REITs, Part 2

Yesterday we received a call from a client that had been approached to invest in a single tenant commercial property with an 8% cap rate. While we are not qualified to render an opinion on such an investment, we do consider commercial real estate to be a separate asset class that belongs in most portfolios. From High Dividend Opportunities on Dec. 16th, with most of our edits in red:

Why Retirees Should Invest In Property REITs

Summary:

- *Unlike most stocks,* publicly traded *REITs tend to produce highly consistent and predictable income out of which a majority is paid in dividends to shareholders.*
- *While it is always difficult to predict short-term share price performance, high-quality REITs tends to appreciate and achieve higher rents over the long run.*
- *Owning hard tangible assets such as commercial real estate through REITs is a great portfolio diversifier from traditional stocks and bonds.*
- *REITs have historically been strong outperformers despite their lower risk profile* (Based on Maximum Drawdown, HCM's preferred Risk metric, this is not true.)*, higher dividends, and low correlation to broader equity markets.*
- *Property REITs make great investments for retirees* (in a properly diversified portfolio that is consistent with their Risk Profile).

Retirees like income…. In an effort to cater to Retirees who usually have a lower tolerance for risk, we have been allocating additional time and effort to focus on conservative high-yield opportunities in the Property REIT space, particularly those with lower price volatility, higher growth, and good potential for future dividend increases.

Since increasing our focus to this particular sector, it is fair to note that a majority of our REIT picks have strongly outperformed and have seen their dividends grow. And this is what really matters the most to our retiree subscribers. They want predictable income that they can live off and count on.

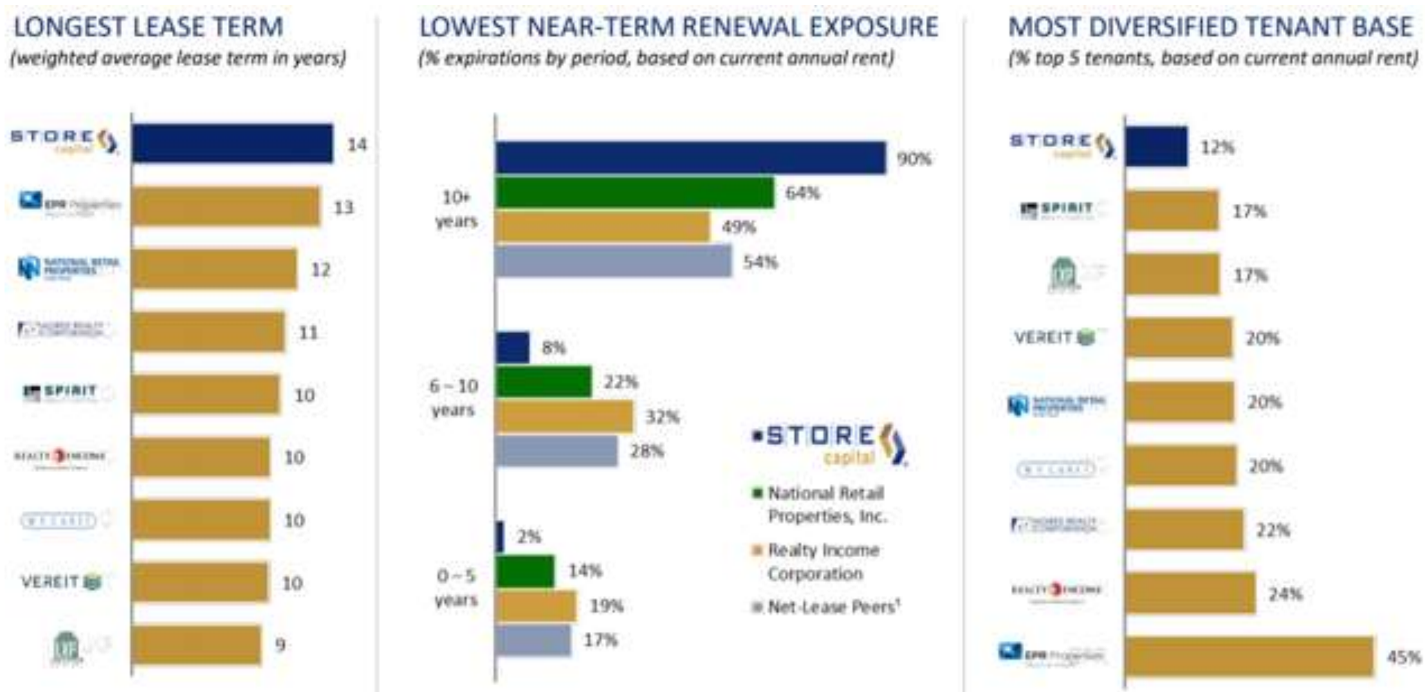
While REITs have clear risks (including in some cases dividend cuts), they have historically been more successful dividend payers than the great majority of other stocks.

This is not a surprise, rather it is just a function of the REIT structure which forces the company to pay out a minimum of 90% of its taxable income in dividends, and the nature of assets which generate stable and consistent income from rents.

We say “consistent” because commercial real estate (at the exception of hotels) tend to be leased to high credit tenants with long contract maturities. As such, the income is most often “contractually” guaranteed (unless in the case of bankruptcy of the tenant), and very predictable for years to come. This is especially true when you consider that REITs are big corporations owning large and widely diversified portfolios.

Take for example **STORE Capital** (STOR), a net lease REIT that we hold in the “High Quality REIT Portfolio” of High Dividend Opportunities (and is owned by 2 of HCM's clients):

This REIT owns a widely diversified portfolio of net lease properties with a weighted average remaining lease term of about 14 years. This is 14 years of almost guaranteed income that will be paid as long as there are no bankruptcies. Moreover, the leases have built-in rent yearly escalators of 1.8% which protect against inflation and provides growth for the future. Finally, the portfolio of leases is widely diversified with very low near-term renewal exposure – reducing risk significantly.



This is just one REIT example among many others. The same applies for the other REITs mentioned in this graph, ... as most have achieved strong track records by following this simple business model. **And this is why we consider such REITs to be ideal investments for retiree investors.**

1. They pay higher than average dividends with a lower than average risk profile.
2. They have strong track record of dividend growth and value appreciation.
3. They provide valuable diversification benefits.

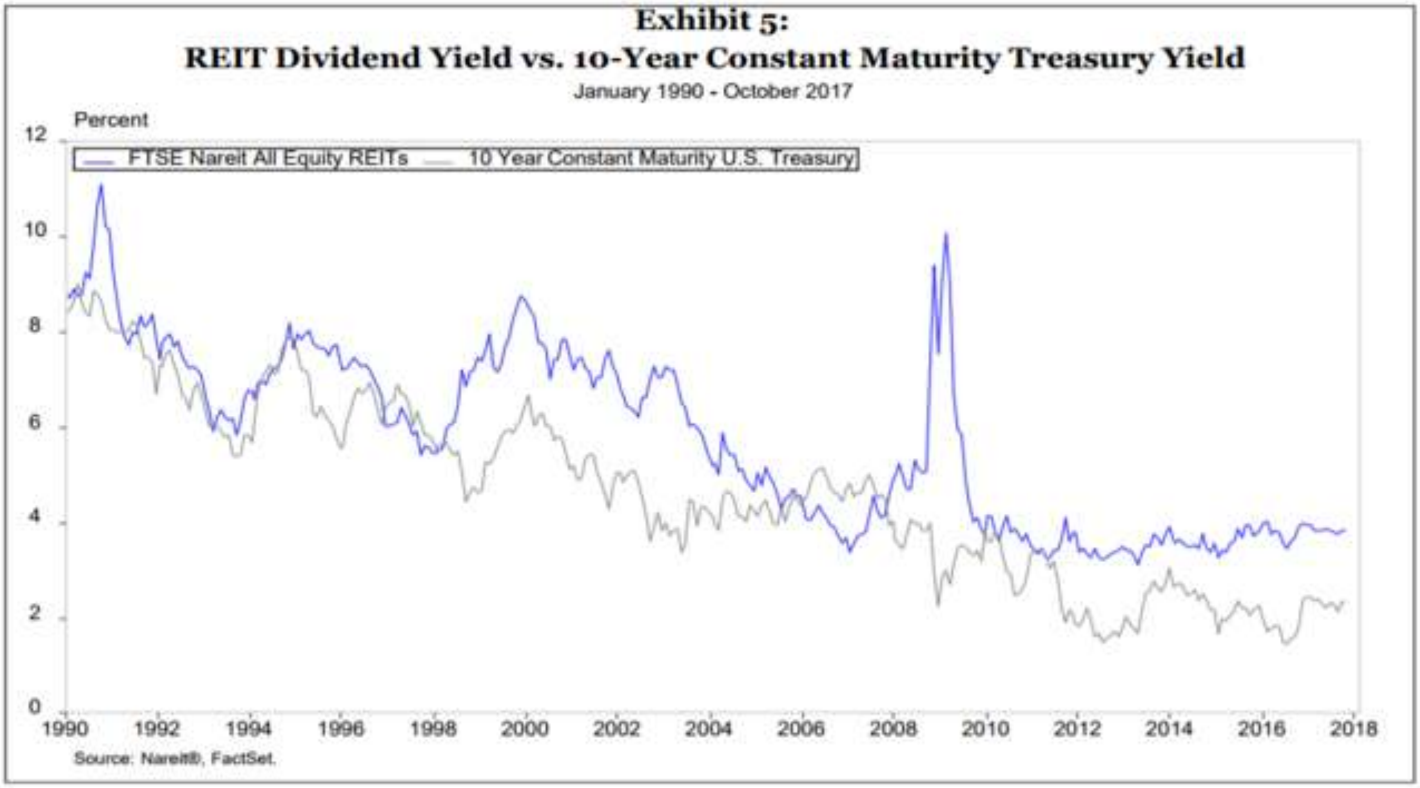
Higher Dividends and Lower Risk

Higher yield is often associated with greater risk. While this is true in many cases, it is far from being a perfect rule, especially when you compare REITs to traditional stocks.

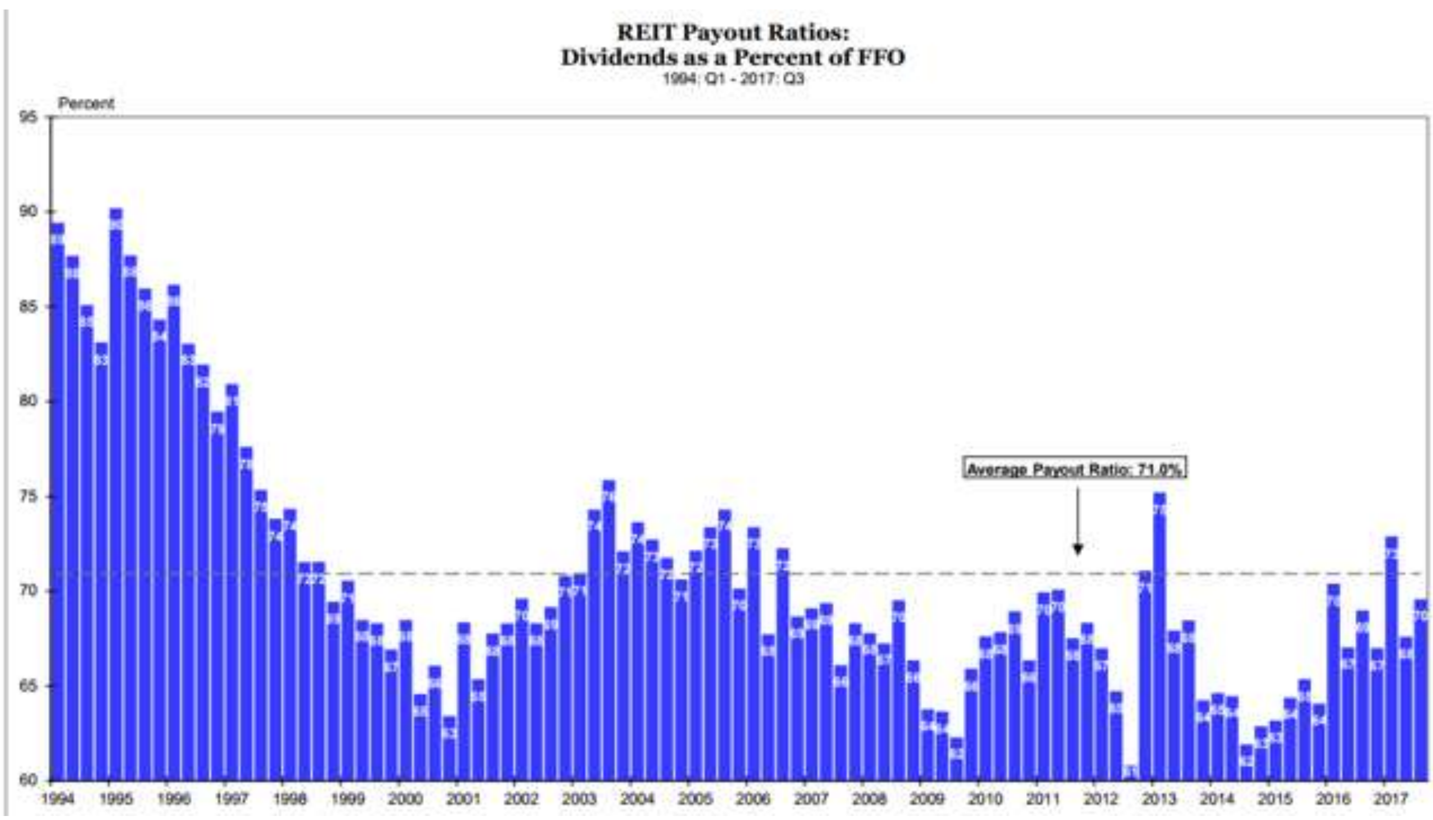
On the contrary, we consider REITs to be safer than the average stock because they generate more consistent cash flow (contractual income from long leases), have historically been less volatile, and provide a better hedge against inflation risk. ...

Yet, the **Vanguard Property REIT Index** (VNQ) - an ETF which tracks 154 of the largest Property REIT stocks - pays a significantly higher dividend yield than other sector ETFs. VNQ currently yields 4.2% compared to 1.9% for the **S&P 500 index**(SPY). It is worth to note that VNQ's management fees are only 0.12% which is one of the lowest fees for a sector ETF.

In fact, Property REITs have historically paid an even higher yield than 10-year treasury bonds:



Moreover, these higher yields have been achieved with very reasonable payout ratios, with the **average payout ratio of only 70%** as of November 2017, leading us to believe that the dividends are sustainable for the most part:



You can agree or disagree with our risk appraisal, but the fact is that a manufacturing company, for instance, will typically feel the impact of a recession long before the average property owner, who is protected through long contractual agreements. This is especially true for REITs as they own highly diversified portfolios with 100s or 1000s of leases. (From a Risk perspective, it is not appropriate to compare REITs to most individual stocks.)

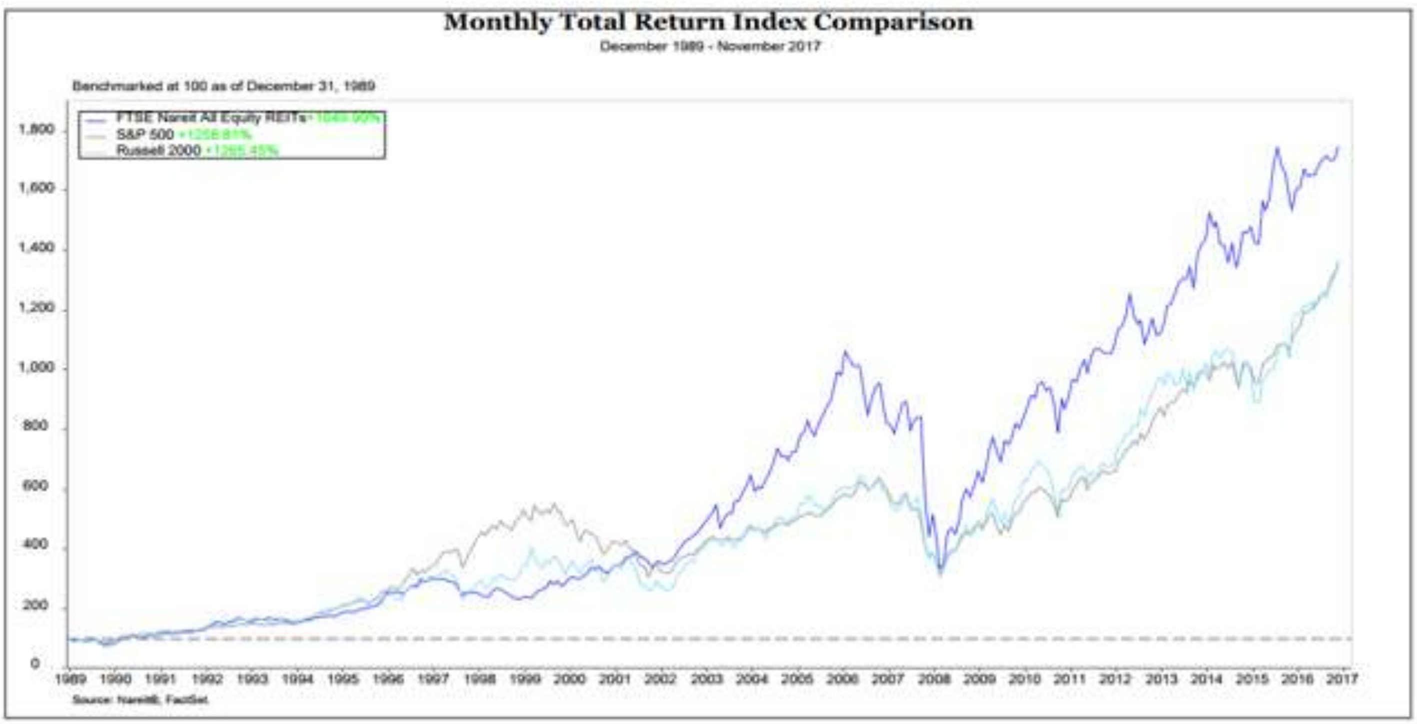
Regardless of market conditions, tenants are likely to keep on paying their pre-agreed rent to landlords, making the business model of real estate management safer than most other businesses.

We conclude that a higher yield does not necessarily come with higher risk in the case of Property REITs. This is an attractive combination for retirees.

Strong Track Records of Dividend Growth

High yield is also often associated with low growth. Once again, this does not however apply to the REIT sector in general, which has proven to be able to keep on increasing dividends on a regular basis.

In fact, REITs have been strong outperformers for the last many decades- **returning over 1600% since 1989** compared to **1258%** for the S&P 500 (as of November 2017):



This is proof that REITs are not only distributing high dividends, but they are also capable of growing them by increasing cash flow as a result of new property acquisitions and rising rents. ...

REITs can be very consistent dividend growth machines. The fact that as a whole the REIT sector has outperformed most other classes is strong evidence of that.

And it is not difficult to envision how this was achieved. Consider a REIT that has built-in rent increases in its lease contracts, but retains a portion of its own cash flow, and raises additional external capital for acquisitions; it is not hard to see how many of these companies achieve a consistent mid-single digit growth rate. When you combine that with a 5% dividend yield, you get quickly to the double-digit return potential. A simple, consistent, and high income generating business model – exactly what retirees need.

Valuable Diversification Benefits

It is highly recommended to hold a well-diversified portfolio at all times and especially in retirement where concentration risk should be taken very seriously. While a young individual may afford to be concentrated and take additional risk, a retiree may not be able to recover from an overly concentrated portfolio that suffered a massive correction.

This is another strong reason to consider REITs and real estate in retirement as part of a portfolio strategy. Research has proven that by allocating some capital to REITs and/or real estate, investors can reduce the overall risk of their portfolio without negatively affecting its expected return.

	FTSE Nareit All Equity REITs	Dow Jones U.S. Total Stock Market	Nasdaq Composite[1]	Nasdaq 100[1]	S&P 500/ Citigroup Value	S&P 500	S&P 500/ Citigroup Growth	S&P Utilities	Russell 2000 Value	Russell 2000	Russell 2000 Growth	ML Corp/Govt Bond	ML Mortgage	Domestic High Yield Corp Bond	Dow Jones Industrial Average[1]
	Period For Upper Right: Nov. 2007 - Nov. 2017														
FTSE Nareit All Equity REITs	1.000	0.768	0.712	0.672	0.775	0.759	0.710	0.482	0.780	0.757	0.713	0.230	0.008	0.721	0.724
DJ U.S. Total Stock Market	0.573	1.000	0.958	0.916	0.976	0.997	0.973	0.476	0.916	0.937	0.932	0.002	-0.143	0.740	0.963
Nasdaq Composite1	0.427	0.885	1.000	0.982	0.898	0.952	0.963	0.414	0.860	0.906	0.927	-0.049	-0.181	0.726	0.892
Nasdaq 1001	0.360	0.851	0.971	1.000	0.840	0.915	0.950	0.430	0.772	0.827	0.858	-0.030	-0.159	0.720	0.848
S&P 500/ Citigroup Value	0.608	0.944	0.725	0.691	1.000	0.978	0.910	0.438	0.923	0.916	0.882	-0.015	-0.154	0.691	0.968
S&P 500	0.547	0.988	0.833	0.819	0.957	1.000	0.977	0.492	0.895	0.913	0.905	0.014	-0.127	0.724	0.973
S&P 500/ Citigroup Growth	0.453	0.955	0.869	0.875	0.849	0.965	1.000	0.523	0.825	0.869	0.888	0.042	-0.094	0.725	0.933
S&P Utilities	0.389	0.400	0.202	0.204	0.467	0.416	0.337	1.000	0.328	0.348	0.357	0.375	0.222	0.405	0.478
Russell 2000 Value	0.719	0.830	0.705	0.611	0.830	0.779	0.675	0.356	1.000	0.985	0.943	-0.073	-0.203	0.660	0.873
Russell 2000	0.624	0.877	0.857	0.767	0.795	0.804	0.753	0.307	0.948	1.000	0.986	-0.082	-0.222	0.692	0.873
Russell 2000 Growth	0.518	0.803	0.915	0.837	0.732	0.783	0.772	0.263	0.853	0.974	1.000	-0.089	-0.234	0.707	0.849
ML Corp/Govt Bond	0.189	0.083	0.006	0.031	0.080	0.105	0.118	0.312	0.007	-0.018	-0.039	1.000	0.810	0.200	0.001
ML Mortgage	0.109	0.089	0.013	0.042	0.085	0.113	0.127	0.230	-0.002	-0.023	-0.041	0.867	1.000	0.009	-0.122
Domestic High Yield Corp Bond	0.588	0.615	0.544	0.488	0.582	0.584	0.544	0.316	0.622	0.614	0.574	0.208	0.151	1.000	0.649
Dow Jones Industrial Average[1]	0.511	0.923	0.726	0.714	0.941	0.947	0.883	0.399	0.748	0.736	0.694	0.057	0.081	0.528	1.000
	Period For Lower Left: Nov. 1987 - Nov. 2017														

This is well reflected in the above correlation table as it shows that REITs have different return drivers compared to traditional asset classes such as stocks and bonds. As such, adding REITs to a traditional portfolio may lead to substantial diversification benefits and help one reduce the overall volatility at the portfolio level.

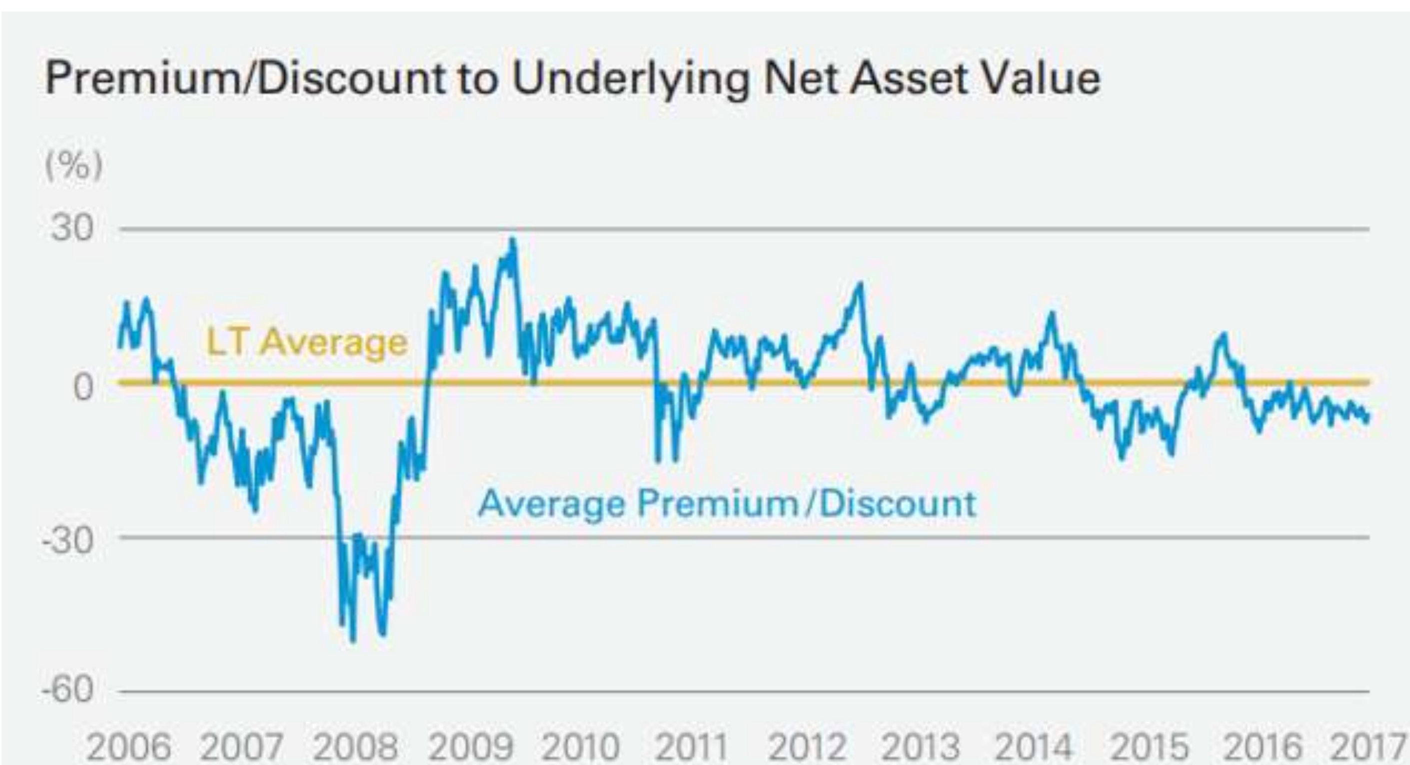
Moreover, especially today as we navigate through a market where some sectors (such as technology ...) have become expensive, commercial real estate becomes increasingly important as a distinct asset class in our view. Diversification is one of the only free lunches you can get… And therefore, we believe that REITs deserve a permanent allocation in each portfolio for retirees. ...

Take Advantage of the Opportunity...

Property REITs have been generally range-bound for most of 2017 as the market has been focused on higher-growth industries. While this lackluster performance has caused the REIT sector to substantially underperform broader equities for the year, ... VNQ still has posted a 5.1% year-to-date return and is positioning to record **a 9th straight year of positive total returns**.

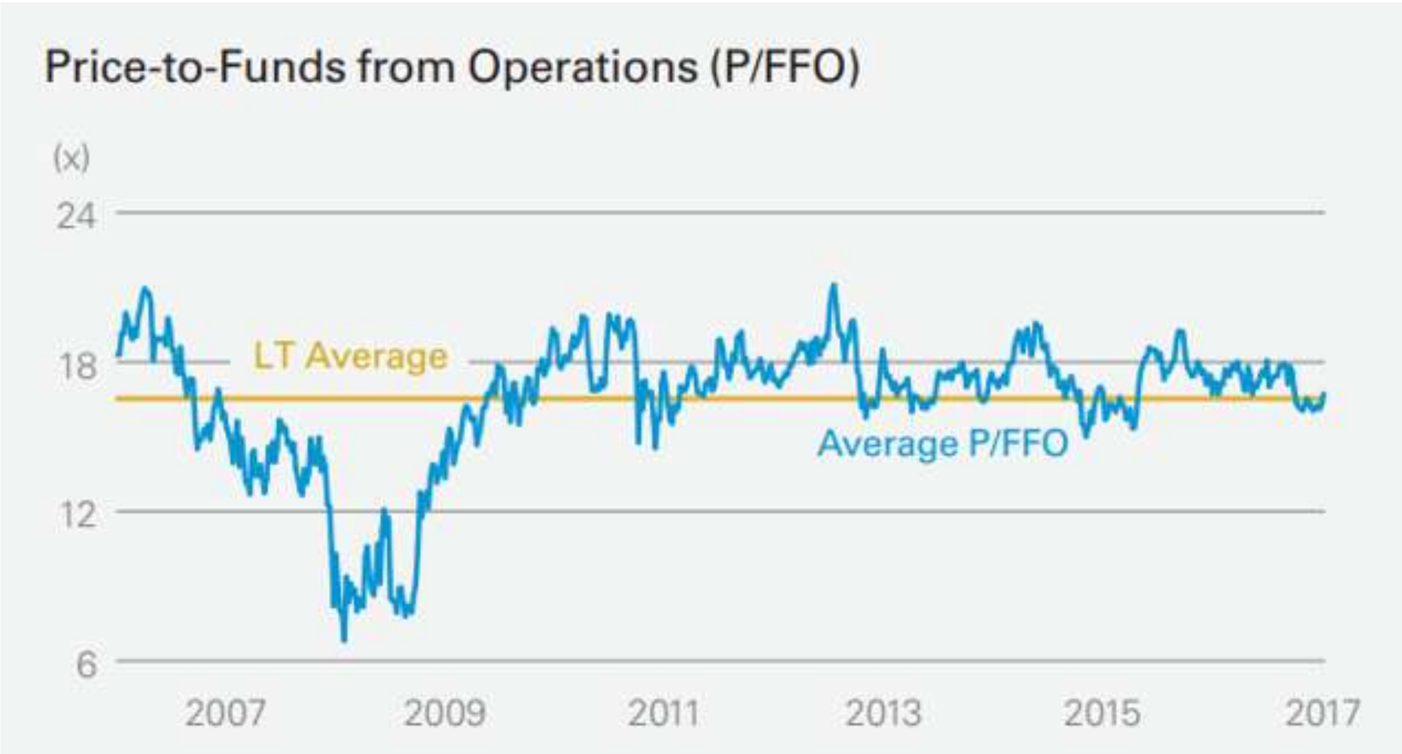
In addition, over the last 15 years (so that we can pick up the full impact of the financial crisis for comparison purposes), Property REITs have had an annualized return of 10.98% as compared to 10.04% for the S&P 500 Index for the same period, **and have also outperformed the S&P 500 Index over 20, 30, and 40-year time periods**.

Today, at a time when many stocks and sectors look expensive, Property REITs are trading at the low end of



their historic valuations if we look at "Net Asset Value" and "Fund from Operations" (or FFO) for the sector. Property REITs trade at a discount based on their historic **Net Asset Value**, as we can note in the chart above.

The same thing can be said when looking at the Price/FFO ratio, another valuation metric used to price Property REITs:



This is great news for income investors who are looking to deploy new money into equities. Current valuations allow investors to lock in higher yields at lower valuations. ...

Final Thoughts

Most investors ... remain underweight in REITs today. Don't make that mistake. REITs have historically generated very attractive risk-adjusted returns and provided great diversification benefits to investors. In fact, historically the simplest way to outperform the market would have been to just overweight REITs while others ignored them…

While all equity investments may suffer from wild fluctuations in their earnings, Property REITs are famous for being particularly stable with little variance from one quarter to another. This allows them to maintain stable dividend policies in place that are highly attractive to retirees.

Yet, this can also apply to younger investors who have the opportunity to enhance the risk-to-reward profile of their portfolio by adding allocation to REITs. Property REITs have in fact, historically generated higher returns while being less risky (they are not) and paid higher dividends.