

The Basics of Real Estate Investment Trusts (REITs)

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Article Highlights

- These investment trusts own or finance real estate; at least 75% of their total assets must be invested in real estate or cash.
- Equity REITs own, operate and sell physical real estate; mortgage REITs provide mortgages and other real estate-secured loans.
- REITs are pass-through entities and must distribute at least 90% of taxable income to shareholders.

There are two main ways to invest in real estate.

One is private real estate investment. As a private real estate investor, you may physically purchase buildings to lease or fix up and resell yourself or you may lend money to a purchaser. Private investors can also directly or indirectly own real estate through partnerships or commingled real estate funds (CREF).

The second option is public real estate investment, which takes the form of real estate investment trusts (REITs), real estate operating companies (REOCs) and mortgage-backed securities.

Within these two general real estate investment categories—private and public—investors can be debt or equity investors. An equity investor has an ownership interest in real estate or securities of an entity that owns real estate. In the private market, equity investors often control decisions such as borrowing/financial strategy, property management, purchases and sales. Real estate equity investors expect to receive an income stream (from tenants paying rent) but also participate in the appreciation/depreciation aspect of the real estate investment.

A debt investor is the lender who owns a mortgage or mortgage securities. It's common to see the mortgage or note secured, or collateralized, by the property itself: If the equity investor defaults on the loan, the debt investor would have the right to seize the property. Generally, lenders receive a



stream of cash flows (as people pay their monthly mortgages) but do not participate in the appreciation/depreciation of the real estate properties.

Since debt investors are paid before equity investors (they have “priority claim”), the value of the real estate asset to the equity investor is the overall property value minus the debt outstanding. Debt investors’ priority claim makes real estate investment riskier to equity investors. This is why equity investors expect to receive a higher return from real estate investments than debt investors receive.

Public investments in real estate are more liquid, have a lower minimum investment, have more limited liability (and therefore less risk), offer the same protections as publicly traded securities, provide easy access to active professional management and require less hands-on work than private real estate investments.

This article focuses on public investments in real estate through real estate investment trusts, or REITs.

What are REITs?

REITs are investment trusts that own or finance income-producing real estate. These companies (structured as trusts) make it easy for individual investors to invest in real estate without having to buy and manage private property themselves. Investors purchase shares much like they do with stocks. Most REITs trade on major stock exchanges and

are tax-advantaged companies (trusts) that are generally exempt from corporate income tax. There are more than 220 REITs in the U.S. registered with the Securities and Exchange Commission (SEC) that trade on one of the major stock exchanges (the majority on the New York Stock Exchange). These REITs have a combined equity market capitalization of more than \$1 trillion.

According to the SEC, in order to qualify as a REIT, a company must:

- Distribute at least 90% of its taxable income to shareholders annually in the form of dividends;
- Be an entity that would be taxable as a corporation but for its REIT status;
- Have shares that are fully transferable;
- Have a minimum of 100 shareholders after its first year as a REIT;
- Have no more than 50% of its shares held by five or fewer individuals during the last half of the taxable year;
- Invest at least 75% of its total assets in real estate and cash;
- Derive at least 75% of its gross income from real estate-related sources, including rents from real property and interest on mortgages financing real property, and at least 95% of its gross income from real estate plus dividends and interest from any source; and
- Have no more than 25% of its assets consist of non-qualifying securities or stock in taxable REIT subsidiaries.

Types of REITs

The National Association of Real Estate Investment Trusts (Nareit) outlines and defines four main types of REITs.

- **Equity REITs:** Own or operate income-producing real estate.

Nareit REIT Stats

The National Association of Real Estate Investment Trusts, or Nareit, is a well-known resource in the REIT industry.

According to Nareit, an estimated 80 million Americans own REITs through their retirement savings and other investment funds.

Other notable statistics include:

- REITs invested \$52.8 billion in new construction and routine capital expenditures to maintain existing property in 2016.
- It is estimated that all REITs own approximately \$3 trillion in gross assets. Publicly traded equity REITs account for \$2 trillion.
- REITs own nearly 290,000 properties across the U.S.
- 226 REITs are in the FTSE Nareit All REITs Index.
- 191 REITs trade on the New York Stock Exchange.
- 32 REITs are members of the S&P 500 index.

Nareit, as well as many investors, often refer to equity REITs simply as REITs.

- **Mortgage REITs (mREITs):** Provide financing for income-producing real estate by purchasing or originating mortgages and mortgage-backed securities and earning income from the interest on these investments.
- **Public non-listed REITs (PLNRS):** Are registered with the SEC but do not trade on national stock exchanges.
- **Private REITs:** Are exempt from SEC registration; shares do not trade on national stock exchanges.

Another type of REIT that Nareit doesn't specifically mention is a hybrid REIT, which is a combination of both an equity and a debt REIT.

This article generally discusses publicly traded REITs, not public non-listed REITs or private REITs.

Equity REITs

Equity REITs own, operate and sell physical real estate. Equity REITs are actively managed trusts that own income-producing real estate and seek to profit by growing cash flows, improving existing properties and purchasing additional properties. Overall, equity

REITs may be fully integrated real estate operating companies or may focus on a specific aspect of real estate operations. Generally, their options include: acquisitions and sale of properties, property management and leasing, property rehabilitation and repositioning and/or property development.

Equity REITs make up the majority of the publicly traded REIT market today: roughly 90% of the total publicly traded REIT market capitalization and roughly 80% of the total number of publicly traded REITs.

Most equity REITs specialize in a specific type of property, but also diversify

within their specific sector by geographic location and other factors. See the box on page 9 for descriptions of the various types of equity REITs. The online version of this article includes a table with defining data on each type.

An equity REIT's performance can be heavily dependent on the sector or geographic location it operates in. Some of the main factors that can affect equity REIT performance include economic growth, the real estate cycle, the job market, population growth, occupancy rates and rents, mortgage rates and interest rates.

Mortgage REITs

Mortgage REITs (mREITs) provide money to real estate owners and operators either directly through mortgages or other loans that are secured by real estate or indirectly through the purchase of mortgage-backed securities. Mortgage-backed securities are publicly traded asset-backed securities that are secured by a mortgage or a collection of mortgages and receive cash flows from the underlying pool of mortgages owned. Essentially mortgage REITs finance real estate transactions, while equity REITs own the physical real estate properties.

Generally, mortgage REITs invest in either residential or commercial debt

securities, although some mREITs may invest in both. Data from Nareit shows that residential mortgage REITs make up roughly 72% of the mortgage REIT sector by market capitalization, while commercial mortgage REITs make up the remaining 28%.

Mortgage REITs' return comes from the income received from the

mortgages owned as well as changes in the net present value of the mortgages owned. This differs from equity REITs, which derive their returns from rents paid by tenants and changes in property values.

Mortgage REITs fund the mortgages or mortgage securities they invest in by borrowing via short-term debt or

raising equity capital. Mortgage REITs' general objective is to earn a profit from their net interest margin, which is the difference between interest income from mortgage assets and the cost of debt. Because income is the main goal, mREITs tend to have a higher dividend yield than equity REITs (see Table 1).

Mortgage REITs are sensitive to

Types of Equity REITs

Data Centers

Own and manage facilities that customers use to safely store data. These facilities offer a range of products and services to help keep servers and data safe, including providing uninterruptible power supplies, air-cooled chillers and physical security.

Diversified

Own and manage a variety of property types and collect rent from tenants. For example, these REITs might own portfolios made up of both office and industrial properties.

Health Care

Own and manage a variety of health care-related real estate and collect rent from tenants. Property types include senior living facilities, hospitals, medical office buildings and skilled nursing facilities.

Industrial

Own and manage industrial facilities and rent space in those properties to tenants. Some focus on specific types of properties, such as warehouses and distribution centers. Industrial REITs play an important part in e-commerce infrastructure and help to meet the rapid delivery demand.

Infrastructure

Own and manage infrastructure real estate and collect rent from tenants that occupy that real estate. Property types include fiber cables, wireless infrastructure, telecommunications towers and energy pipelines.

Lodging/Resorts

Own and manage hotels and resorts and rent space in those properties to guests. Lodging REITs own different classes of hotels based on features such as the hotels' level of service and amenities. Their properties service a wide spectrum of customers, from business travelers to vacationers.

Office

Own and manage office real estate and rent space in those properties to tenants. The properties can range from skyscrapers to office parks. Some office REITs focus on specific types of markets, such as central business districts or suburban areas. Some emphasize specific classes of tenants, such as government agencies or biotech firms.

Retail

Own and manage retail real estate and rent space in those properties to tenants. They commonly focus on large regional malls, outlet centers, grocery-anchored shopping centers and power centers that feature big box retailers. Net lease REITs own freestanding properties and structure their leases so that tenants pay both rent and the majority of operating expenses for a property, including taxes, utilities and maintenance.

Residential

Own and manage various forms of residences and rent space in those properties to tenants. Residential REITs may specialize in apartment buildings, student housing, manufactured homes or single-family homes. Within those market segments, some residential REITs also focus on specific geographical markets or classes of properties.

Storage

Own and manage storage facilities and collect rent from customers. They rent space to both individuals and businesses.

Specialty

Own and manage a unique mix of property types and collect rent from tenants. Specialty REITs own properties that don't fit within the other REIT sectors. Examples of such properties include movie theaters, casinos, farmland and outdoor advertising sites.

Timberland

Own and manage various types of timberland real estate. They specialize in harvesting and selling timber.

interest rates. When interest rates rise, the mortgage securities in an mREIT's portfolio lose value (which has historically caused share prices of mREITs to lose value). They can act like bonds in this aspect, as interest rates rise, bond prices decline and vice versa. Longer-term securities, like mortgages, tend to be more sensitive to changes in interest rates.

On the other hand, mortgage REITs can also lose value when interest rates decline. In the case of adjustable rate mortgages (or ARMs), lower interest rates reduce the overall payment that has to be made—allowing some to pay back their loan quicker than if the payment remained the same. Some fixed-rate mortgages may be refinanced as rates decline. Essentially, lower interest rates may lead to early loan repayment and refinancing, which lowers the income amount a mortgage REIT receives.

However, lower interest rates can be beneficial to mortgage REITs, as more people may be enticed to purchase a home when rates are low. In the case of commercial properties, real estate investors may undertake more projects if they know they can secure financing at an attractive rate.

Mortgage REITs are susceptible to credit risk. Credit risk is the risk that a borrower may default on the loan. Riskier mortgages tend to pay higher interest, but have greater credit risk (risk of default).

Investment Characteristics of REITs

There are a couple of notable characteristics that you can expect REITs to bring to your portfolio.

Relatively High Yield

In order to gain their tax-exempt status, REITs are required to distribute 90% of their income as dividends to shareholders. Because of this, REITs tend to have relatively high yields. Their yield is generally higher than that of equities or bonds. As previously mentioned, mortgage REITs tend to

Table 1. FTSE Nareit Index Dividend Yields

Index	2013	2014	2015	2016	2017	2018*
FTSE Nareit All REITs	4.4%	4.0%	4.3%	4.3%	4.3%	4.8%
FTSE Nareit All Equity REITs	3.9%	3.6%	3.9%	4.0%	3.9%	4.4%
FTSE Nareit Mortgage REITs	10.3%	10.7%	12.2%	10.6%	9.8%	10.9%
FTSE Nareit Real Estate 50	4.2%	3.8%	3.7%	5.5%	3.8%	4.2%

*As of 2/28/2018.
Sources: FTSE, Nareit.

Table 2. Average Annual Returns: REIT Indexes vs. Stock Market Benchmarks

	FTSE Nareit Indexes			S&P 500	Russell 2000	Nasdaq Composite	DJIA
	All REITs	All Equity REITs	Mortgage REITs				
2018 YTD	(10.0%)	(10.0%)	(10.0%)	1.8%	(1.4%)	5.5%	1.7%
1-Year	(5.9%)	(6.1%)	0.4%	17.1%	10.5%	26.2%	23.1%
3-Year	2.2%	2.0%	6.0%	11.1%	8.6%	14.9%	14.2%
5-Year	6.4%	6.5%	4.6%	14.7%	12.2%	19.6%	15.0%
10-Year	7.1%	7.1%	5.2%	9.7%	9.8%	13.6%	10.3%
15-Year	9.9%	10.5%	3.6%	10.4%	11.5%	12.0%	10.8%
20-Year	8.2%	8.7%	3.8%	6.9%	7.5%	7.3%	8.0%
25-Year	9.5%	9.9%	6.1%	9.7%	9.4%	10.0%	8.4%*
30-Year	9.1%	10.1%	5.0%	10.5%	9.9%	10.5%	8.7%*
35-Year	9.4%	11.2%	4.9%	11.4%	9.7%	10.0%	9.3%*
40-Year	10.7%	12.3%	6.3%	12.1%	—	11.3%*	9.2%*
1972–2018	9.4%	11.6%	—	10.6%	—	9.7%*	7.5%*

*Price return only.
Source: Nareit. Data as of 2/28/2018.

have higher dividend yields than equity REITs.

According to Nareit (as of February 28, 2018), the FTSE Nareit All REITs index had a dividend yield of 4.8%, while the FTSE Nareit All Equity REITs Index has a yield of 4.4%. This compares to the S&P 500 index's dividend yield of 1.9%.

Table 1 shows FTSE Nareit indexes and their respective dividend yields from 2013 to the end of February 2018.

Stable Earnings and Income

The long-term contractual nature of many leases, rental agreements or mortgages results in REIT earnings being comparatively more stable than corporate earnings.

Additionally, dividend distributions are a fixed percentage of income (90%), which also adds to the relative stability of earnings and income received. While some REIT exposures

differ from stocks, both security types are economically sensitive and can fall during periods of general sector or geographic contractions. See the online version of this article for a comparison of standard deviations between REITs and stock and bond market indexes.

Capital Appreciation

Not only do REITs provide income, they can also appreciate over time (much like stocks).

Return figures can be seen in Table 2. Over the last 10 years REITs have underperformed major stock indexes on an annualized basis. However, over longer time periods, equity REITs have slightly outperformed large-cap stocks on an annualized basis.

Diversification

Historically, REITs have had a low correlation with other assets, as shown in Table 3. Correlation measures how

Table 3. Correlations With FTSE Nareit All Equity REITs Index

Index	Feb. 2008– Feb. 2018	Feb. 1988– Feb. 2018
DJ U.S. Total Stock Market	0.76	0.58
Domestic High Yield Corp Bond	0.72	0.59
Dow Jones Industrial Average*	0.72	0.51
Nasdaq Composite*	0.71	0.42
Russell 2000	0.76	0.63
Russell 2000 Growth	0.71	0.52
Russell 2000 Value	0.78	0.72
S&P 500 Index	0.75	0.55

*Price return only.
Sources: Nareit, FactSet.

two variables move in relation to one another. A correlation of 1.0 means that two variables move in lockstep, while a correlation of -1.0 means two variables have historically moved in opposite directions (when one goes up the other goes down by the same amount). A correlation of 0.0 means the two variables have no linear relation to one another. Adding asset classes with low correlations allows investors to diversify their portfolio, lowering the risk.

The lower correlation between REITs and the stock market is attributable to real estate investments having different characteristics (yields, business models, interest rate sensitivity, economic exposures, etc.) than the general stock market. Some stock market sectors may be heavily affected by a specific business cycle. REITs are not completely immune to the business cycle, but the longer-term nature of leases helps to cushion the blow of short-term fluctuations in economic activity.

Because REITs own real assets (real estate is a tangible investment), they also provide some inflation protection. When inflation rises, rents and property values can rise as well. This differs from bonds, which can be negatively affected by inflation.

Investing in REITs

There are a couple of important distinctions to make when it comes to investing in REITs.

of equity REITs outlined in the box on page 9. Selecting individual REITs also allows an investor to better manage tax liabilities (capital gains, tax loss harvesting, etc.), as would be the case with individual stocks.

Another option for investing in REITs is through mutual funds. Mutual funds are investment vehicles that pool money from many investors. Mutual funds provide investors access to professional management, though the cost of operating the fund is charged to the shareholders.

One notable issue with mutual funds is less control over taxes because of capital gains distributions. Exchange-traded funds (ETFs) are more tax-efficient in this aspect.

Unlike mutual funds, ETFs trade like stocks, and most ETFs track an index (and, depending on the index, may give less exposure to smaller REITs). Tracking an index is “passive” investment management, so ETFs that track an index don’t have the opportunity to profit from active management (by making tactical decisions on which investments to buy and sell).

Owning mutual funds and ETFs helps to spread out the company-specific risk within your portfolio. One share of a REIT fund could cost the same as one share of an individual REIT, but with the fund you are receiving exposure to potentially hundreds of REITs. With one share of an individual REIT, you are only exposed to the performance

of that one REIT. Investors have the option to invest in individual REIT securities, much like they do with individual stocks. Selecting individual REITs allows an investor to have control over the types of REITs owned, whether mortgage REITs with a specific strategy or one of the many types

of that one REIT.

Additionally, investing in REITs through mutual funds (and ETFs) may be less time-consuming than selecting individual REITs because there may be less research involved.

Advantages of REITs

REITs offer some advantages over direct real estate investment. However, it’s worth noting that both have their advantages and disadvantages.

Superior Liquidity

Compared to investing in physical real estate, investors in exchange-listed real estate securities enjoy far greater liquidity: It is easier and cheaper to buy and sell such REITs.

The low liquidity of a direct real estate investment stems from the relatively high value of an individual property, the lack of public exchanges with frequent transactions and the unique nature of each property.

Additional Protections and Transparency

Exchange-listed REITs must meet the same requirements applicable to other publicly traded companies, including rules related to financial reporting, disclosure and governance.

Because these REITs have required disclosures with the SEC, their operations are more transparent to investors.

Limited Liability

Much like stocks, the financial liability for REIT investors is limited to the amount they invest. Other types of real estate investment, such as general partnership interests, have potential liabilities greater than the amount originally invested.

With REITs, the risk is pooled among many different investors, as opposed to direct real estate where there may be just one or relatively few owners open to risk.

Lower Initial Investment

In most cases, direct real estate investment generally requires a 20% to

35% down payment and, depending on the size of the building or property, the initial upfront cost can be quite high. That doesn't include other expenses such as closing costs and realtor fees.

Most REITs trade with per share prices below \$100. The lower initial investment compared to buying real estate directly allows REIT investors access to properties they would otherwise not have access to. For example, with a specific REIT an investor could invest in a hotel, shopping mall or other landmark buildings. These properties may be difficult for an individual to invest in otherwise.

Active Professional Management

Some investors manage their own properties when investing directly in real estate. REITs employ professional management to control expenses, maximize returns and rents, conduct acquisition analysis to potentially acquire new properties and much more. Direct real estate investors can employ professional managers, but they often still have a level of involvement with day-to-day operations.

Disadvantages of REITs

While there are some advantages that REITs have over direct real estate investments, there are also disadvantages.

Tax Implications

REITs generally do not pay taxes at the corporate level. They are considered pass-through entities that can avoid most entity-level federal tax by complying with detailed restrictions on ownership structure, distributions and operations.

Unlike qualified stock dividends, which receive the preferential 15%/20% tax rate, REIT dividends are considered "pass-through business income" and are therefore taxed at the recipient's ordinary income rate. Because dividends received from REITs are taxed

as ordinary income, REITs are better suited for tax-preferred accounts such as traditional and Roth IRAs (they can be held in a taxable account as well). Although this can be a negative, it's important to note that compared to corporate dividends, REITs are only taxed once (at the shareholder level, meaning you pay the taxes), whereas corporate dividends received are taxed at the corporate level and at the shareholder level (meaning the corporation pays taxes on dividends and so do you).

According to Nareit, 59% of the annual dividends paid by REITs qualify as ordinary taxable income, 17% qualify as return of capital and 24% qualify as long-term capital gains.

The Tax Cut and Jobs Act included a 20% deduction on income from pass-through entities. This includes the income that flows to REIT investors through dividends. This means that investors can deduct 20% of the income, with the remainder of the income taxed at the investor's marginal tax rate. This lowers the effective maximum tax rate of REIT dividends from 37.0% to 29.6%. The benefit is available even if the tax payer doesn't itemize deductions.

Capital gains distributions are generally taxed at the 15%/20% tax rate. Both types of distributions are subject to the 3.8% net investment income tax.

Lack of Control

REIT investors can't control what a REIT does or doesn't invest in. Investors who invest directly in real estate (purchase their own buildings) have control over what properties are purchased and sold. The lack of control can be viewed as a positive or a negative depending on the investor; some prefer professional expertise, while others may prefer to be very involved with operations and investment decisions.

Limited Potential for Income Growth

Because REITs pay out 90% of

their income to shareholders in the form of dividends, that leaves roughly 10% to be reinvested in the REIT itself. This limits a REIT's ability to generate future growth through reinvestment. Because REITs distribute most of their earnings, they are likely to finance additional real estate acquisitions through equity offerings (selling additional shares) or debt issuance. Equity issuance dilutes current owners' value per share. However, equity issuance isn't always bad: If the REIT productively uses the new funds, equity issuance could be beneficial.

REITs have minimal levels of financial leverage they are required to maintain by law. If credit is not available (due to market conditions), or a REIT is highly leveraged, it may be forced to issue equity at a disadvantageous price when funding is needed.

Conclusion

Both public and private real estate investing can be lucrative, but understanding the advantages and disadvantages is paramount.

It's worth noting that while many investors may own their homes, homeownership is not a substitute for real estate investment. Your primary residence doesn't produce current income, but rather it is a place to live. It also has ongoing costs such as mortgage payments, real estate taxes, insurance costs, maintenance, etc.

Overall, REITs can be an important part of an individual investor's portfolio. REITs have delivered competitive total returns, composed of relatively high (and steady) dividend income, as well as capital appreciation. REITs' comparatively low correlation with other asset classes provides an added diversification benefit.

As with any investment, keep in mind that historical performance (and correlation) is not a guarantee of future performance. ▲

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