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How to invest in REITs, which perform better than stocks in up cycles and 'do well in times of inflation'

By LARRY LIGHT

Being a landlord sounds like a lucrative idea—reaping rental income, snagging tax breaks—until you realize what a pain it is.

While owning commercial real estate can turn nice profits, you have to endure dealing with rent-delinquent tenants, fixing leaky roofs, scraping by through high-vacancy periods. Plus, if you need some quick cash, forget about trying to unload your building in a hurry. The sale will take months.

But Wall Streeters, bless 'em, back in the 1970s invented a simple way to become a landlord. They created publicly traded baskets of properties, called real estate investment trusts or REITs (rhymes with "eats"), that anyone can buy on the stock market. And these pools of properties are very liquid: Need to raise a bunch of cash suddenly? You can sell your REIT shares within minutes.

Many financial advisers recommend having around 5% to 10% of your investment portfolio in REITs. Now, these trusts are somewhat correlated to stocks, in that they slide when stocks do. Yet the two asset classes aren't *that* tightly correlated, according to a 2020 study from investment house Cohen & Steers, which sponsors REITs.

In the early 2020 market panic, REITs got the stuffing kicked out of them. With the economic recovery and market comeback, however, REITs revived, too, and then some. The S&P 500, representing the market as a whole, rallied 26.9% in 2021, while the FTSE Nareit All Equity REITs index rocketed 43.2%. In the current year, both benchmarks are down almost 6%.

REITs perform better than equities early in economic up cycles and suffer less in recessions, Cohen & Steers found. REITs also "do well in times of inflation," says John Worth, executive vice president, research and investor outreach at Nareit, the REIT trade group. Reason: Real estate prices tend to increase along with inflation.

Escalating inflation often means higher interest rates, as we're seeing now. REITs generally "hold up pretty well in a rising rate environment," argues David Klink, senior equity analyst at Huntington Private Bank. Although REITs use gobs of borrowed money to buy new properties, the existing loans aren't usually linked to overall inflation.

Another advantage to REITs is that they pay richer dividends than the stock market as a whole: yielding 2.85% annually, more than double the S&P 500's 1.3%. Equity REITs (which excludes those dealing with mortgages) are now valued at $1.5 trillion, by Nareit's count.

REITs to buy now

Across the spectrum of commercial real estate, promise is flourishing even amid the damage that the past couple of years has wrought. The most interesting investments are comeback plays from sectors hit the hardest two years ago, such as offices and malls, and also pandemic winners, with more room to rise, like industrials.

Office REITs

They were long the leading sector in commercial real estate until the category got slammed by the pandemic and by this year's market unpleasantness. But the market sees salvation ahead. After a devastating 2020, down 18.4%, Nareit data show, office REITs bounced back by 22% last year and are up almost 3% through this year's first quarter.

This is a sector in which to be choosy, though. There's a bifurcation underway. The clear victors are the newer, high-end Class A buildings, with their state-of-the-art tech links, spacious areas, and enormous windows offering lots of light. On the losers' side is the Class B stuff, namely older spaces with low ceilings, soulless cube farms, and drab lobbies.

While workers are only now trickling back to the office, the betting is that once the pandemic is history, Class A buildings will succeed and even thrive. And for some deluxe properties, that is already happening, even in troubled real estate locales.

Consider One Vanderbilt, a new 93-story skyscraper in Midtown Manhattan, a building that property research firm CoStar Group says is almost fully leased. This glamorous tower is the exception in the devastated Midtown Manhattan office market. In Midtown, availability, a gauge of both present vacancies and space soon to be emptied, hit a record 17.4% in February, says real estate firm Colliers.

Geography is a key factor in finding good office REITs. So-called gateway cities (New York is one of them, along with places like Boston and Chicago) are generally to be avoided nowadays, warns Matt Werner, managing director of REIT strategy at Chilton Capital Management. He finds these locations too slow-growing and less amenable to raising rents that could bolster their endangered revenues.

A better idea, he advises, is to go to the Sunbelt: Atlanta, Austin, Tempe, Charlotte. Populations are growing there and, thanks to laxer regulations than in the gateway cities, "it's easier to build," Werner says. Real estate analytics firm Green Street projects that revenue per available square foot will rise 2% over the next four years in Charlotte, gain just 0.1% in New York, and shrink 1.3% in Chicago.

As such, one office REIT that stands out is **Kilroy Realty** (KRC), which focuses on California and now Texas, with a burgeoning presence in rapidly growing Austin. Kilroy caters to life sciences and technology, with modern buildings that appeal to these tenants. "Kilroy really knows the tech industry," says Cedrik Lachance, director of research at Green Street.

The stock, which suffered a 29% downdraft in 2020, rallied 19.2% in 2021, and this year has

advanced 17.6%. Kilroy still is about 20% below the 2019 high this century; 2007 was its peak. Revenue has swelled, and earnings are robust. (Earnings are called "funds from operations" in REIT parlance, or FFO, which adds back noncash items like depreciation, as real estate tends to appreciate.)

Kilroy's FFO was up 10.5% in 2021's final quarter, compared with the year-prior period. Writes Morningstar analyst Kevin Brown: "The company's high-quality office portfolio has been able to deliver superior results compared with other office REITs in our coverage throughout the pandemic." The dividend yield, per Bloomberg, is 2.8%.

Industrial REITs

This REIT subset consists mainly of warehouses, which Amazon likes to call "fulfillment centers." Huge storage-and-shipment spaces are sprouting up across the land to service the e-commerce rush that started with the pandemic; the phenomenon is likely to keep on trucking.

Industrials were one of the rare REIT groups to do well in COVID-stricken 2020, ahead 12.2%, says Nareit. Rents for warehouses are up some 20.4% yearly, and vacancies are a mere 3.4%, with construction of new facilities increasing almost two-thirds over the past two years.

The segment's stocks had a boffo 2021, up 62%, although this year they have slipped along with the rest of the market, down 6.1%.

A good prospect is **Prologis** (PLD), says Huntington's Klink. The company rents out space to Amazon, FedEx, and DHL, among others. "Their quarterly results are strong, even if the stock is not," Klink observes. The REIT's stock rose 14% in 2020 and 72% in 2021, but thus far this year it is flat as worries abound about supply-chain constraints. "Right now, that's a weakness," Klink notes.

Once those kinks dissolve, the REIT's proponents say, the upward trajectory should resume. Meanwhile, Prologis's FFO advanced in 2021 by 9%, with rent vaulting some 20%, the REIT's financial report states. Occupancy is 97%. Dividend yield: 1.9%.

Mall REITs

Going into the pandemic, the nation already was over-malled, with enormous amounts of inventory. For decades, malls were celebrated as America's downtowns—meccas for teenage hangouts, food courts, Cineplexes, and, of course, stories galore.

How things have changed. Even before the virus's onset, a shrinkage was occurring, first seen as the appeal waned for mall anchor department stores. At the malls' peak in the 1990s, the U.S. had about 1,500 of them; that since has shrunk to around 1,000, by Green Street's measure. As big retailers like J.C. Penney and Brooks Brothers filed for bankruptcy, several mall REITs also went bust, such as CBL Properties, which emerged from Chapter 11 in 2021 after a painful restructuring.

But all malls are not created equal, and the more upscale ones show every sign of returning to their previous prominence. The dreck, not so much.

Exhibit A is Simon Property Group (SPG), which created an empire of high-end shopping emporiums in affluent suburbs. "They're in prime demographic areas," says Green Street's Lachance. "They have Bloomingdale's and Nordstrom," two chichi department stores that stand apart from the likes of Penney, and have used their cachet to soldier through the pandemic.

A big tailwind for Simon in particular and malls in general is the revival of retail sales, thanks to vaccinations, job growth, and wage increases. Following a vibrant 2021 holiday season, the National Retail Federation predicts that retail sales will rise between 6% and 8% this year. The tally omits restaurants, gas stations, and auto dealers, and concentrates on stores.

The nation's largest mall operator, Simon benefits from a big footprint, encompassing 232 malls in North America, Asia, and Europe. The REIT has used the recent economic turmoil to scoop up wobbly yet storied retailers such as Brooks Brothers. In earnings terms, Simon has distinguished itself, last year garnering $4.5 billion in FFO, up 31% from 2020 and eclipsing its pre-pandemic 2019 result. The company also had an enviable 93% occupancy rate. And its dividend yield is a rich 5.2%.

Needing to work through problems that the rocky 2020 economy generated, Simon cut its dividend and gave some tenants rent breaks. The stock got hammered in 2020, losing 38%, recovered in 2021 with a 95% rise, but this year is off 19.6%. Analysts attribute 2022's share slump to management's guidance suggesting a slightly smaller FFO for 2022. But for the long pull, optimism is rife on Wall Street that Simon will power though any snags.

The mutual fund alternative

To feel safer, you always can go for pools of real estate pools. Another way of investing in REITs is via mutual funds, which aggregate a wide panoply of REITs (storage, lodging, offices, retail, etc.) under one banner. With them, you enjoy the virtue of diversification, so if one REIT type slides, then others can offset it. Like individual REITs, funds are easy to cash in.

Morningstar has recommended Vanguard Real Estate Index Fund Admiral Shares (VGSLX), which is down 4.77% for the year and is up an average 9.98% annually over the past 10 years; T. Rowe Price Real Estate Fund (TRREX), minus 2.34% in 2022 and positive 8.79% over 10 years; and Cohen & Steers Realty Shares–Class L (CSRSX), negative 3.85% this year and ahead 11.11% for the past decade.

Note that, over the previous 10 years, these three funds lagged the performance of the S&P 500 index, which tracks the bulk of U.S.-listed stocks and clocked a 14.51% annual gain. That superior showing is not surprising as the boom in tech stocks has buoyed the benchmark index to record heights. The technology run has only recently flagged amid rising interest rates (which tech is especially allergic to) and the turmoil in Ukraine.

In 2022, both our trio of REIT funds and the index are in the red, except the REITs aren't as bad off. The SPDR S&P 500 ETF Trust (SPY), an exchange-traded fund that apes the index, logged a deeper loss than the three REIT funds year to date, down 5.48%.

The Vanguard fund benefits from the lowest expense ratio (the portion of returns that go to the fund company, and not to you) of the three, at 0.12%, and has a broad-ranging portfolio covering most of the REIT field. Typically, any expense ratio below 1.0% is considered affordable.

The T. Rowe offering is known for its discriminating style, sometimes avoiding the hottest areas, but has a good long-term record. Although its expense ratio, 0.78%, is not as low as Vanguard's fund, Morningstar still termed the T. Rowe a "bargain." The Cohen & Steers fund also covers a broad array of REIT types. Its ratio is 0.88%.

All told, it pays to know that, despite some dips, real estate has a history of climbing in value. REITs remain the easiest way to go along for the trip.

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