REITs 101: Understanding Real Estate Investment Trusts

There are many ways an investor can get exposure to the real estate market. One can buy an asset outright, such as a home; purchase the debt or equity of companies whose primary business is real estate related, such as home-builders and developers; or purchase the debt or equity of companies that own and manage income-producing properties. In this article, our focus is on the third alternative and more specifically, the Real Estate Investment Trust (REIT) market. We will explore the domestic REIT market in the United States and why it may continue to be attractive despite the current housing downturn. We will also take a look at the growing international market in real estate securities and how global REITs offer investors another way to diversify their portfolios.

What Is a REIT?

REITs are essentially pass-through vehicles structured to facilitate the flow of rental income to investors. A REIT's primary business is to invest in, own and operate rental properties. REITs in the US are often characterized by sector specialties such as office, retail, residential, industrial, or storage. Outside the US, most real estate companies are considered "diversified," with some combination of office, industrial, retail or residential investments.

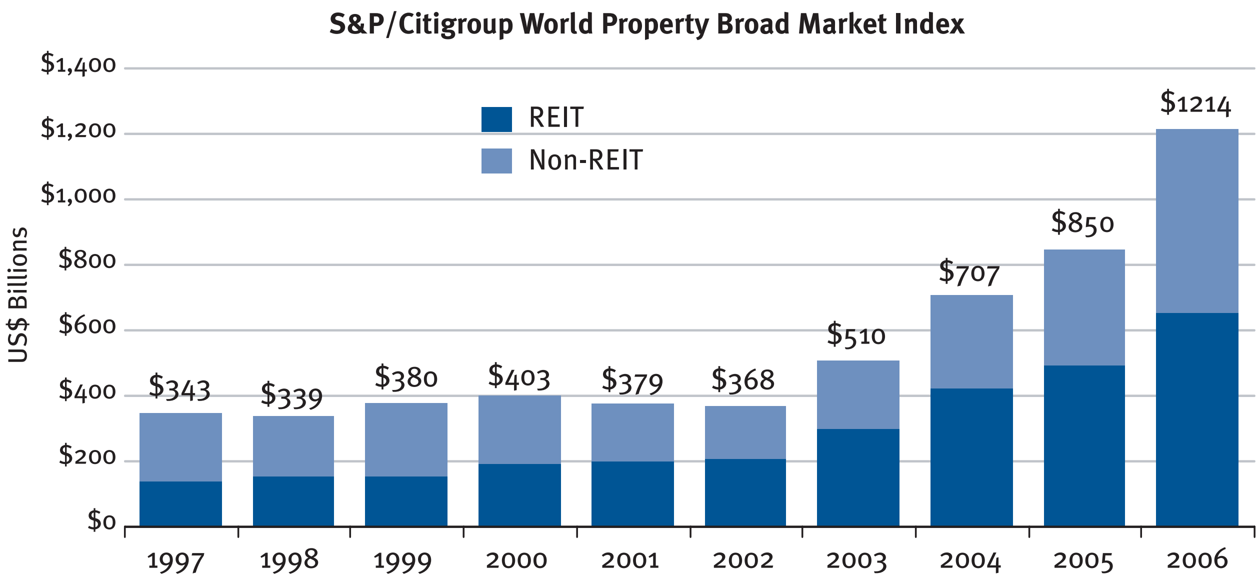
A REIT's primary business is to invest in, own and operate rental properties.

The REIT structure was originally designed to offer investors a means of getting broad exposure to pools of real estate assets similar to the way that mutual funds provide investors with the opportunity to invest in the common shares of many companies. For the small investor, REITs have several advantages over purchasing property directly. For one, the REIT market is liquid and has lower transaction costs. In addition, REITs are more diversified and are managed by investment professionals. The Real Estate Investment Trust Act of 1960 laid the foundation for the development of the US REIT market. Like any corporation, a REIT can be publicly or privately held. There are nearly 200 publicly traded REITs in the United States today with a market cap of over $400 billion compared to less than $9 billion in 1990.

The market has also developed and continues to grow overseas. Companies traded in the international real estate market can generally be broken down into real estate companies that have REIT status and those that do not. The major distinction has to do with tax designation: REITs are tax-exempt because they distribute the lion's share of their taxable income to stockholders in the form of dividends. The percentage of income that must be paid out to achieve REIT status varies by country, but for example, US and UK REITs must pay out at least 90% of their income in dividends. Some other distinctions include minimum numbers of shareholders and the percentage of income derived from rental revenue.

According to the Standard & Poor's (S&P)/Citigroup World Property Broad Market index, the total market capitalization of global real estate securities has increased from $343 billion in 1997 to $1.2 trillion in 2006. This represents a compound annual growth rate of 19% for REITs, 12% for non-REITs and 15% for the total global real estate market. As can be seen below, most of the growth has taken place in the past four years.

The Market Cap of Global Real Estate Securities Has Ballooned



Source: S&P/Citigroup World Property Broad Market Index

An Impressive Run By US REITs

Strong fundamentals including high occupancy rates and rising rents have caused US REITs to perform exceptionally well in recent years. The National Association of Real Estate Investment Trusts (NAREIT) US REIT index returned more than 34% in 2006, outperforming all other US equity market benchmarks for the seventh year in a row. Although last year's performance is unlikely to be repeated in 2007, US REITs should continue to post positive returns as long as the unemployment rate remains low and the US economy continues to expand.

The steep downturn in the residential real estate market may actually bolster the apartment REIT sector. There is still a huge affordability gap nationwide that may keep potential homeowners renting apartments until they are able to save up a

The steep downturn in the residential real estate market may actually bolster the apartment REIT sector.

down payment. Put simply, people need a place to live and as long as people have jobs, they will pay for a roof over their heads.

However, investors must do their homework before investing in US REITs since valuations are relatively high at the present time. One of the more commonly used valuation metrics for REITs is the funds from operations multiple, or FFO, which is similar to a price/earnings ratio. Currently, the average FFO multiple is approximately 18.5x, which is almost 50% higher than the ten year average of 11.5x.

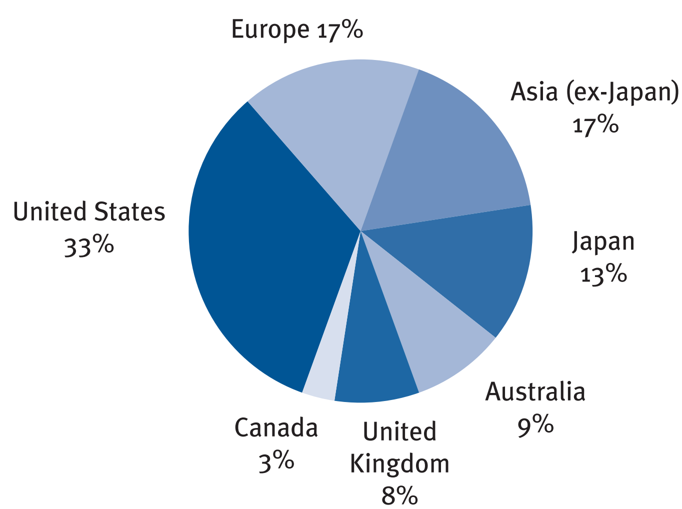
Diversifying Globally Makes Sense

For those investors who would prefer not to have all their eggs in one basket, global REITs offer a good way to diversify their real estate holdings. Although US REITs make up the largest single component of the global real estate market (33% of the S&P/Citigroup World Property Broad Market Index), the non-US real estate market is rapidly growing. Many countries have facilitated an increasingly liquid real estate securities market by passing REIT legislation. In the past five years, Japan, Singapore, Hong Kong and France have joined the ranks of REIT participants. The UK converted to REIT status in January of this year. Germany converted in March, and REIT legislation is expected for Italy before year-end.

The opportunities in the global REIT market vary by country, but there are some broad trends.

The opportunities in the global REIT market vary by country, but there are some broad trends. According to a recent study by Cushman and Wakefield, office rents around the world increased an average of 12% in 2006 versus a 4.3% increase in 2005. Office rents have been boosted by steady economic growth, making the sector a landlord's paradise. Japan has an extremely tight office market with a 2.9% vacancy

The Global REIT Market is Becoming More Diversified



Breakdown of S&P/Citigroup World Property Broad Market Index
Source: S&P/Citigroup World Property Broad Market Index

rate in Tokyo's five central wards. This provides landlords with the ability to raise rents while keeping tenants. In Tokyo, the average year-over-year rent growth in December 2006 was nearly 10%. Singapore's office markets are also severely supply constrained. In fact, with a vacancy rate of 4.4%, Singapore's office rents rose 30% in 2006. After years of low rents and recessionary pressures, the city-state is going through an economic recovery. Even so, office rents in Singapore trail other Asian cities. According to Jones Lang LaSalle, a property consulting company, office rents in Singapore average $495 a square meter ($46 a square foot), lower than Mumbai ($550), Hong Kong ($1,059) and Tokyo ($1,232).

Real estate prices generally have a low correlation with stock markets and therefore offer investors another way to diversify their portfolios. According to S&P/Citigroup, the rolling 30-month correlations between its property and equity indices have been running between 50% and 80%. In addition, different countries appear to have distinct real estate cycles which are independent of other countries. Consequently, the correlations between US, European, and Asian REITs are low.

Real estate prices generally have a low correlation with stock markets and therefore offer investors another way to diversify their portfolios.

Opportunities Remain, but There Are Risks

Investors are turning their attention to the global real estate market in increasing numbers in hopes of capturing some of the impressive returns generated by real estate in recent years. However, the market is not without risks and investing in reputable real estate companies in countries with developed REIT or REIT-like structures is essential because information is not always transparent. The downturn in the US real estate market suggests that US REITs may not perform as well as those in some European and Asian markets. However, moderate economic growth and stable employment should continue to drive rising rents and low vacancies in US office, retail and apartment properties. Overall, the REIT sector offers investors another tool with which to diversify their portfolios and improve returns. ■

Metzler Payden FUNDS

333 South Grand Avenue | Los Angeles, California 90071 | Tel 866 673-8637 | Fax 213 830-4374 | metzlerpayden.com