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Bullish REITs soon may be facing the bear

Business First of Columbus - by [Adrian Burns](#) Business First

It's almost always a good idea to make sure your investment portfolio is diversified - but not everyone agrees on whether real estate investment trusts are still a lucrative way to achieve it.

For many investors, having direct ownership in investment properties such as strip centers, apartment buildings or rental houses is a step that could prove too complex, time-consuming and risky. So for the rest of us there are the shareholder-owned, typically publicly traded corporations known as REITs, which strive to purchase and maintain real estate that will appreciate and generate an income stream for investors - without requiring them to purchase land or buildings outright.

As property values have skyrocketed, REITs - which were less popular in the late '90s while tech stocks were hot - have gained value and drawn investors looking for a strong investment following the bursting of the tech bubble.

The value of REIT shares have reflected the increased demand. The Morgan Stanley Capital International Inc. U.S. REIT index, which represents 85 percent of U.S. REITs, posted a 19.66 percent annualized return during the five years leading up to April 1, compared with a 5.25 percent annualized return for the Standard & Poor's 500 Index in the same period.

But that surge has also made some investors wary that REITs have peaked. With the prices of many REIT stocks at double or triple their prices five years ago, growth may soon slow or come to a halt as what once were bargain priced shares reach full value, or become overvalued, said Travis Upton, portfolio manager at Joseph Group Inc., a Columbus-investment management firm.

Overvalued stocks often have a high share price per dollar of earnings - known as a price-earnings ratio. The higher share price also drives down yield, which is the stock's dividend divided into its share price. Many advisers look for value stocks, which often have low PE ratios and high yields, though neither has been a hallmark of REITs lately, he said.

"Their valuations and dividend yields are not as attractive to us," said Upton, whose firm pulled most of its clients out of REITs in 2004.

Peggy Ruhlin, a principal of Budros Ruhlin & Roe Inc., a Columbus financial advisory firm, has also shied away from REITs, not just because she thinks they've crested in value, but also because as a diversification tool, REITs are far more tied to the stock market than outright ownership of property, she said.

"You do need to have diversification, but you can get it through bonds, foreign versus U.S. stock, cash or you can even buy gold," Ruhlin said.

Although tied at a basic level to the company's real estate holdings and earnings potential - and with a dividend that comes from income generated on the properties from leases or rent - the value of REIT stock can also fluctuate if investors pile into or out of the stocks during stock market rallies or busts, she said.

"It might not be that you're buying what you think you're buying," she said. "A lot of people want to buy low correlation assets ... but in REITs you don't really get that," she said.

Not everyone is down on REITs, however.

After strong results during the first few years of the REIT boom, some investors cashed out thinking the shares had reached full valuation - but yet they've continued to grow for years, said David Rodgers, a Cleveland-based REIT analyst with the RBC Capital Markets.

"There are good underlying fundamentals for real estate, and they pay above average dividends versus broader market," he said.

The Morgan Stanley REIT Index, for example, continued to beat the S&P 500 index during the first quarter, growing 2.6 percent compared to the S&P 500's growth of less than one percent.

The laws governing REITs require they pay out 90 percent of their net income to shareholders, usually in the form of dividends, said Jim Coons, principal of **J.W. Coons Advisors LLC**, a Columbus investment management firm. That payout is a big plus, he said.

"They generate a lot of income for the shareholder," he said.

So even if a REIT stock isn't growing in value, it can still make money for a shareholder, he said.

An example is the Columbus-based REIT, Glimcher Realty Trust, which has seen its share prices remain flat over the past year. The stock, however, has an annual dividend of about 7 percent. Yields are about all REITs are likely to return over the long term as share-price appreciation slows or recedes, according to a March REIT industry analysis by investment research firm Morningstar Inc. A cyclical real estate market could punish REITs in the future, and so it might be wiser to gravitate toward bond returns - which currently sit at near 5 percent and are all but guaranteed, the report stated.

During the last 10 years, REIT dividends averaged 6.2 percent and had an average yield of 4 percent as of March, the report stated. But an underlying cause for optimism is a continued surge in the value of privately-held commercial properties, which make up about 90 percent of the real estate in the U.S., Rodgers said. REITs continue to lag behind values of privately-held real estate, which means there's still room for appreciation, he said.

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A fairly valued REIT should produce such returns, but on average REITS are about 30 percent overvalued - thanks to popularity among institutional investors looking to add a real estate portfolio component and strong merger and acquisition activity, the Morningstar report said. But they aren't likely to produce such returns and may even lose share value as they become more fairly priced, the report said.

Coons said he still directs some client's money into REITs but not as often.

"We don't turn up as many opportunities that we think are attractive, " he said.

Still, there are elements of REITs that continue to make them attractive, Coons said. For many investors interested in using real estate investments to diversify a portfolio, REITs are a much more realistic choice than direct property ownership, Coons said. One big reason is liquidity.

"You can sell a share in a REIT much more easily than you can an apartment building," he said.

A shareholder can also tap into REIT stocks with a lot less money than they would need to buy properties outright, another benefit of REITS, Coons said.

"Most investors can't afford an entire office building, " he said.

Whether a REIT is a good investment or not can depend on the type of return an investor is looking for, said Glimcher CFO Mark Yale.

"Like anything, it comes down to picking the right opportunity, being educated and on top of things," he said.