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ANALYSIS

REITs: why they make such great investments

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Before I extoll the virtues of real estate Investment Trusts and why they are truly different from any other sector of the Canadian capital markets, I should first address exactly why they are *not* different.

First, all investors should know by now that REITs are equities with all the associated risks (e.g., volatility, capital loss) and benefits (e.g., capital appreciation, business ownership). The risks of investing in equities were hammered home to investors during 2008.

The Dow Jones Industrial Average fell 31.9 per cent while the S&P 500 index fell 37 per cent. Not to be outdone, the S&P/TSX Composite Index fell 33 per cent as the price of oil skyrocketed from US$96 to US$147 before collapsing to US$45. In the midst of a global financial crisis, return correlations on all asset classes and sectors appeared to converge at 1 — before collectively plunging off a cliff like so many lemmings.

Global real estate markets followed and, in some cases, lead the precipitous decline in equities. The genesis of the global financial crisis was increasingly attributed to undisciplined buying and lending in the U.S. residential and commercial real estate markets.

Accordingly, the EPRA/FTSE/NAREIT Index, which measures the returns of listed global real estate securities, plunged 48.9 per cent. No geography was spared, as U.S. REITs (measured by the MSCI REIT Index) fell 37.7 per cent and Canadian REITs (measured by the S&P/TSX Capped REIT Index) fell 38.3 per cent.

Investors should recognize that in a broad-based, macro-driven market pullback, so-called "defensive sectors" will likely *not* provide the definitive downside protection they seek. Equity investments expose investors to this type of market volatility in return for the potential to generate strong compound annual returns. As equity investments, REITs are no different and 2008 proved that.

REITs are sensitive to the level and outlook for GDP growth and interest rates. In this respect as well, REITs are no different from "traditional equities." However, in the case of REITs, this sensitivity appears to be magnified by the fact that there are relatively fewer moving parts in a REIT as compared to other equity sectors.

Operating businesses focus on how many widgets can be sold at what price and the outlook for widget-input costs and global widget demand. Will Chinese industrialization and urbanization continue to support the widget market? Will the U.S. continue to outsource widget production and support to India? And what about the new Apple widget? Does that spell the end for the dated, but trusty, widget?

REITs are simpler businesses with fewer moving parts. Because of this relative simplicity, they are relatively more sensitive to the larger moving parts of the economy — GDP and interest rates. The high fixed asset and relatively high leverage structure of most REITs also increases the perceived sensitivity to interest rates in investor's minds, potentially adding to their market price volatility. But *all* businesses are sensitive to these factors, arguably more so than to other macro or micro factors.

The Canadian capital markets are dominated by financial services, energy and materials companies. All are very sensitive to GDP and interest rates, arguably more so than to any other macro or micro input. So, contrary to popular belief, REITs and their sensitivity to GDP and interest rates do *not* make them different.

So what does make REITs so different from other equities that I felt compelled to type this missive? Much of it has to do with the components of total return that investors receive. Since 1900, the total return generated by the S&P 500 index has been split, 51 per cent capital appreciation and 49 per cent dividend reinvestment and compounding.

But the market is very cyclical and the components vary during different business and market cycles. From 1980 to 1998, the returns were approximately 79 per cent from capital appreciation (bull market after the early '80s recession and tech bubble) and only 21 per cent from dividends.

However, since 1998, the returns have flipped to approximately 28 per cent from capital appreciation (tech meltdown, global financial crisis) and 72 per cent from dividends. Investors point out that during the decade of the 2000s, the S&P 500 generated a total return of -0.2 per cent.

REITs are different because they are designed and managed to provide higher, after-tax income streams to patient investors over long periods of time.

But this ignores the performance of individual sectors and subgroups. The best performers in the S&P 500 during the decade of the 2000s were those companies that paid dividends (up 1.3 per cent) and the absolute best performers were those that paid rising dividends (up 2.2 per cent). Conversely, the worst performers

were non-dividend payers (-3.1 per cent) and those that cut their dividends (-6.3 per cent).

It should not be a surprise then, that REITs delivered some of the best total returns during the decade of the 2000s. The MSCI REIT Index delivered a 10.4 per cent total return and the S&P/TSX Capped REIT Index delivered a 27.8 per cent total return. Much of this had to do with the dividends and distributions paid by REITs during this decade.

Many readers will point out that rates were steadily declining during the decade of the 2000s but this is positive for *all* equities, not just REITs. In addition, the Government of Canada 10-year bond yield fell from about 3.7 per cent to 2.7 per cent during 2008 and this didn't lead to outperformance for REITs.

Falling interest rates were not a floor for REIT prices in 2008 and rising interest rates in 2011 will likely not be a ceiling for REIT prices. In fact, given the outlook for developed global economies (e.g., austerity budgets, rising taxes, de-leveraging), it is likely for the foreseeable future that rates will remain relatively low and equity returns will continue to be driven by dividend reinvestment and compounding. In such an environment, REITs should continue to be standout performers.

What really makes REITs different is their strong, consistent, tax-efficient income streams and the effects on total returns. My mother continues to be one of the best investors I've ever met. Her first stock purchase was **RioCan REIT** (REI.UN-TSX, $21.72)at $8.95 in December of 1999. Her yield at that time was 11.6 per cent while the Government of Canada 10-year bond yielded 6.18 per cent. Of the $1.04 annual distribution, 52.6 per cent was return of capital, making her after-tax yield 7.8 per cent using today's tax rates.

Since December 1999, RioCan has delivered a 298 per cent total return (slightly more than half from distributions) compared to the miniscule returns from the broader indexes over that time period.

Yield

Since 1999, RioCan has fluctuated from $9 to $27 to $11 and now trades around $22. Last year's distribution was $1.38, and 63 per cent of it was return of capital. That means that my dear mother now receives a 15.4 per cent cash yield on her cost and her after-tax yield is up to 10.5 per cent.

My mother is unconcerned about the "back up" in the 10-year bond yield to 3.2 per cent, especially since she knows that it has averaged 4.5 per cent since 2000. She is unconcerned about inflation, deflation, Irish debt levels or the outlook for equity markets in 2011. She knows that when the calendar year changes she will be in line to receive about 10.5 per cent on this investment in current after-tax income, regardless of the volatility in the equity markets. Investors will be hard pressed to find similar return profiles in the market today.

Many equity investments are designed to deliver the bulk of their returns in capital appreciation. But over the long term, equity markets deliver their total returns as an almost even split between dividends and capital appreciation. Investors have been conditioned to think that they must buy and sell equities to generate returns when in fact, historically, this only accounts for half of the total return.

Investors should consider REITs as a sector that is capable of delivering higher cash yields, especially on an after-tax basis. It stands to reason that any business that can pay regular dividends over the long term is a stable business. Furthermore, any business that can consistently deliver rising dividends would seem to have a defensible business model (such as contractual rental income streams).

REITs are different from other sectors of the Canadian capital market not because they are immune to global macro event risk or company-specific operational risk. Neither are they different because of any acute sensitivity to interest rates. REITs are different because they are designed and managed to provide higher, after-tax income streams to patient investors over long periods of time.

Investors who currently hold REITs purchased over the last two years should ask themselves a question. The question is *not* "Will REITs outperform next year?" The question investors should ask themselves is, "If I'm locked into a seven per cent-plus tax-efficient cash yield and I expect it to grow at the rate of inflation or better for the next 10 years, then what could I invest the proceeds into that would generate a similar risk-adjusted return profile if I sell?" The answer to that question might just be to hold on and enjoy the compounding. I know that's what my mom would say and she's usually right.

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