

Real Estate Investment: Who Wants to be a Landlord?

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“Always do what you are afraid to do.” - Ralph Waldo Emerson

We are all very familiar with the residential real estate market's recent decline from its peak in 2006. Add to that the realization that commercial property, such as apartment buildings, malls, and offices, have also dropped in value over the past two years! So, it begs the question, why would anyone want to invest in real estate?

The answer is simple. Wise investors seek out buying opportunities in troubled markets. They say that the majority of money in real estate is made when you BUY, not when you SELL. moving in when 'the herd is scared'. Fortunately, there are real estate investment options available that can take advantage of economic swings and provide investors with diversification and solid returns. In this analysis, we will examine some investment vehicles that focus on real estate and discuss their inherent strengths and weaknesses.

Real Estate Investment Trusts (REITs):

A REIT is an organization that pools investors' money to acquire commercial real estate. The Investment Company offers common shares to the public. In this way, a REIT is similar to any stock that represents ownership in an operating business. A REIT has two unique features. The first is that its primary business is to manage groups of income-producing properties. The second is that, as mandated by IRS regulation, a REIT must distribute at least 90 percent of its taxable income back to investors in the form of dividends.

REITS are historically one of the best-performing asset classes available. Between 1990 and 2010, the REIT index's average annual return was 9.9 percent. This is second only to mid-cap stocks, which averaged 10.3 percent.

Equity REITs tend to specialize in owning certain building types, such as apartments, regional malls, office buildings or lodging facilities. Approximately 24 percent of REIT investments are in shopping malls and freestanding retail. This represents the single biggest investment by type in the U.S. Whatever shopping center you frequent, it's likely owned by a REIT.

Another type of REIT is the 'Mortgage REIT', but fewer than 10 percent of all REITs fall into this special class. These REITs make loans secured by real estate, but do not generally own or operate real estate. While a handful of hybrid REITs run both real estate operations and transact in mortgage loans, most focus on the “hard asset” business of real estate operations.

Residential REITs own and operate multi-family rental apartment buildings, as well as manufactured housing. The best performing funds tend to be where home affordability is low, relative to the rest of the country. In places like New York and Los Angeles, the high cost of

single homes forces more people to rent. This drives up the price that landlords charge for rent. As a result, the biggest residential REITs tend to focus on large urban centers.

Healthcare REITs another very popular sector, will be interesting to watch in the coming years. As Americans age and healthcare costs continue to climb, alternative Healthcare options will undoubtedly emerge. Healthcare REITs invest in the real estate of hospitals, medical centers, nursing facilities and retirement homes.

By spreading investments over many real estate types and geographical locations, a REIT can lower risk. REITs are bought and sold like stock on the New York Stock Exchange and other major exchanges, and are therefore more liquid than owning the property personally. REITs are a key consideration when constructing a diversified portfolio.

REITs have the ability to generate dividend income, along with capital appreciation, making them an excellent counterbalance to stocks, bonds and cash. Unlike a typical corporation (where dividends can be taxed twice), REITs do not pay tax on their earnings. However, the dividend is taxable to the investor as ordinary income.

Real Estate Mutual Funds:

As discussed in our last segment of this series, mutual funds are made up of a pool of investment components. There are specific mutual funds composed exclusively of real estate related companies. Mutual funds in this special area have enjoyed an average annual return of 11 percent over the past 10 years. Returns in these mutual funds are influenced by some of the same factors as the REITs. Two of the most significant influences are supply and demand for commercial office space and interest rates. Much like REITs, real estate mutual funds lower overall risk but have the advantage of being overseen by a professional manager. These managers know how to slice the market into areas that behave differently during economic cycles.

The current low interest rate environment has forced investors to look beyond bonds for income-producing investments. With the advent of REITs and real estate, the insatiable appetite of Americans to invest in real estate (and other tangible assets) has been adequately addressed. Real estate is a low correlating asset that tends not to move in tandem with stocks, and has almost no correlation with short-term bonds. It is for these reasons that TPI believes real estate is a very strategic asset allocation in our portfolios.