

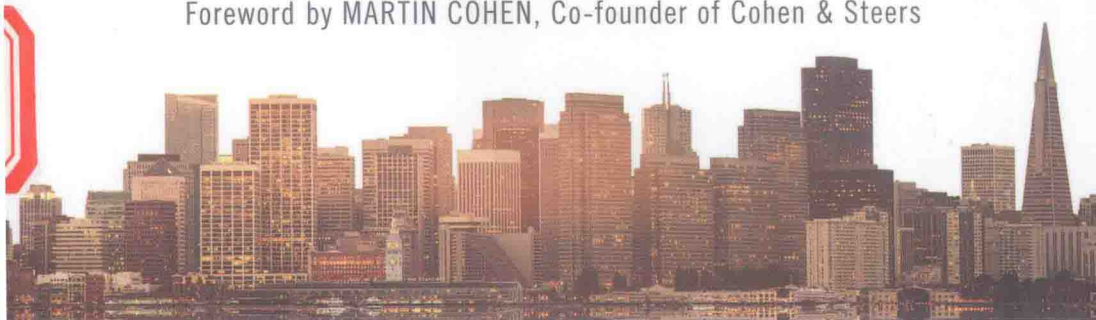
A **Forbes** PUBLICATION

THE
INTELLIGENT
REIT INVESTOR

**HOW TO BUILD WEALTH WITH
REAL ESTATE INVESTMENT TRUSTS**

STEPHANIE KREWSON-KELLY
R. BRAD THOMAS

Foreword by MARTIN COHEN, Co-founder of Cohen & Steers



WILEY

The Intelligent REIT Investor

HOW TO BUILD WEALTH WITH
REAL ESTATE INVESTMENT TRUSTS

Stephanie Krewson-Kelly
R. Brad Thomas

WILEY

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data is available:

ISBN 9781119252719 (Hardcover)

ISBN 9781119252740 (ePDF)

ISBN 9781119252764 (ePub)

Cover Design: Wiley

Cover Image: © Leonardo Patrizi/iStockphoto

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

*To William,
so that someday you understand
why Mommy
turned the dining room
into "an office" for a year*

Foreword

The ability to understand the characteristics and value of an asset when others do not is often the key to investment success. For my entire professional life, REITs have been one of the most misunderstood investments. Early on, real estate experts called them stock, and stock market investors called them real estate. As a result, they found no natural home in diversified portfolios. Although that has changed dramatically over the years, there are still many poorly understood aspects of this asset class. That is why this book is such an important resource.

For much of the post-1974 period, the term *REITs* was associated with the mortgage REIT debacle that preceded it. Financial institutions had offloaded mortgage businesses onto this new vehicle and the combination of an economic recession and soaring interest rates precipitated bankruptcies and substantial investor losses. Somehow, the public had a lot of trouble getting over this—it's as if there was no statute of limitations on the damage done in this period. Periodically, investor appetite for current yield irrespective of risk allowed the mortgage REIT to resurface in subsequent cycles, often with similarly disappointing results. Throughout, as Stephanie Krewson-Kelly demonstrates, equity REITs—that is, property owners as opposed to lenders—have delivered consistent and superior investment performance.

The modern publicly traded equity REIT is, quite simply, the purest form of corporate and property ownership. Professional management is employed by shareholders and subject to performance-based compensation. There is strong corporate governance. Portfolio decisions are made with a long-term perspective and not with an arbitrary internal rate of return objective that is used to determine a promoter's compensation. The company has the ability to employ nearly every type of equity and debt financing. And the company pays no taxes; pretax profits of the enterprise are entirely distributed to its shareholders in direct proportion to their ownership stakes.

The importance of this book is that it gives the reader the tools required to properly analyze and evaluate property companies. I often advise investors that they should look at the numbers before they look at the pictures. This book tells you how.

The industry was not always as resilient as it is today. Over the years there were issues with respect to conflicts of interest, high expenses, poor balance sheet management, and lack of clarity of company strategy. (I should add that this, sadly, is still the case with many private or nontraded REITs.) But the natural selection process has been in full force in the industry. Evolution has favored companies that adhered to best practices and became industry leaders, producing excellent returns to investors and earning a place as components of all major indexes. This was also the result of an army of dedicated and professional investors and analysts following these enterprises. So-called corporate activism, whereby a small group of investors challenge management and directors or attempt to affect the liquidation or sale of a company, is not new to the REIT industry. As far back as the late 1970s astute investors seeing share prices that did not reflect underlying values were very effective at producing change.

Despite such progress, there remain a great number of misconceptions about the nature and behavior of equity REITs. For example, many believe that share price performance is directly related to the level and direction of interest rates. Empirical evidence of this is lacking. In fact, it is the economy that most strongly influences property and REIT fundamentals and, when rising interest rates accompany a robust economy, REITs perform exceptionally well. Many direct real estate investors complain that the volatility of this publicly traded asset class makes it an inferior investment to that which doesn't trade at all. Being long-term investors, they are happy to sit on their asset until there is a final outcome—that is, sale. It could be argued that if one is truly a long-term investor, day-to-day volatility should be ignored, unless it presents an occasional compelling trading opportunity.

The Intelligent REIT Investor will help you understand and appreciate the newest innovations and developments in the REIT industry. The most important is the rise in popularity of exchange-traded vehicles that provide broad diversification and liquidity. Although many active managers are capable of outperforming popular indexes, the low expense ratios and tax efficiency of ETFs make

them a compelling choice—so much so that they are experiencing greater capital inflows than actively managed real estate mutual funds. Also new are REITs that own formerly uninvestable assets such as single-family homes, an outgrowth of the housing crisis. Here, as it has in the past, the public market has filled a capital void, providing an opportunity to investors.

There are more positive developments in the REIT industry on the horizon. Rules governing the taxation of foreign owners of U.S. assets have been relaxed. Already, REITs are extremely popular among Japanese investors and this interest is quickly spreading to other parts of Asia. In 2016 real estate has been given its own sector in the Global Industry Classification Standard (GICS). Formerly part of the *Financial* sector, this separation significantly raises the profile of the asset class.

Publicly traded real estate companies have become a cornerstone of investment portfolios. I trust that this new edition will provide the reader the tools required to find appreciation of, and profit from, this asset class.

Martin Cohen
April 2016

Preface

Over the 15-year period that ended on December 31, 2015, Real Estate Investment Trusts (REITs) were the best performing investments, delivering annualized total returns of 11.1 percent. By contrast, the S&P 500 and NASDAQ Indexes achieved annualized total returns of only 5.0 percent and 4.8 percent, respectively, over that same time period. Yet many investors are unfamiliar with equity REITs—companies that own commercial property, such as office buildings or apartments—or with mortgage REITs, which invest in real estate-based loans.

In 2016, the REIT industry will experience a watershed event that will likely increase demand for REIT shares dramatically: Standard & Poor's Dow Jones Indices (S&P) and MSCI Inc. (MSCI) will create a new Global Industry Classification Standard (GICS) sector called *Real Estate*. S&P is a leading provider of financial market indexes and, historically, has classified REITs as part of the *Financials* sector. MSCI is a leading provider of investment-decision-support tools. Together, the organizations determined that investors' view of real estate has evolved such that it is regarded as a distinct asset class—one that is different from banks and financial institutions. Accordingly, after the market's close on August 31, 2016, publicly traded equity REITs and other listed real estate companies will be removed from Financials and be promoted into their own GICS code. (Note that mortgage REITs will remain in S&P's Financials sector.) The creation of the Real Estate GICS sector should elevate investor awareness of REITs and broaden the industry's appeal to individuals and institutions alike.

The Intelligent REIT Investor conveys essential information about REITs in a concise, easy-to-understand format. Even novice investors can gain a thorough understanding of the REIT market by reading the relevant industry background and simple examples presented in these pages. Part I, An Introduction to REITs, presents basic information that will help investors quickly gain an understanding of what

REITs are in order to have more informed conversations with their financial advisors. Part II, Investing in REITs, is more technical in nature, with content geared for individuals who want to analyze and evaluate specific REITs before investing in them. *The Intelligent REIT Investor* is a steppingstone that provides critical information about the REIT industry and individual companies and, in sharp contrast to other REIT books, can be read cover-to-cover in less than a day.

Here are a few industry background facts to get started:

- The REIT industry's aggregate equity market capitalization has increased exponentially from a mere \$8.7 billion at the beginning of 1990 to its December 31, 2015, level of \$939 billion, for a compounded annual growth rate of 34 percent (see Table 1.1).
- Innovations to the REIT structure that eliminated conflicts of interest between management and shareholders helped fuel the industry's explosive growth. Perhaps the most significant event in modern REIT history occurred in October 2001, when the first equity REIT was added to the S&P 500 Index. Since then, REIT shares have attracted an increasingly broader array of investors, including general money managers, pension funds, hedge funds, and individual investors. As a result, the average daily trading volume for REITs increased from approximately 16 million shares in 2000 to 175 million shares a day in 2015, according to S&P Global Market Intelligence.
- Despite the industry's outperformance and the upcoming creation of the Real Estate GICS sector, most investor portfolios are under-allocated to real estate securities. The 2015 *Institutional Real Estate Allocations Monitor*, published by Cornell University's Baker Program in Real Estate and Hodes Weill & Associates LP, found the average institutional portfolio contains an 8.5 percent investment in real estate versus their targeted investment level of 9.56 percent. REITs are viewed as an established investment class, and demand for REIT shares has increased by multiples since 2000—but they are not yet mainstream.
- Just as the demand for REITs has increased, the marketplace for REIT shares has also evolved dramatically. As previously mentioned, the average daily trading volume for component companies in the FTSE NAREIT All REITs Index, which at

December 31, 2015, tracked 223 publicly traded REITs, has increased exponentially. By dollar volume, the average daily trading volume of companies in the FTSE NAREIT All REITs Index increased from \$400 million in 2000 to \$6.2 billion in 2015 (source: NAREIT).

- In addition to higher trading volume, REIT volatility also has increased dramatically. The MSCI® US REIT Index (ticker symbol: RMZ) is an index that tracks approximately 150 publicly traded equity REITs. According to S&P Global Market Intelligence, during the 1,508 trading days in the 2000–2005 period, the RMZ rose or fell by more than 3 percent only 13 times; in the 1,508 trading sessions of 2010–2015, the RMZ saw 51 such daily swings. With greater volatility comes greater risk, but also greater potential returns.

As a final observation, given the industry's rapid growth in the last 15 years, it is surprising that basic information about REITs is not easy to find. Even something as simple as a complete listing of publicly traded companies in the REIT industry is difficult or expensive to obtain, as each brokerage firm typically has access only to information about the REITs actively covered by their research department's analysts (the individuals who analyze and rate stocks as *buy*, *hold*, or *sell*). To remedy this information gap, the appendices of this book list the 223 REITs that comprised the FTSE NAREIT All REITs Index at the end of 2015, as well as some basic information about each company. The following chapters present information in a progressive manner. Read as much or as little as you require, and welcome to the world of REITs.

Note: Unless noted otherwise, all prices, total returns, and data used in this book are as of December 31, 2015.

Acknowledgments

Sincere thanks to the following individuals and organizations for their permission to reproduce select material and for the time they invested in editing this book's more technical content:

- Paul Reeder at S&P Global Market Intelligence (formerly SNL Financial)
- Matthew Bechard, John Barwick, John D. Worth, Ph.D., Christopher T. Drula, and Kurt Walten at the National Association of Real Estate Investment Trusts (NAREIT)
- Cohen & Steers, Inc. (NYSE: CNS)
- Green Street Advisors

At the risk of omitting someone, I would also like to thank numerous colleagues at Corporate Office Properties Trust (NYSE: OFC), the executives at Pebblebrook Hotel Trust (NYSE: PEB), and Andrew T. DiZio at Sterling Capital Management for their technical readings of select chapters.

Sincere thanks to R. Brad Thomas for discovering my prior book and realizing its potential.

A very special thanks to Ralph L. Block, author of *Investing in REITs*. His work and writings have inspired and influenced countless investors and REIT industry veterans, including myself and Brad Thomas. We both thank him for his love of real estate and generosity of spirit to educate a still young industry.

Last but not least, I want to thank my family and friends for their support and patience during the many months it took to compose this work.

About the Author

Stephanie Krewson-Kelly is head of investor relations at Corporate Office Properties Trust (NYSE: OFC), a publicly traded office REIT. Her experience in the REIT industry dates back to 1994 and includes work as a senior associate in investment banking (1994–1997) and as a research analyst (1997–2009) in New York City at Salomon Smith Barney (which today is part of Citi Global Markets) and J.P. Morgan, followed by five years as the head of REIT research at BB&T Capital Markets in Richmond, Virginia. In between retiring from Wall Street and joining her current firm, Ms. Krewson-Kelly authored *REIT Roadmap: An Insiders Guide to Successful Investing in Real Estate Investment Trusts* (second edition published in 2012 under her maiden name, Krewson; now out of print).

Prior to her career in REITs, Ms. Krewson-Kelly worked as an internal auditor for a global corporation headquartered in Paris, France. In 1992, Ms. Krewson-Kelly graduated from the University of Pennsylvania's College of Arts & Sciences and Wharton School of Business, where she earned her respective BA in English and BS in Economics.

Ms. Krewson-Kelly also authored *4-Leaf Clovers* (Cedar Tree Books, 2015), a new and original children's book that explains why the finder of a four-leaf clover gets one wish.

Brad Thomas has over 25 years of experience in commercial real estate. He is currently the senior analyst for iREIT Forbes and the editor of the Forbes Real Estate Investor (monthly subscription-based newsletter).

He is an active real estate analyst and business journalist for both Seeking Alpha and Forbes.com where he has a combined following of over 27,000. He has consistently been ranked as the number-one REIT and finance analyst on Seeking Alpha and in 2014 he was ranked by TipRanks as the number-one analyst on Seeking Alpha.

Thomas has also written articles or has been featured in *Forbes* magazine, *Kiplinger's*, *US News & World Report*, *Money*, NPR, *Institutional Investor*, *GlobeStreet*, *The Motley Fool*, *The Street*, *Investopedia*, and Fox, CNN, and Fox Business.

Over the last five years Thomas has written over 1,500 articles that have generated over 7.5 million annual page views. In 2015 his articles generated 3 million annual page views and on Seeking Alpha he authored over 280 articles, of which 75 percent were Editor's Picks.

Thomas considers himself a value investor and much like Warren Buffett, his investment strategies are rooted in the same margin-of-safety principles taught by the legendary investor, Benjamin Graham.

Thomas considers fundamental research to be the key to intelligent investing, and in the words of Ben Graham, "You are neither right nor wrong because the crowd disagrees. You are right because the data and reasoning are right."

Thomas received a bachelor of science degree in business from Presbyterian College and he resides in South Carolina with his wife and children.

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