The New Real Estate Sector

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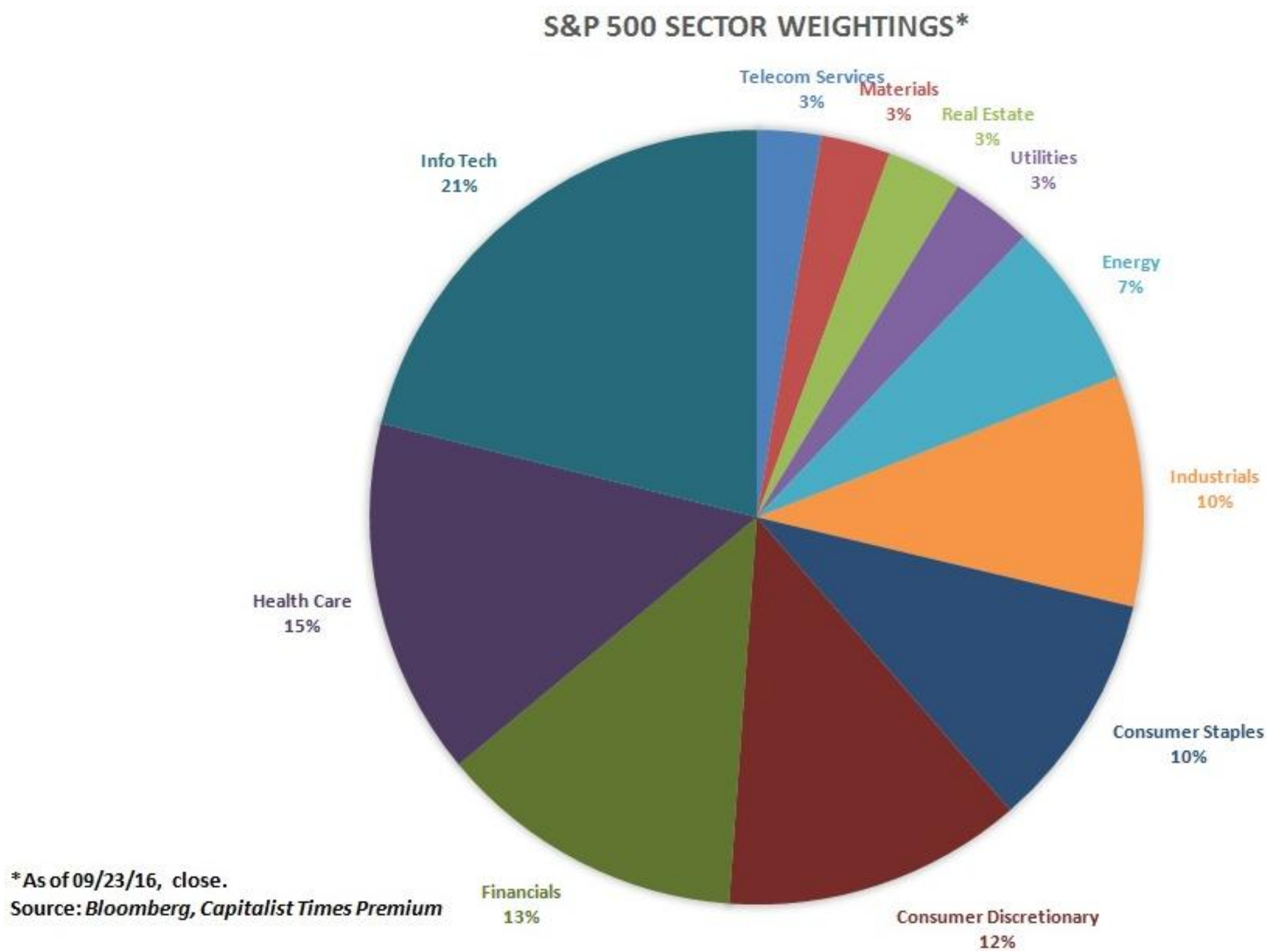
REITs: A Sector of Their Own

by Roger S. Conrad

As of the opening bell on Sept. 19, the S&P 500 moved the 27 real estate investment trusts (REIT) previously categorized as financials to the newly created real estate sector.

These stocks represent roughly 3 percent of the S&P 500's market capitalization, giving real estate a larger weighting than telecommunication services (2.68 percent) and the cyclically weak materials sector (2.89 percent).

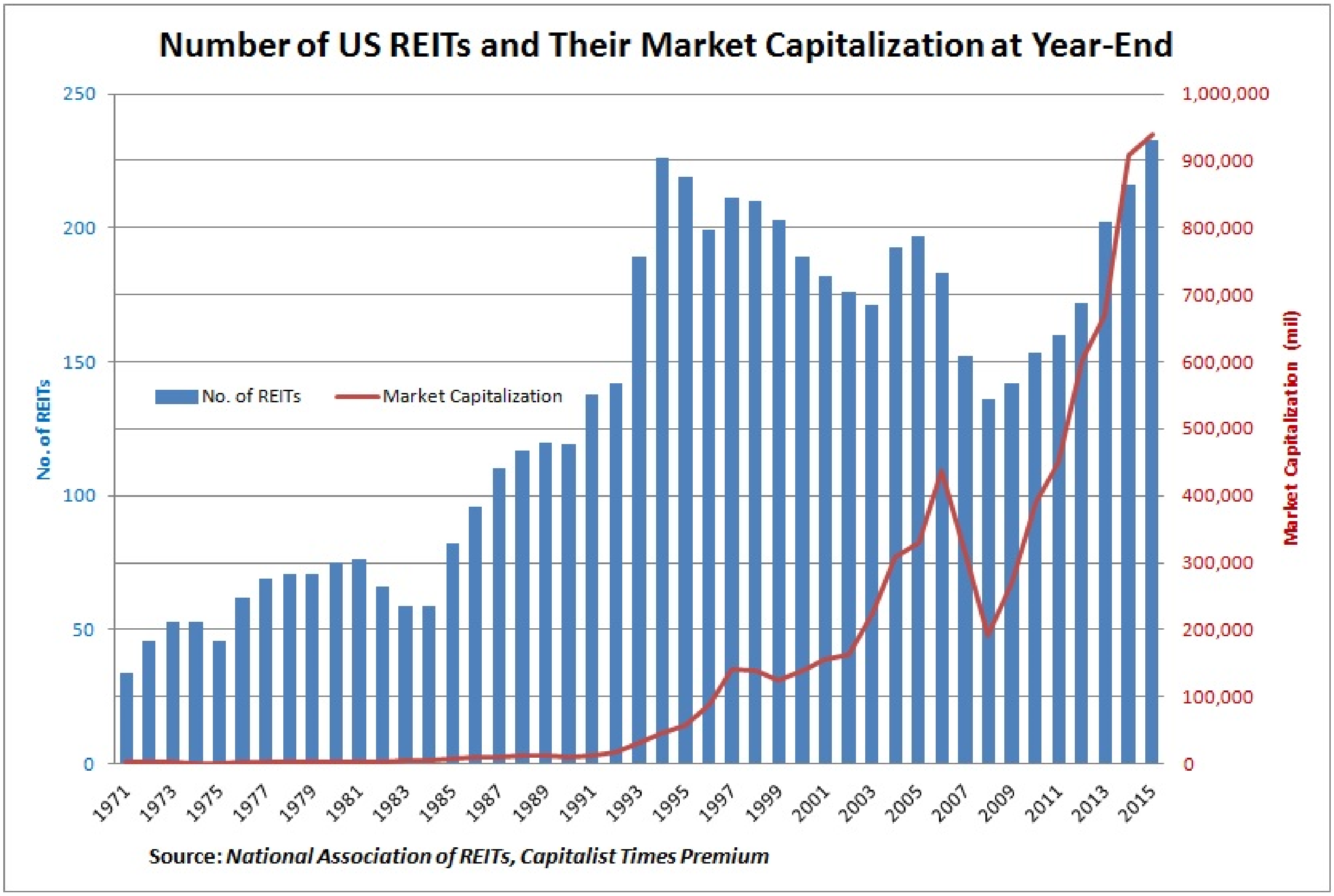


This move marks only the third time since 1957 that S&P Dow Jones Indices has changed its classification system, with the most recent shake-up in 2001 increasing the number of sectors to 10 from four and replacing transportation with information technology.

When the information technology sector debuted in 2001 at 18 percent of the S&P 500, Standard & Poor's effectively acknowledged this group's emergence as a meaningful asset class.

Real estate investment trusts have also come a long way, with this investable universe expanding to roughly 240 names since President Eisenhower signed the REIT Act in 1960 and the first one listed on the New York Stock Exchange in 1965.

... The market capitalization of US REITs has soared since 2009 and approached $1 trillion 2015.



Barring a major change in the tax code, REITs should have staying power, thanks to the importance of real estate to the US economy as well as the structure's operating and tax advantages and investor demand for dividend-paying securities.

However, investors have piled into REITs in recent years, especially the 27 names that make up the S&P 500 Real Estate Index, which trades at 3.42 times book value—more than two times the 1.66 multiple that this group fetched at the end of 2008. This record valuation suggests that REITs, like utility stocks, could be due for a reversion to the mean. ...

Bottom Line: US REITs' coming-out party as an asset class doesn't necessarily mark a huge buying opportunity for income-seeking investors, especially when you consider the group's elevated valuations. We continue to prefer alternatives that offer superior yields and less-demanding valuations without making concessions to safety. ...

Our thoughts:

Most of our clients, including those focused on Capital Appreciation, are significantly overweight REITs, fortunately bought at a time when they were out of favor. For clients looking for Income, we normally recommend a 10% allocation to this asset class, using a Closed End Fund (CEF) like the Global IGR as a Transitional Fund when it is trading at a significant discount to NAV. However, as shown below, it is currently trading at a below average discount, -12.5%:

Our valuation concerns, as previously shared, are also evidenced by our Buy/Watch list of stocks with heavy Insider Buying that meet our other criteria. That list doesn't currently contain any REITs. As a result we currently recommend that investors seeking Income be patient. The Fed is likely to raise interest rates at their December meeting, and the inherent volatility of REITs should provide future opportunities.