



“On The Money Report”

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Investing In Real Estate Investment Trusts. Is It Too Late After Last Quarter's Huge Rally?

What is a REIT? (Real Estate Investment Trust)

A REIT is a company that buys, develops, manages and sells real estate assets.

REITs allow participants to invest in a professionally-managed portfolio of real estate properties, whose main function is to pass profits on to investors. A REIT's business activities are generally restricted to generation of property rental income.

So, a REIT's is basically a company which owns real estate properties and passes through the cash flow generated by those properties to investors. The REIT passes the majority of earnings to shareholders so the dividend rates are much higher than ordinary stocks.

Recent Performance

REITs have had another fabulous year in 2003, gaining nearly 25% through October 28th, besting the S&P by almost five percent. Moreover, REITs shot the lights out in the third quarter, gaining more than 9%, well ahead of most other types of equities (except for small growth). This comes on the heels of very strong relative performance in 2000,

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2001, and 2002. These gains have more than offset the REIT bear market of 1998-99, and REITs now show better average returns than the S&P 500 over the past five and ten years

Important Facts

Since REITs have exhibited very strong performance relative to equities and bonds, both on a year-to-date basis and throughout the three-year bear market that preceded the recent rally, it's important to look at their current valuation. Remember investing through the “rear-view mirror” can be quite dangerous. One must look at current valuations in order to judge an investment's current attractiveness.

- This strength has reduced the valuation appeal of REITs,
- Relative to stocks and bonds, REITs still represent better-than-average values, although the picture is somewhat distorted by today's very low interest rates.
- Relative to their underlying properties, REITs are selling at a premium of **almost 14%**, which is somewhat expensive;
- Fundamentals continue to be weak, but in this regard REITs tend to lag the overall economy. Current forecasts suggest that 2004 cash flow will grow by 4.7% above 2003 levels.
- Demand from both retail and institutional investors has been very strong, and there is some evidence that this will persist. At the same time, the new supply



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of REITs has not been a major factor. The result has been bullish for REIT prices.

- Given their 6% yield and a couple percentage points of earnings growth, returns could realistically fall in the mid- to upper single-digit range on average over the next several years. If underlying real estate values rise, there is the possibility of some expansion in the price-to-earnings multiple, which would enhance returns. However, some of this is already priced into the current price of REITs, and while we think it adds to the potential upside in REITs, it is not an outcome on which we can definitively rely.

Conclusion

While REIT expected returns are still competitive with most other financial assets and should continue to be included in portfolios, they should be scaled back to reflect current pricey valuations.

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