Embracing The Role of REITs

In Diversified Investment Portfolios

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WEALTHMANAGEMENT
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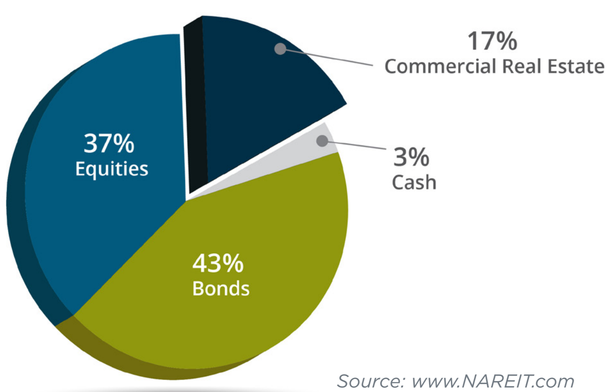
When a new client chooses WT Wealth Management, one of our favorite things is getting to see their portfolio as constructed by their previous advisor. It's just like seeing how your neighbor decorated their house when you both have the same floor plan.

One thing we have consistently seen is that REITs, Real Estate Investment Trusts, are a much underrepresented part of most clients' investment portfolios. This is somewhat surprising considering:

- **Real estate is a fundamental asset class (along with stocks, bonds and cash)**
- **REITs are an effective, liquid, and low-cost means of investing in the real estate asset class**
- **REITs provide diversification in a well balanced portfolio**

At 17%, commericial real estate is the
third largest asset class
in the U.S. Investment market



Source: www.NAREIT.com

Since nearly all WT Wealth Management clients hold REITs as one component of their diversified portfolio, we felt it was a good time to provide some basic educational material on the subject.

Why real estate?

Real Estate Investment Trusts (REITs) have unique characteristics that may make them attractive to both income and growth investors. REITs trade like stocks and can fluctuate in price, but they also pay out a large part of their income in the form of dividends.

REITs may be used to help provide income in conservative portfolios or long-term growth in more aggressive portfolios. Some portion of every portfolio may be appropriately allocated to REITs for a broad range of investor types.

As outlined on the website of the National Association of Real Estate Investment Trusts (www.NAREIT.com), REITs of all types collectively own more than $3 trillion in gross real estate assets across the U.S., with stock-exchange listed REITs owning approximately $2 trillion in assets. U.S. listed REITs have an equity market capitalization of more than $1 trillion.

Just like everything in the field of investments today, offerings have become numerous and highly specialized. There are ETFs that offer allocations to a variety of individual REITs. For example, Vanguard's and iShare's REIT offerings have 181 and 114 holdings, respectively. There are also sector REITs where we can provide our clients exposure in a wide variety of diversified REITs that focus on Data Centers, Healthcare, Retail, Self-Storage, Residential, Commercial, Warehouse, Cell Phone Towers, Lodging and Resorts, Office Buildings, Farms, Timber and even Highway Billboards.

Since most investors are already heavily allocated to real estate due to home ownership, REITs need only be a small component of a diversified portfolio.

Reasons to invest in REITs

REITs historically have delivered competitive total returns, based on high, steady dividend income and long-term capital appreciation. Their comparatively low correlation with other assets also makes them an excellent portfolio diversifier that can help reduce overall portfolio risk and increase returns.

In our opinion, at WT Wealth Management, the point of having REITs in a portfolio is not necessarily to beat or challenge stock market returns. Some compelling reasons are:

Diversification. REITs follow a different cycle than stocks. REITs follow the real estate cycle is which is typically longer (18 years) than the economic business cycle (4-5 years on average). So when stocks suffer in a recession, REITs may outperform, providing diversification for your portfolio.

Higher yields. In addition to providing diversification, REITs may provide higher yields – or cash dividends. Since a REIT must distribute at least 90% of its taxable income to shareholders annually, REITs generally have a higher distribution of income than stocks. In fact, the NAREIT All REITs Index has a dividend yield of 4.8% compared to 2.2% for the S&P 500 index. This enhanced income stream is attractive to nearly all investors and makes REITs particularly attractive in retirement accounts.

Inflation hedge. REITs provide an inflation hedge, a known benefit of real estate assets in general. As inflation rises, rents and leases tend to rise as well.

Performance: Stocks, Bonds, Bills, and REITs
A 25-year examination of REITs vs the S&P 500 through December 31, 2018 shows some interesting results.

9.9%	The trailing 25-year annualized total return of the index*
16	The total number of years out of the past 25 that the index* has outperformed the S&P 500
4.8%	The divided yield of the index* (which was more than double the S&P 500 dividend yield of 2.2%)

Source: www.NAREIT.com

Dividends and principal invested in REITs, like equities, are not guaranteed. REITs typically provide high dividends plus the potential for moderate, long-term capital appreciation.

Risks of Investing in REITs

Like any investment, we always look for the downside in any asset class. REITs are not bulletproof.

REITs only have 10% of annual profits to use for growth. 90% of profits must be distributed to investors. So in order for REITs to grow, they must constantly seek additional investments to cover capital expenditures and expand their portfolio.

REITs are susceptible to the macroeconomic environment. The Great Recession of 2008 is a good example of that. Market statistics show that REITs were down 48% in 2008 (recovered by 37% in 2009). A market downturn leads to decreased spending in retail shops, lower demand for office space, and property devaluation in general. This, in turn, hampers the performance of REITs.

Publicly traded REITs can be volatile in the short term and exhibit similar behaviors to stocks. So these may not be appropriate for investors who want a more even-keeled ride.

REIT Responsiveness to Interest Rates

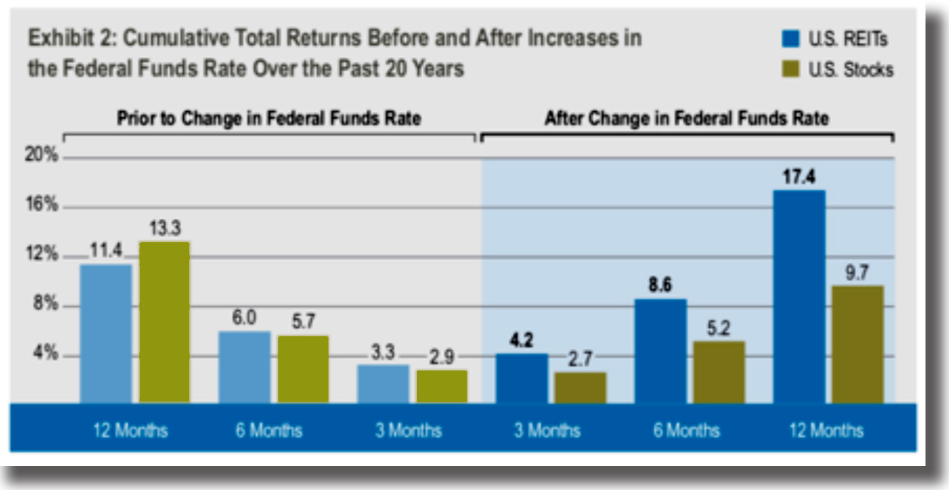
One might expect that rising interest rates would increase borrowing costs of a REIT and depress the present value of future cash flow, making REITs inversely sensitive to changes in interest rates. However evidence has shown this is not always the case. In a study from 1979 to 2007, there were 6 separate periods when the 10-year U.S. Treasury yield increased by at least 75 basis points. REITs as a group declined in only two of those periods and generated positive returns in four of these periods.

REIT Performance in a Rising Rate Environment

Period	REIT Performance	10 Year Treasuries
1979-81	133.8%	9.1% to 15.3%
1987	-6.6%	7.1% to 9.0%
1984	2.7%	5.7% to 7.8%
1996	37.1%	5.6% to 6.3%
1999	-2.6%	4.7% to 6.7%
2003-07	131.4%	3.3% to 5.0%

Wilshire REIT Index (source FRED)

One possible explanation for this counter-intuitive performance is that periods of rising interest rates are generally correlated with an improving economic backdrop, which increases demand for commercial real estate and subsequent cash flow. The positive impact of an improving economy may prove stronger than the negative impact of rising interest rates. That being said, certain REIT sectors do tend to be more sensitive to interest rates: strip malls, health care, and senior living.



Source: www.financialsamurai.com

Guidelines for setting portfolio allocations

What is an appropriate REIT allocation? The answer will vary based on each investor's goals, risk tolerance and investment horizon, but here are some guidelines that can help:

5% to 15%

Multiple studies have found that the optimal REIT portfolio allocation may be between 5% and 15%

David F. Swensen, PhD, Noted CIO of the Yale endowment and author of *Unconventional Success: A Fundamental Approach to Personal Investment,* recommends a 15% allocation to REITs for most investors.

Source: www.NAREIT.com

As we said earlier, since most investors already own a home, they are already heavily allocated to real estate. So WT Wealth Management generally recommends a REIT allocation in the investment portfolio on the lower end of the above range.

CONCLUSION

Overall, WT Wealth Management believes it is a good idea to include REITs as part of any well-diversified portfolio. REITS offer compelling risk-adjusted returns and solid yields through their required dividends.

REITs are a simple and convenient way to indirectly invest in real estate. REITs, on average, offer higher yields than corporate stocks and are a good hedge against inflation.

Historically, REITs have performed well and add a bit of diversification from the equities market. REITs have a unique set of attributes that make them perform differently than stocks and bonds. Reduced overall portfolio volatility and competitive returns make REITs an attractive combination.

As always, we hope you found this discussion of REITs educational and worth the read. White Papers are fundamental in our effort to educate our clients. Informed and empowered investors make the best investors.

SOURCES

REIT Resources for Financial Professionals *(www.NAREIT.com)*

Will Rising Rates Hurt REIT Performance? *(www.awealthofcommonsense.com)*

How Rising Interest Rates Affect REIT Price Performance: Not As Bad As You Think. *(www.financialsamurai.com)*

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