

Are REITs Right?

By David Twibell

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When asked about the best time to buy real estate, property mogul Donald Trump once remarked, “real estate is always good as far as I’m concerned.” And, for most of this decade at least, he was right. But following years of strong performance, the commercial real estate market is now in tatters which raises an interesting question – should equity investors be buying real estate investment trusts, or REITs, in anticipation of a coming recovery?

REITs are companies that buy, develop, manage, and sell real estate. Some focus on particular property types like apartments, shopping malls, or office buildings, while others own diversified portfolios. In exchange for preferential tax treatment, REITs distribute at least 90 percent of their taxable income to shareholders. As a result, they tend to blur the line between stocks and bonds, combining high dividend yields with potential capital appreciation.

During most of this decade REITs were an outstanding investment. Indeed, spurred higher by declining interest rates, the collapse of the technology bubble, and growing demand for higher-yielding investments, REITs as measured by the Morgan Stanley REIT Index rose more than 306 percent from 2000 to 2007 -- for an average annual return of 22.18 percent.

But the good times ended in 2007 as concerns about residential housing and other issues snowballed into a full-blown debt-market crisis. As a result, the Morgan Stanley REIT index has dropped over 64 percent since then. Moreover, many sub-sectors of the REIT market – including not surprisingly almost every housing-related REIT – have collapsed even further.

So, should cagey investors be looking to step back into REITs at this point? That’s a difficult question. Historically REITs have provided solid returns to investors with a relatively low correlation to the US stock market. Moreover, many REITs are extremely cheap, with several trading at substantial discounts to their underlying net asset values. Many of these same REITs were trading at a premium just two years ago.

But before making the plunge into REITs, consider that commercial real estate fundamentals are still deteriorating rapidly with occupancy rates in some sectors hitting all-time lows. Moreover rental rates, particularly in the apartment and retail areas, are slumping with no letup currently in sight. So, while REITs may be cheap, the fundamentals of the commercial real estate sector show no sign of improving any time soon.

Investors interested in REITs have a variety of options. Perhaps the easiest way to access REITs is through one of the many specialized mutual funds focusing on the sector. Examples include the CGM Realty Fund (CGMRX), Cohen & Steers Realty Shares Fund (CSRSX), and T. Rowe Price Real Estate Fund (TRREX).

Alternatively, investors can purchase shares directly in one of the myriad publicly-traded REITs including Simon Properties Group (SPG), Vornado Realty Trust (VNO), and Boston Properties (BXP).

Finally, there are also a variety of exchange-traded and closed-end funds that offer exposure to REITs, both domestic and international. These include the Vanguard REIT ETF (VNQ), ING Clarion Global Real Estate Fund (IGR), iShares Dow Jones U.S. Real Estate Index Fund (IYR), and – for investors willing to walk on the wild side – the recently-released Claymore/AlphaShares China Real Estate ETF (TAO).

REITs were market stars for most of this decade, but nothing lasts forever. While opinions differ on whether REITs are still headed lower or ready to recover, for most long-term investors they will likely continue to be an important part of a diversified allocation strategy.

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