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REITs

Retire Rich With REITs: May The Force Be With You

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by: Brad Thomas

Summary

- As a developer, I'd always had partners. So I'd always had to use K1s from the various partnerships I operated within to file my tax returns.

- REITs are much simpler in that they generate 1099s, a much more efficient way to own high-quality real estate.

- It's interesting to see that unlisted real estate produced average net returns of 8.1% over the period, about 280 basis points less than REITs – or 2.8% per year.

- *This idea was discussed in more depth with members of my private investing community, iREIT on Alpha. Get started today »*

Over the years, I've witnessed firsthand the vast wealth that can be created by owning real estate.

My mother recently retired, although she does maintain a part-time job as a real estate agent. That's not to say she's ultra wealthy, only that she created the ability to have an above-average lifestyle – especially for a single mom – while she was raising two kids.

As soon as I graduated from college (Go, Blue Hose!), I decided to immediately begin working in real estate.

Incidentally, that happened to be the same year Donald Trump wrote *The Art of the Deal*. Like him or hate him, let me tell you: That's one truly inspirational book for anyone who wants to make something of themselves by owning real estate. It definitely had a positive affect on me.

For over two decades, I forged a career developing free-standing and multi-tenant properties. By learning value creation from the ground up, I was able to turn a student loan (around $25,000 in 1988) into a net worth of around $30 million.

I was doing good and flying high.

Photo Source

A Change of Plans

During this high-flying time, I bought and sold properties to real estate investment trusts, or REITs. So I knew what they were. But I've got to admit: I was never interested in actually owning the shares.

I knew they had exceptional cost-of-capital advantages and, for the most part, good management. However, I was much more interested in getting rich by developing private real estate at the time.

Fast forward to 2008, when the word "developer" became virtually extinct. I had lived through previous recessions, of course. Yet the "great" one turned out to be the catalyst for my new career as a real estate analyst.

If someone had asked me at the time – if they had given me the choice to proceed the way I had to after that – I would have turned them down flat.

Yet, looking back at those painful times, I can honestly say that I learned a lot from them, to the point where I can't help but consider them all exceptionally worthwhile. As Benjamin Graham recounts:

> "Adversity is bitter, but its uses may be sweet. Our loss was great, but in the end we could count great compensations."

Becoming an Intelligent REIT Investor

As I began learning more about the REIT structure, I have to say - I became fascinated by the tax-efficient mechanism in which REITs must – by law – pay out at least 90% of their taxable income in the form of dividends.

As a developer, I'd always had partners. So I'd always had to use K1s from the various partnerships I operated within to file my tax returns. That can be a royal pain in the neck, let me tell you.

However, REITs are much simpler in that they generate 1099s, a much more efficient way to own high-quality real estate. That got my attention.

I also was attracted to the highly predictable dividend income they generate. As Ralph Block pointed out in his book *Investing in REITs*:

> "What makes REIT shares so attractive compared with other high-yield investments like bonds and utilities is their significant capital appreciation potential and steadily increasing dividends."

As I began to dig deeper into the REIT platform, I was amazed to see how many investors weren't familiar with what they were and how they operated, including when it came to the repeatable income they offered. Unlike ordinary stocks that pay out dividends more sporadically, REITs are much more systematic.

Quoting Ralph Block again:

> "Analysts who cover REITs are normally able to forecast quarterly results within one or two cents, quarter after quarter, because of the stability and predictability of their operating cash flows, rents, built-in-increases, and real estate operating costs."

And then there are the dividends they offer, which can be extremely effective. To say the least.

Dividends at Their Best

Everyone knows that dividend stocks aren't what you turn to if you want to get rich quick. Yet REITs can offer impressive gains nonetheless thanks to their dividends, which historically make up half of their total returns.

It's true that, "historically," they haven't been around the block as many times as other investing options. Yet they do still come complete with a well-established history of consistently raising their dividends. From the early 1990s all the way up through 2007, for instance, U.S. REITs upped their payouts at a 5.8% average annual rate.

It's true that 2008 was a less-than-impressive year for these entities. Many of them had to cut their dividends to the absolute minimum level legally allowed in order to maintain operations.

Yet as conditions improved and cash flow began actually flowing with cash again, REITs are looking good all over again. In fact, in many ways, they're better than ever having emerged from the Great Recession seeing what can happen – and knowing that they never want to do that again.

Better yet, they should keep right on producing healthy dividend growth for at least the near and mid-terms. If not longer.

Exhibit 2: Contribution of Reinvested Dividends to Total Return 1990–Q2 2016
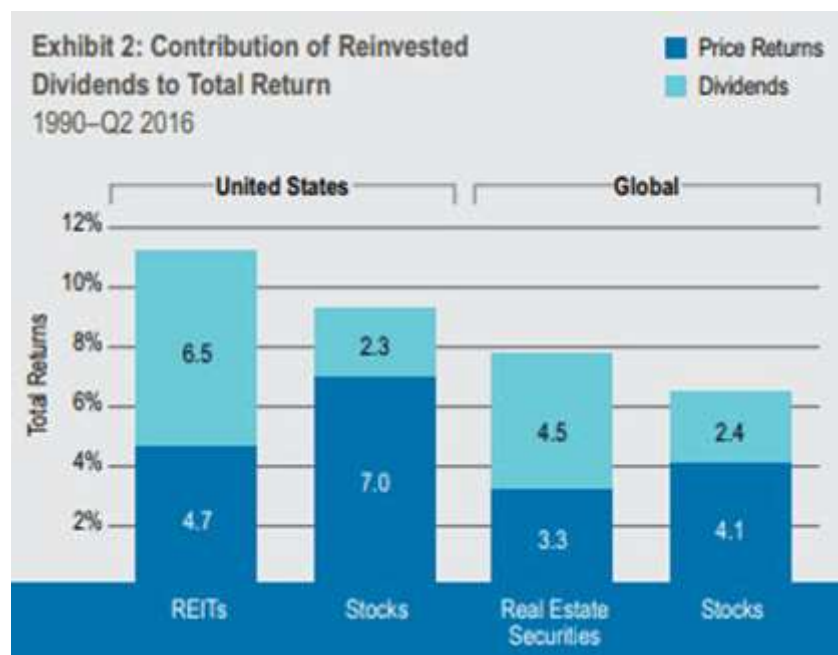
Source: Cohen & Steers

Show Me the Money

Here's some further reason to like REITs, quoted from Nareit, a well-respected champion of real estate investment trusts:

> "CEM Benchmarking's 2019 study, sponsored by Nareit, offers a thorough look at realized investment performance across asset classes over a 20-year period (1998-2017) using a unique dataset covering over 200 public and private sector pensions with nearly $3.8 trillion in combined assets under management.

> "One of the unique benefits of the CEM dataset is that it provides the actual realized performance of the assets chosen by plan managers and trustees. The study compares gross and net average annual total returns as well as correlations and volatilities for 12 asset classes with appropriate adjustments for reporting lags associated with illiquid asset classes (unlisted real estate and private equity).

> "The 2019 study also compares the performance of different styles of unlisted real estate, including internally managed, core, value-added/opportunistic and fund of funds. Over the 20-year period covered by the study, there are striking differences in performance across asset classes. The figure below summarizes average annual net returns and expenses for the 12 asset classes."

**Annual Net Total Return and Expense by Asset Class
for U.S. Defined Benefit Pension Funds
1998 - 2017**

Source: CEM Benchmarking, 2019.
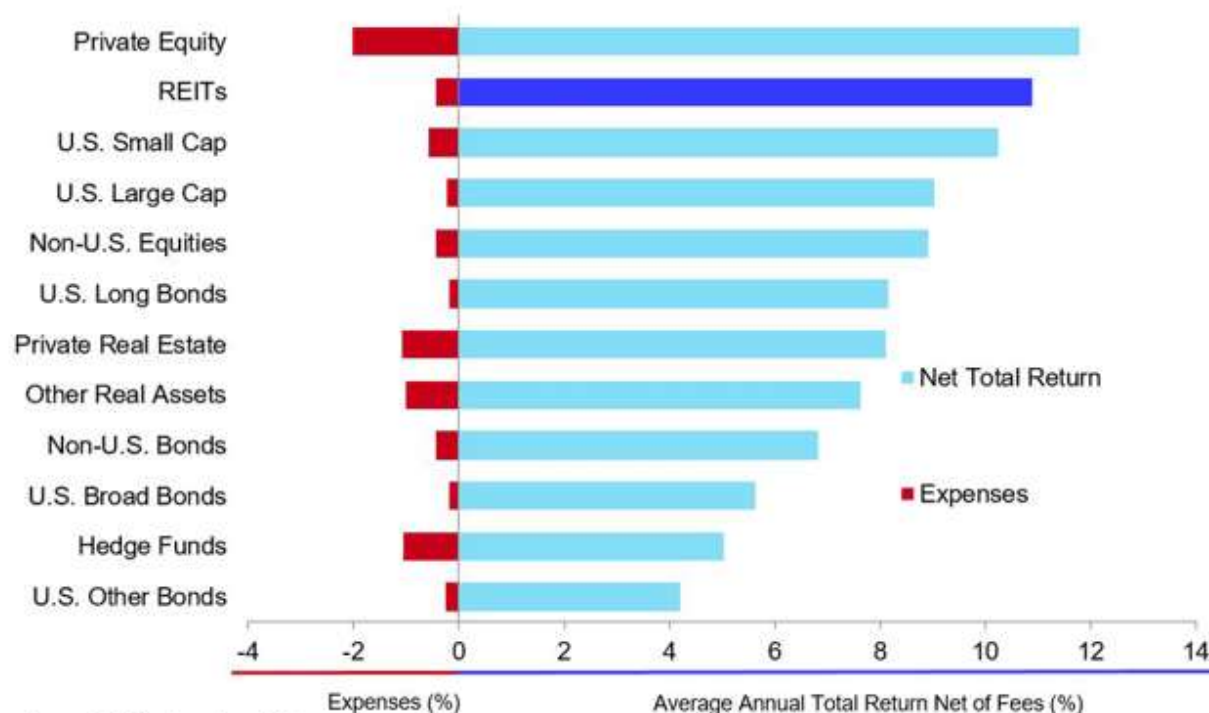
As you can see, at 10.9%, listed equity REITs had the second-highest annual net return over the period. It's interesting to see that unlisted real estate produced average net returns of 8.1% over the period, about 280 basis points less than REITs – or 2.8% per year.

The two worst-performing asset classes, meanwhile, were hedge funds/tactical asset allocation strategies and "U.S. other fixed income."

It's a very interesting study, from start to finish. Which is why I'm not quite done talking about it just yet…

REITs From Every Angle

The study computed correlations of annual returns among the 12 asset classes. So the correlation table below summarizes some key correlations between broad equities, REITs and unlisted real estate.

As you can see in the green-highlighted box, REITs and unlisted real estate returns are highly correlated at 0.91 "when illiquid returns are adjusted for reporting lags," as the previously cited report notes. Truth be told, that isn't surprising given the similarities in underlying assets.

Then there's the dark blue highlights, which show that the returns on REITs and unlisted real estate "have relatively low correlations with bonds and listed equity returns. These reflect the well-known diversification benefits associated with the real estate asset class, whether REITs or unlisted real estate."

Key Correlations
(1998 - 2017)

	REITs	Private Real Estate	U.S. Long Bonds	U.S. Large Cap	U.S. Small Cap	Non-U.S. Equities	Private Equity	Hedge Funds
REITs	1.00	0.91	-0.03	0.53	0.62	0.56	0.49	0.50
Private Real Estate		1.00	-0.06	0.47	0.57	0.54	0.53	0.43
U.S. Long Bonds			1.00	-0.41	-0.51	-0.50	-0.61	-0.30
U.S. Large Cap				1.00	0.92	0.89	0.85	0.92
U.S. Small Cap					1.00	0.88	0.89	0.79
Non-U.S. Equities						1.00	0.89	0.85
Private Equity							1.00	0.79
Hedge Funds								1.00

Source: CEM Benchmarking, 2019

Also note that private equity (which is ranked highest for total returns over the 20-year period) proved to be the most volatile asset class by far after adjusting for valuation lags.

I'd also like to point out how, despite REITs crushing all the asset classes in this study, they're the most underweighted based on the CEM data. Listed equity REITs represent 0.74% in this regard compared with 4.95% for private real estate.

Why is that?

I wish I knew the answer to that question. And I will definitely take a closer look at this topic in my upcoming book. My guess is that it has to do with:

- Education
- Lack of capacity/liquidity 15-20 years ago
- The fact that pension funds have in place private teams
- The misconception that private real estate is less volatile
- A combination of 1-4

Either way, it's a shame considering how much REITs can do for most portfolios.

May the Force Be With You

In *The Intelligent Investor*, Benjamin Graham explains his approach to dividend investing this way:

> "Paying out a dividend does not guarantee great results. But it does improve the return of the typical stock by yanking at least some cash out of the manager's hands before they can squander it or squirrel it away."

As an intelligent REIT investor, my goal is to always stay focused on not only dividend safety, but dividend growth. They're certainly correlated and provide significant meaning.

To show as much, I'll turn to Ralph Block one last time:

"Growth REITs are those viewed by investors as having the ability to increase FFO (funds from operations) much faster than other REITs. This growth potential may be because a specific sector is enjoying the boom phase of its property cycle when rental rates and occupancies are rising rapidly, or because their management's strategy is to implement a very aggressive acquisition of development program."

Block went on to explain how "Many outstanding REITs will, over many years, be able to report FFO growth of 6%-10% per year."

Since I'm in full agreement with that assessment, I decided to put together a list of the top 10 fastest-growing REITs using data obtained from our Intelligent REIT Lab, of course.

So without further ado, here they are…

Bring on the Real Good REITs

We recently launched our quality scoring model known as R.I.N.O. that stands for *REIT Indicator Numerically Optimized*. We use this tool as a means to screen each REIT based upon well-defined quality metrics such as dividend safety, earnings growth, and management track record. Before we screen these REITs, let's first take a look at 10 REITs with the best 10-year FFO per share growth:

REIT Name	Ticker	10-Year FFO/sh
CorSite Realty	COR	17%
American Tower	AMT	15%
Crown Castle	CCI	12%
Equity Lifestyle	ELS	11%
Prologis	PLD	11%
EPR Properties	EPR	10%
Essex Property	ESS	10%
Medical Properties	MPW	9%
AvalonBay	AVB	9%
First Industrial	FR	9%

Source: iREIT

It should be no surprise to see the technology-focused REITs at the top of the list, namely CorSite (COR), American Tower (AMT), Crown Castle (CCI), Prologis (PLD), and First Industrial (FR). The other top-growers include Equity Lifestyle (ELS), EPR Properties (EPR), Essex Property (ESS), Medical Properties (MPW), and AvalonBay (AVB).

Now let's take a look at the five-year FFO per share chart below:

REIT Name	Ticker	5-Year FFO/sh
Arbor Realty	ABR	14%
Terreno Realty	TRNO	14%
Catchmark Timber	CTT	12%
Equinix	EQIX	11%
CyrusOne	CONE	11%
American Tower	AMT	11%
CoreSite Realty	COR	11%
CareTrust REIT	CTRE	9%
Iron Mountain	IRM	9%
Sun Communities	SUI	8%

Source: iREIT

A few of the same names are on the 10-year chart, such as CorSite and American Tower. However, a few new names appear such as Arbor Realty (ABR), Terreno Realty (TRNO), Catchmark (CTT), Equinix (EQIX), CyrusOne (CONE), CareTrust (CTRE), Iron Mountain (IRM), and Sun Communities (SUI).

By using the R.I.N.O. screening tool, we can examine each REIT by various valuation metrics, such as dividend yield, P/FFO, NAV, or the variance to P/FFO. We decided to use the later (five-year variance to P/FFO) vs. our R.I.N.O. (quality) scores.
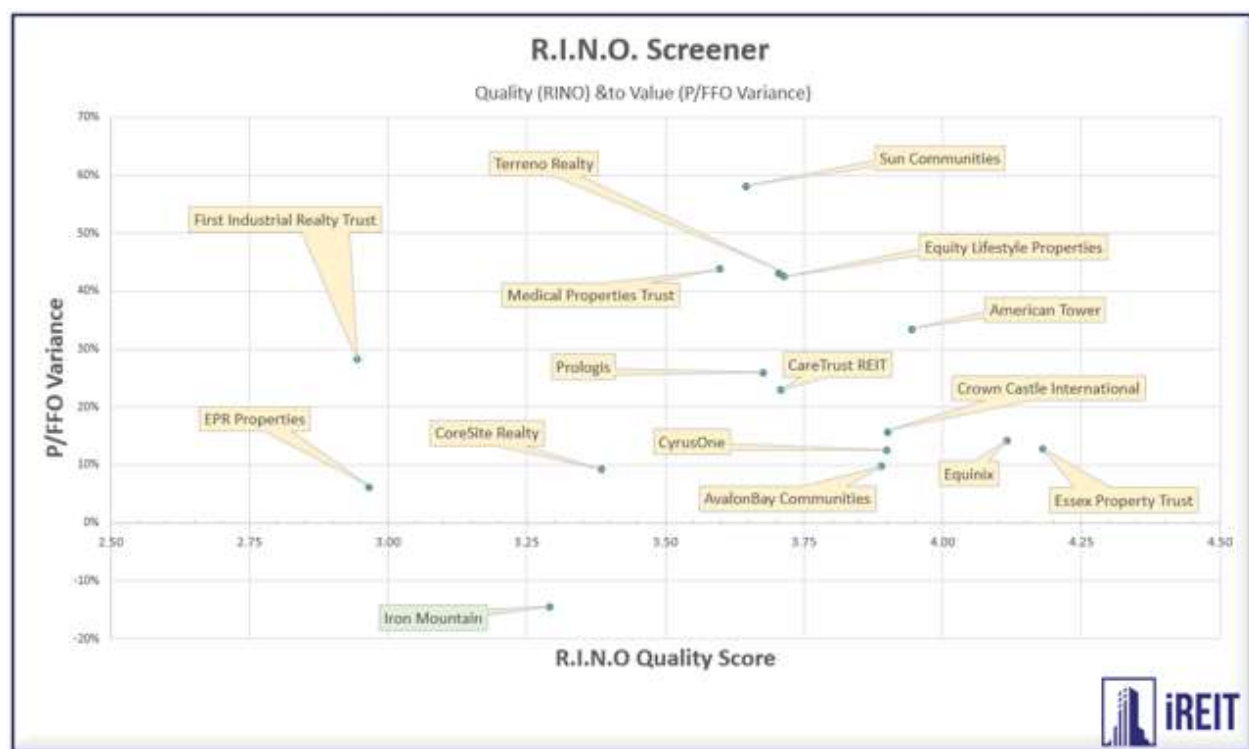
As you can see, **Iron Mountain** (IRM) is the only equity REIT we would buy at this time (we do have a Buy on Arbor, but it's a commercial mREIT). Actually, Iron Mountain is a Strong Buy and we plan to include an article on this outlier in the marketplace this week.

Also, CyrusOne is on our "Buy Watch" List as a result of the earnings news last week (full update on the marketplace).

We own a number of these high risers including Iron Mountain, CyrusOne, Crown Castle, Medical Properties, and Catchmark Timber (we did own CTT in our hedge fund strategy and we still on shares in the small cap portfolio).

By carefully examining the growth catalysts we have found success in optimizing portfolio returns. Since inception our Durable Income Portfolio has returned 22.43% annualized, compared with the **Vanguard Real Estate ETF** (VNQ) that has returned 9.68%.

That's much better than my record as a private developer and of course I have benefited as a result of the painful losses of the past. The biggest lesson of course, and the reason I spend so much time on researching REITs, is because I adhere to the most important rule of investing: *Protecting my principal at all costs*.

Author's note: Brad Thomas is a Wall Street writer, which means he's not always right with his predictions or recommendations. Since that also applies to his grammar, please excuse any typos you may find. Also, this article is free: Written and distributed only to assist in research while providing a forum for second-level thinking.

The Cat Is Out Of The Bag... Or Shall We Say, R.I.N.O.

We are set to launch our new REIT scoring model we call R.I.N.O. that stands for **REIT Indicator Numerically Optimized.** Subscribers to iREIT on Alpha will get access to RINO and over 125 REITs screened by QUALITY and VALUE. Our research is powered by qualitative data analysis that provides a decisive edge to achieve **superior portfolio results**.