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# What Should Investors Consider When Investing In REITs?

*Why REITs make a good investment in an investor's portfolio.*

By definition, a Real Estate Investment Trust, or a REIT as it is commonly referred to is a company that owns and, in most cases, operates incomeproducing real estate entities such as apartments, office buildings, warehouses, shopping centers, regional malls, and/or hotels. REITs were initially formed in the 1960s in the United States as a way for small investors to obtain ownership in commercial real estate without the barriers to entry associated with traditional property ownership; mainly large price tags and illiquidity. Therefore, REITs are designed to allow investors to gain exposure to a portfolio of real estate assets by simply owning equity shares of a REIT.

Many of these companies are fully integrated organizations, which engage in the acquisition, development and management of
commercial real estate for their own account. Most REIT property portfolios are concentrated in a specific sector which is referred to as their core portfolio.

Before considering investing in REITs, investors should search for their main catalysts of performance like economic growth,
demographics, and market conditions.

Economic growth or expansion is one of the primary drivers of commercial real estate performance. Growth in the GDP will typically increase demand for space and rents. Additional office space is required to house new hires; warehouse and distribution space is needed to address increased inventories. Retailers with leases tied to a percentage of their sales will have to pay higher rents to property owners as consumers spend more. Also new households are formed, increasing demand for apartments. Even business and leisure travel accelerate, raising hotel occupancy and room rates.

Demographics or population change, immigration, and migration patterns are significant contributors to the growth, development,
and demand for real estate. Equally important are the trends and preferences of large age groups. Over a market cycle, demand and space requirements can change, buildings may be at risk of becoming obsolete, and once-popular neighborhoods or destinations can experience a decline.

Market conditions like excess demand and tight supply will favor landlords, whereas a prolonged, favorable environment can lead to a glut of new construction and downward pressure on occupancy and rents. A cycle of oversupply, equilibrium, and undersupply has historically been the norm for real estate.

When looking at their metrics, the Net Asset Value(NAV) is one of the most important valuation metrics for REITs. Reason is that the value of a REIT is mainly derived by the

assets it owns. This is also why NAV doesn't apply to companies that don't own hard assets. Determining NAV requires calculating a REIT's 12-month projected net operating income and dividing by an appropriate
capitalization rate*. This results in an estimated value of a REIT's properties. After including additional income sources, cash, and land and subtracting liabilities, you arrive at the NAV. Capitalization rates represent the rate of return, or yield, based on the income that a property is expected to generate in its first year. It is calculated by dividing the property's projected 12-month net operating income and dividing by the current market value of the asset.

We should also look at the dividend yield of a REIT and compare it to other potential REITs or even bonds. Due to its significant contribution to total return, comparing yields among REITs as well as bonds (10-year government and corporate bonds) can provide investors a useful relative valuation tool.

Moreover, qualitative factors should be also accounted for when studying REITs. These factors include portfolio quality of underlying real estate assets and their location; the development pipeline of the assets, pending acquisitions, lease term and structure, and the management team quality.

**How do REITs add value to investors' portfolios?**

From a portfolio construction point of view, REITs are typically attractive to investors seeking consistent, regular income and long-term growth. Investors, in particular, can view commercial real estate, as an asset with potential to provide strong and stable income flows. Some investors have viewed REITs as comparable to equities due to their strong total returns and volatility. Others relate REITs to bonds due to their historical high yields.

In fact the return profile of a REIT has characteristics that can be similar to both bonds and equities. The long-term nature of contractual leases in a REIT portfolio provides income visibility, like bonds, while the mark-to-market valuation of leases allows REITs to take part in the economic cycle, similarly to equities. What makes REITs a distinct asset class though is their differentiated source of returns. Through the contractual lease obligation of the tenant to the landlord, a stable income stream is generated. And through occupancy growth, rent growth, or redevelopment of properties, REITs have the ability to grow their income stream. Therefore, we should allow REITs a separate allocation within an investor's portfolio, depending of course on one's investment goals and risk tolerance.

Real estate plays also the role of an inflation hedge. In an inflationary context and when underlying leases are indexed to inflation rates, REITs see their dividend grow. As REITs offer cash flow growth to investors in the form of dividends, it therefore helps reduce the devastating aspects of increasing inflation.

Also the advantage of listed real estate securities is that they are designed to be more liquid than direct real estate itself. Also as
listed securities, REITs provide a lower cost of trading, faster execution and a more certain execution environment compared to than direct real estate.

In conclusion, an appropriate allocation of REITs in one's portfolio can improve its potential to generate higher returns at lower volatility. Whether through attractive potential total returns, stable and significant income, enhanced diversification, or a hedge against inflation, it is believed that REITs can serve most investors' objectives.

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