help mitigate inflation risk can add a meaningful risk management tool to a portfolio. Finally, REITs can be a reliable source of income for investors. The income derived from REITS is one of the few sources of investment-based income that can increase as inflation moves higher due to the ability of owners to increase rents. REITs can be a key component of an income-oriented portfolio.

Risks of REITs

REITs can be attractive investments but also contain risk that investors need to be aware of. REITs are subject to many of the same general risks as stock, including economic contractions and recessions. Real estate can be subject to overinvestment in specific sectors or regions which can create bubble conditions. REITs can be negatively impacted by increases in interest rates as well. Many real estate investments are financed with debt, which may be challenging to refinance if interest rates increase. REITs are also subject to the skill of the management team. If the REIT manger makes poor decisions, the investments may suffer.

Public vs. Private

There are both publicly traded REITs and private REITs. Public REITs can take two forms: Publicly traded REITS and public non-traded REITS. Publicly traded will trade on a stock exchange like the NYSE. These public REITS behave similarly to other public equities with daily liquidity and typically, quarterly dividends. These REITs are subject to the same reporting requirements of other public exchange traded companies. The major benefit of these REITs are liquidity and transparency. Investors that require liquid investments will likely prefer these types of REITs. In addition, the holdings of these REITs are more easily determined. Public REITs can also be offered in a non-traded format where there are not listed on stock exchange. These REITs are registered with the SEC but do not have the same liquidity as exchange-treaded REITs. There may be limited liquidity offered monthly or quarterly by the REIT sponsor. These investment values tend to be more stable as they are not traded daily.

Private REITs have grown in popularity over the last 20 years. These REITs are not registered with the SEC and do not trade on an exchange. These REITs often have lock up periods where there is no liquidity available. These private REITs are typically only offered to institutions or individuals who meet enhanced suitability requirements.

	Publicly Traded REITs	Non-Traded REITs
Overview	REITs that file reports with the SEC and whose shares trade on national stock exchanges.	REITs that file reports with the SEC but whose shares do not trade on national stock exchanges.
Liquidity	Shares are listed and traded, like any publicly traded stock, on major stock exchanges. Most are NYSE listed.	Shares are not traded on public stock exchanges. Redemption programs for shares vary by company and are typically very limited. Investors may have to wait to receive a return of their capital until the company decides to engage in a transaction such as listing of the share on an exchange or a liquidation of the company's assets.
Transaction Costs	Brokerage costs the same as for buying or selling any other publicly traded stock.	Typically, fees of 9-10 percent of the investment are charged for broker-dealer commissions and other upfront offering costs. Ongoing acquisition and management fees and other expenses also are typical. Backend fees may be charged.
Management	Typically, the managers are employees of the company.	Typically, the company has no employees and is managed by a third party pursuant to a management contract.
Minimum Investment Amount	One share.	Typically, $1,000 - $2,500.
Independent Directors	Stock exchange rules require a majority of directors to be independent of management. NYSE and NASDAQ rules call for fully independent audit, nominating, and compensation committees.	North American Securities Administrators Association ("NASAA") guidelines, which have been adopted by many states, require a majority of directors to be independent of management. NASAA guidelines also require that a majority of each board committee consist of independent directors.
Investor Control	Investors elect directors.	Investors elect directors.
Corporate Governance	Specific stock exchange rules on corporate governance.	Subject to state and NASAA guidelines.
Disclosure Obligation	Required to make regular SEC disclosures, including quarterly financial reports and yearly audited financial reports.	Required to make regular SEC disclosures, including quarterly financial reports and yearly audited financial reports.
Share Value Transparency	Real-time market prices are publicly available. Wide range of analyst reports available to the public.	No independent information about share value available. Company may provide an estimate share value 18 months after the offering has closed.

Source: National Association of Real Estate Investment Trusts (NAREIT)

Key Take Aways

- REITS offer exposure to real estate without the associated management cost and requirements
- REITs can be a reliable source of income
- REITs are subject to economic and market risks. In addition, REIT investors are dependent on the skill of the management team to produce returns. Poor management can lead to poor returns.
- REITs can add meaningful diversification to a portfolio

To learn more about the benefits, risks, and key differences between various types of REITs, contact BakerAvenue to understand if REITs are a could be a good investment alternative for you.

Sources

1. https://www.sec.gov/files/reits.pdf
2. https://www.reit.com/news/blog/market-commentary/return-correlations-between-reits-and-the-broad-stock-market-by-property-type

Helping You Embrace Life's Transitions.

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