Diversify Income with Real Estate Investment Trusts

It's been challenging for fixed income investors to meet their cash flow needs in recent years with interest rates hovering near historically low levels. A number of investors have turned to an alternative vehicle for income – real estate investment trusts (REITs).

While REIT investments will likely change the risk profile of an investment portfolio (when compared to bonds and other asset classes), the potential for income generation may be attractive to certain investors.

How REITS add value to a portfolio

Congress created REITs in the United States in 1960 as a way to make investments in large-scale, income-producing real estate accessible to individual investors. Prior to the creation of REITs, these types of investments were limited to institutions and wealthy individuals having the financial wherewithal to invest in commercial real estate by purchasing properties — such as office, retail and distribution warehouse buildings — directly.

Most REITs do not pay corporate income tax and all REITs must annually distribute at least 90% of taxable income to shareholders — potentially making them current income vehicles[1] and providing investors diversity in their sources of cash flow.[2]

REITs seek to generate their income through the rents the tenants of their buildings pay to use the properties for their businesses. A REIT's income is dependent on the health of the real estate market and that of the broader economy.

There are two primary types of REITs available to individual investors – publicly traded and public, non-traded.

Publicly traded REITs trade on exchanges, like the New York Stock Exchange. They are registered with the Securities and Exchange Commission (SEC), and provide transparency to investors through regular reports and filings.[3] These REITs offer investors greater liquidity since their shares can be bought and sold just like any other shares traded on an exchange. But their prices are subject to the risk and volatility the exchange-traded market can produce.

Public, non-traded REITs do not trade on an exchange, however, they are also registered with the SEC and offer the same transparency through regular reports and filings.[3] Non-traded REITs are sold at a set price over a specified offering period and have more limited liquidity than publicly traded REITs.[4,5]

Can REITs address the risk of rising interest rates?

A major element of the broader economy that many people wonder about in relation to REITs is interest rates and if REITs can provide protection against interest rate risk that exists for more traditional fixed income investments.

While investors are concerned with rising interest rates having negative effects on both the debt market and financial stocks, it is clear that interest rates have not had a major effect on private market commercial real estate (not traded on an exchange) investments over the past five economic cycles.[6]

It is also clear that the higher cost of interest on mortgages that REITs may incur during rising interest rate years has historically been more than offset by the increases in income (from occupancies and rents) and price appreciation that commercial real estate has experienced.[6]

REITs may be one way to help diversify holdings in an individual investment portfolio.[2] Talk to your financial advisor to understand more about the potential role alternative assets could play in your financial plan.

[1]There can be no assurance that these objectives will be met. Many REITs do not produce income but still pay distributions. These distributions may represent a return of capital. There is no guarantee that shareholders will receive dividend distributions or that an investment in a REIT will be profitable or that it will realize growth in the value of its assets. Distributions may be paid from sources other than cash flows from operating activities, such as cash flows from financing activities, which may include net proceeds from primary shares sold in this offering and borrowings (including borrowings secured by the REIT's assets), which means it may have less funds available for the acquisition of properties, and stockholders' overall return may be reduced.

[2]Diversification does not ensure a profit or guarantee against a loss.

[3] SEC registration should not be construed as an endorsement from the SEC.

[4] The initial share price of a non-traded REIT typically is determined arbitrarily and is not adjusted during the offering period. Accordingly, the share price of a non-traded REIT may not accurately represent the value of the non-traded REIT's assets ay any particular time. The value of underlying properties will fluctuate and may ultimately be worth less than the REIT initially paid for them. Since there is no public trading market for shares of non-traded REITs, investors may not be able to sell their shares in the investment.

[5] *Generally, quarterly redemptions may not exceed the lesser of 1/4th of 5% of the outstanding shares at the date of measurement in the prior calendar year and the amount of shares sold pursuant to the distribution reinvestment plan in the preceding quarter. Typically, a REIT's board of directors may amend, suspend or terminate a redemption program at any time.*

*[6]**Past performance is no guarantee of future results**. Source: Commercial Real Estate Investments in a Growing Economy: Do Rising Interest Rates Really Matter? November 2013.*

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