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Do Real Estate Investment Trusts (REITs) Make Sense for Your Portfolio?

[By Douglas Charney]

By now you should have heard the word “REIT” in the investment world, but you may be wondering what one is and how it works. First, realize that REITs (Real Estate Investment Trusts) are not new. They’ve been around for more than 45 years. However, it has only been since the 1990s that REITs have gained popularity.

From the end of 1992 to the middle of 2001, the size of the REIT industry has increased almost tenfold. But according to the Institute of Business and Finance*, the REIT industry has only captured 10% of the \$3.5 trillion commercial real estate market, and it still has plenty of room for growth.

So what exactly is a REIT? REITs are corporate real estate entities overseen by financially skilled management teams. Although past performance is no guarantee of future returns from dividends, as measured by the NAREIT Equity REIT Index (an index of about 150 trade REITs), they have averaged about 8% and have never fallen below 4.8%. In simple terms, they are companies that run commercial real estate properties, such as business skyscrapers, apartment communities, hospitals, golf courses, shopping centers, etc. By investing in a REIT, you can become part owner of real estate you would probably never be able to own by yourself.

To be considered a REIT, the investment must adhere to certain rules, including:

1. It must distribute at least 90% of its annual taxable income, excluding capital gains, as dividends to its shareholders.
2. It must have at least 75% of its assets invested in real estate,

mortgage loans, shares in other REITs, cash, or government securities.

3. It must derive at least 75% of its gross income from rents, mortgage interest, or gains from the sale of real estate property, and at least 95% must come from these sources together with dividends, interest, and gains from securities sales.
4. It must have at least 100 shareholders and no more than 50% of the outstanding shares concentrated in the hands of five or fewer shareholders.

Advantages of a REIT

According to the National Association of Real Estate Investment Trusts (NAREIT)*, in 2006 REITs were up 34% to 35%. Additionally, 2006 was the seventh consecutive year that REITs outperformed the overall stock market. Add to that the fact that REITs have had a positive performance in 28 of the past 34 years (more than 80% of the time).

Another big advantage of REITs is that they are not correlated with the stock or bond markets. Realize that stocks and bonds typically go up and down at the same time, but REITs tend to have their own up-and-down cycle. In fact,

REIT stocks have only a 55% correlation with the broad market, as measured by the S&P 500 Index (period followed was 1972-2000). This means that when the S&P 500 goes up or down, REITs are not as likely to follow suit with the broad stock market. Since REITs tend not to perform with the market, they can be a good choice for asset allocation.

Even if the near-term outlook for real estate is not good, REITs can still be a good investment since good management teams with access to capital have the potential to find opportunities in bad times as well as good. Even during a bear market, a REIT’s yield potential can provide a steady income for investors.

Real Risks in Real Estate

Just like common stocks, REITs come with risks; however, the risks associated with REITs are different from those of other investments. Real estate ownership and management, like any other business or commercial endeavor, is subject to all sorts of risk. For example, shopping mall REITs are subject to the changing tastes and lifestyles of consumers; apartment building REITs are subject to overbuilding, and healthcare REITs are subject to the politics of government cuts in healthcare reimbursement. While typical stocks go up or down according to the market, REITs fluctuate because of changes in society, so they are subject to credit risk, interest-rate

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fluctuations, and the impact of varied economic conditions.

Is a REIT in Your Future?

Because REITs were not heavily marketed in the past, many people have never heard of them, but REITs are easy to buy (they're available on the various stock exchanges), and even some money managers buy REITs. Additionally, REITs have traditionally been U.S. stocks, but now they are becoming more global. In January 2007, Britain legalized them, and Germany is expected to come out with its version of the REIT this year. Currently, 17 countries outside the U.S. have REITs. As they become more global, they will likely experience more growth.

REITs often appeal to retirees because of their dividend potential. REITs can also be good for people trying to grow assets because they have historically performed well over the long term. They can also be used to diversify risk to an overall portfolio because they're not tied to general stock market instruments.

As you look to broaden your portfolio, investigate a few REITs. Their track record may be what you're looking for in order to see more positive long-term investment results.

*Institute of Business and Finance Certified Fund Specialist Course, 2006

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