ADVANTAGES OF REITS

Many people are vaguely familiar with Real Estate Investment Trusts (REITs) but don't have a thorough understanding. An REIT is a type of real estate company that resembles a mutual fund, a stock, and a bond. ***It provides those lacking the expertise, time, or financial means the opportunity to invest in real estate.***

These companies invest in land, apartments, hotels, office space, retail space, industrial space, mortgages, and mortgage backed securities.

Most of us are unable to invest in a shopping mall or other large property on our own, but REITs provide a means to do just that. Imagine being able to invest in those huge properties like Donald Trump.

REITs are unique and provide many advantages for the average investor. First, it's important to understand real estate investment trusts.

TYPES OF REITS

There are three types of real estate investment trusts:

1. **Equity.** These REITs invest predominantly in real estate properties and receive most of their revenue via collecting rent. Revenue is also generated by property sales. Approximately 90% of REITs fall into this category.

2. **Mortgage.** These REITs receive the majority of their revenue from investing in mortgages and related securities. The risk tends to be higher with mortgage REITs because of the unpredictability of interest rates.

3. **Hybrid.** These REITs are a combination of equity and mortgage REITs.

Many REITs are listed and traded on the major stock exchanges. There are also private REITs that require an invitation to become an investor.

While public REITs are subject to the same reporting and disclosure laws as other equity firms, REITs are unique and operate under their own set of rules dictated by Congress.

FEDERAL REQUIREMENTS

There are several requirements for a company to be classified as an REIT:

1. **A minimum of 75% of its assets must be invested in real estate or real estate securities.** This prevents REITs from sitting on cash that could otherwise be invested. It also keeps them in their area of expertise: real estate.

2. **A minimum of 75% of its income must be derived from rents, mortgage interest, or sale of real estate.**

3. **REITs can't keep their earnings in most cases.** ***At least 90% of the taxable income generated must be distributed as dividends to the shareholders.*** There are a few exceptions, provided the REIT can show that it benefits the shareholders.

4. **There must be at least 100 shareholders.** It is also stipulated that fewer than six investors cannot hold more than 50% of the shares.

REITs were created by Congress and are controlled by a specific set of laws. They're similar to both stocks and bonds. Thus, they share many of the same advantages of both while minimizing the disadvantages.

ADVANTAGES

REITs have several advantages for investors:

1. **Income.** REITs provide excellent income in the form of dividends. REITs pay approximately $30 billion in dividends each year.

2. **Liquidity.** Most REITs are easily bought and sold on the major stock exchanges.

3. **Diversification.** REITs invest in properties in all 50 states. REITs also don't mimic the major stock indices. They are an excellent hedge against a poorly performing stock exchange.

4. **Equity Returns.** ***REITs provide equity returns that beat all the major market indexes over the last 25+ years.***

There are two additional advantages that deserve special attention: Tax advantages and high yields:

Tax Advantages

1. **REITs don’t pay corporate income taxes.** This means that more of the profits are available to be distributed to the shareholders. Most corporate earnings are ultimately taxed twice. The earnings are taxed and then the shareholders are taxed.

2. **Dividend payments.** Dividend payments are classified as ordinary income, return of capital, and capital gains, depending on the source.

    - Income related to the selling of assets results in that income being classified as capital gains, which is taxed at a lower rate for most people than normal income.

    - The ordinary income part of the dividend is taxed as normal income.

    - The net distributions beyond the earnings and profits are applied to reduce the cost basis of the underlying shares. This doesn’t impact the investor until the shares are sold.

Any gains realized when selling the shares are taxed as capital gains. Again, this tax rate is lower for most people.

In the past, many financial experts were concerned that the special tax status of REITs would be changed. However, this is now considered to be unlikely.

The current tax mechanism provides a reasonable level of income to both the shareholder and the government. The government has little to gain by changing them, as any change would result in the lower capital gains rate being used more heavily.

High Yields

1. **Over the long haul, REITs have averaged about 8% in dividend yield. *Dividends are one of the most reliable income sources.*** 8% is outstanding and better than the yield of the S&P 500 over a similar timeframe.

    - In fact, REITs have beaten the S&P 500 returns by 80% over the last 10 years. Since the financial crisis of 2009, REITs have outperformed the S&P 500 by over 220%

2. **The source of REIT dividends is especially stable. *Most of the dividend income is derived from long-term leases.*** Rents also tend to be more stable than real estate prices.

INVESTING IN REITS

Real estate investment trusts deserve consideration for any portfolio. ***The returns have tended to be better than for the overall market, and they provide reliable income.***

The diversification is excellent. Not only are these firms invested all over the country in a variety of properties, REITs don't move along with the major market indices. They typically perform well during bad market conditions. This is especially true for equity REITs. Remember that mortgage REITs are affected by changing interest rates.

The tax advantages and returns are considerable. Take a long look at REITs and determine if they should be included in your portfolio.