

# The REIT Stuff

By William Hammer, Jr., CFP®



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*"The major fortunes in America have been made in land."  
-John D. Rockefeller*

Throughout history, real estate has been an incredible tool for building wealth. However, real estate has taken a beating over the last few years because of the speculative bubble that burst after being fueled by people using houses as ATMs, easy bank lending standards, and the idea that real estate prices could never fall.

Even though the residential and commercial markets are still struggling to recover, investment real estate remains an attractive addition to a broadly diversified portfolio. The great news is that you do not have to be a Rockefeller to invest in real estate.

Most investors will find real estate investment trusts (REITs) to be the easiest, cheapest, and most liquid way to gain exposure to real estate. Picking individual REITs carries the same risks as individual stocks, but you are instantly diversified if you buy low-cost REIT mutual funds or ETFs. On top of that, new fund offerings allow investors to diversify further by including foreign real estate in their portfolios.

**Another benefit of REITs** is that their historical returns are similar to stocks, while they have low correlations to both stocks and bonds. Low correlations mixed with high expected returns make them a perfect diversifier that can lower a portfolio's overall volatility. Because the properties owned by REITs can raise rents over time and rise in value, REITs have also provided a good hedge against inflation.

REITs must pay out a large fraction of earnings as dividends, so they tend to have higher yields than stocks. Higher current yields make them an appealing option for clients looking to generate more income. Keep in mind, though, that chasing yields in the REIT market is dangerous. Quality matters.

Just like any other investment, REITs are no panacea. Their higher expected returns come with higher expected risk. At the same time, high cost, actively managed REIT funds should be avoided since lower cost, passive funds tend to perform better over time.

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The tax inefficiency of REITs also presents some difficulty, especially to investors in higher tax brackets. REIT dividend income is not treated as qualified dividend income, but rather as ordinary income (unless part of the distribution is a return of capital).

It is generally preferable to put REITs into tax-deferred IRA or 401(k) accounts, regardless of clients' income levels. The asset location decision is crucial with REITs, and you must look at the portfolio holistically.

For example, let's assume that you decide on a 10% REIT allocation for a high tax bracket client with \$500,000 in an IRA and \$500,000 in taxable accounts. If you split the REIT allocation evenly between the two accounts, you would end up paying more in tax than you should. Instead, you would most likely want to put the entire \$100,000 of REITs in the IRA account. Obviously, these tax decisions should be made in conjunction with an accountant.

**Another consideration** when analyzing REITs is whether the client has a large portion of his net worth tied to the real estate market. If the client works in the real estate industry or owns a large number of properties, REITs may not provide the diversification element that you seek.

Personal residences do not apply as part of a real estate allocation. A home is not an investment, it is where you live. Your home takes money out of your pocket every month, it never puts money into your pocket unless you sell it, downsize, and invest the difference.

If you decide to include real estate in clients' portfolios, it should be viewed as equity because of its risk-reward characteristics. For instance, if your client has 70% of his portfolio in stocks and you invest 10% in REITs, that leaves 60% for other stock investments.

Real estate is an underutilized asset class, but its benefits are tremendous. REITs provide strong cash flow, high expected returns, an ability to lower overall portfolio risk, and numerous fund options.

What's not to like?

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