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# Trusting REITs

REITs add value without risk and offer liquidity without hassles.

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Public corporations in the business of renting or leasing property to earn revenue are often categorized as real estate income trusts (REITs). They elect to be taxed differently to qualify as a REIT, paying out 90 per cent of their taxable income in the form of a dividend.

REITs have proven to be an attractive investment vehicle over the past two decades. When used properly in an asset allocation model, REITs have a low correlation with both fixed income investments and equities. On average, REITs carry a 6.5 per cent dividend yield.

Correlation to other asset classes remains one of REITs' strongest selling points. The past few years have demonstrated the need for diversification. Both the volatility and poor returns in the markets have led a significant number of investors on a quest for a more diversified portfolio. The more asset classes investors have in their portfolios, the better risk-adjusted return they can expect.

REITs exhibit a risk-adjusted return of 0.34 on a 10-year basis when pegged against the Standard & Poor's index (S&P). This means that over the past decade, REITs have resembled the S&P 34 per cent of the time. When compared to Nasdaq, this figure shrinks to 0.18.

## Question of cash

Over the past 10 years, dividends have become more secure. Payout ratios, or dividends as a percentage of

funds from operations (FFO), are used to gauge the health of REIT yields. FFO is a proxy for cash flow, or net income, after depreciation and amortization are included. This is significant because it shows that REIT companies are paying out less of their cash flow to fuel the dividend.

Lower payout ratios have two major impacts on a REIT. First, they usually afford REIT companies extra cash to grow the business. Second, if the corporation hits a slow growth cycle, excess funds are available to pay out the dividend. This is crucial as dividend cuts are negative when it comes to REITs.

The components of total return are important to understand. Historically, they have consisted of income and price. Of the 9.86 per cent total return, four per cent is price appreciation. Yield plays a major role in performance.

Incorporating REITs into a fixed income portfolio has been proven to increase return without significantly increasing risk. Adding a 20 per cent REIT allocation to a pure fixed-income portfolio would yield a higher return without notably increasing risk.

One way to track valuation for REITs is to map the stock price against the value of the underlying real estate. The net asset value (NAV) refers to the liquidation value. In other words, NAV is a way to define the value of the underlying bricks and mortar in a particular REIT portfolio.

The question of whether REITs should trade at a premium to NAV can be easily answered. The benefit of owning real estate in publicly traded, or 'public wrapper' form, versus hard assets warrants a premium in stock price.

Investors receive the benefit of liquidity and can sell their assets and receive the going price on the same day. Also, owning REIT stocks eliminates the task of managing the property itself. REIT companies manage their properties and bear the burden of doing so in the public wrapper format. ■

