TD Asset Management

Investment Update

November 2012

REITs: Yours to discover

With fixed income yields at historical lows and the possibility of increasing inflation looming, investors who are seeking investment income are considering alternatives. With their attractive, relative yields and regular cash flows, many are looking at real estate investment trusts (REITs) as a vehicle to provide additional yield to their portfolios. Over the past 18 months, REITs have seen significant inflows as yield-hungry investors have been drawn to the healthy regular distributions REITS have been providing.

What are REITs?

REITs are portfolios of properties that are managed by investment companies. Their distribution levels result from their trust structure under which they pay no taxes. In exchange for this tax-exempt status, they must pay out 90% of profits in the form of distributions to unit holders, which are taxed in unit holders' hands. First introduced in the U.S. in the 1960s, and launched in Canada in 1993, REITs have evolved from those early days, and today investors can choose from REITs specializing in a host of different property types, including residential, retail, office/industrial, health care, self-storage, and hotels/resorts.

Given the heightened level of interest in REITs, here are some of the benefits and risks associated with REITs from the perspective of TD Asset Management Inc. (TDAM).

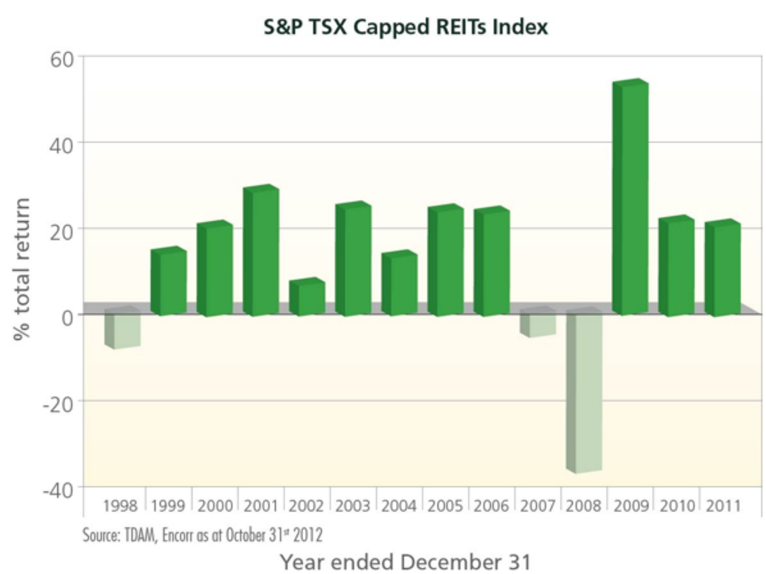
Benefits

An Easy Way to Invest in Real Estate

REITs offer an easy and accessible way for people to invest in real estate without the need to take on a mortgage. Rather than buying and maintaining a physical property, investors can use REITs to gain entry to the real estate sector. REITS also provide much more liquidity than a physical property. Most REITs trade on stock markets, so they are easy to sell, with no need to worry about waiting for the right buyer or enduring lengthy closings. And the wide variety of REITs available allows investors entry into segments of the market that would, in most cases, be inaccessible to them. For example, not many people are in a position to buy their own resort, but if they are interested in that sector, purchasing units of a REIT that specializes in hotel and resort properties, allows access to that niche.

Attractive Yield Advantage

REITs have largely produced solid returns over the long-run with some occasional downdrafts as demonstrated in the chart below, which outlines the total return by year since 1998. This means that they are currently trading near the top end of their range.



There is still some potential for capital growth if lease rates rise or companies are able to refinance their debt at low levels. However, many now consider REITs a spread product, with investors buying them to benefit from the yield advantage rather than in anticipation of capital growth. Although yields have come down as a result of REITs' recent popularity, the yield advantage is still attractive — the S&P/TSX Capped REIT Index currently yields just under 5% and the MSCI U.S. REIT Index currently yields more than 3.5%. Both provide a significant yield advantage over fixed income (with Government of Canada 10-year bonds yielding 1.78% and 10-year U.S. Treasury bonds yielding 1.70%) and over the dividend yields of both the S&P/TSX Composite Index and S&P 500 Index (2.9% and 2.1%, respectively)[1].

Access to an Improving U.S. Economy

A number of Canadian REITs also contain U.S. holdings, so it is worthwhile looking at the potential benefits associated with an improving U.S. economy. In spite of ongoing macroeconomic challenges, corporate earnings continue to grow, which supports property prices, as well as reliable rent and mortgage payments. In addition, the U.S. unemployment rate has been showing signs of improvement, dropping (albeit slowly) from 10% in 2009 to its current level of 7.8%. Rising employment often translates into improvements in the housing sector, and indeed, the beleaguered U.S. housing market seems to be turning a corner. Home sales, resale home prices, demand for new homes and new housing starts, have all increased this year. In addition, foreclosure inventories continue to decrease nationally, which is positive as it reduces the risk of a large negative real estate correction.

Risks

Sensitive to Rising Interest Rates

Of course, it is also important to consider the potential risks associated with REITs. Like bonds, REITs provide a regular income stream. However, bonds have a term structure – you loan out your funds for a set period of time, and when that term expires, you can reinvest the funds as you choose. In contrast, REITs operate in perpetuity, which makes them much more sensitive to rising interest rates.

Vulnerable to Macroeconomic Risks

As with other investments, REITs are subject to macroeconomic risks, which currently include the lingering European debt crisis, the fiscal cliff in the U.S., and slowing Chinese growth. Any or all of these could potentially impact economic growth in North America and lead to REIT price volatility.

May be a Challenge to Find Profitable Canadian Properties

The recent significant inflows to Canadian REITs have allowed REITs to purchase additional properties. This additional investment has helped to increase the value of the Canadian real estate market, which may make it challenging for companies to find reasonably priced, profitable properties going forward.

Decreasing Demand for Rentals

In the U.S., rental rates are at historical highs and vacancy rates are at historical lows, which is positive for REITs currently. However, the home ownership rate is at its lowest level since 1997, indicating pent-up demand for real estate. As employment improves and home ownership increases, demand for rentals may decrease, along with rents.

Geographic Risks

REITs are also subject to a variety of geographic risks, such as a REIT with concentrated holdings in one region that would be susceptible to downturns in the local economy. For example, a REIT with a large number of properties in Alberta would likely feel the effects of a reduction in oil production. In addition, the U.S. housing recovery has not been universal. Some states, such as Florida and New York, have not seen a decrease in foreclosure rates. This means they are still vulnerable to possible downturns in prices, which could result in capital losses.

TDAM's Viewpoint

REITs are a tempting asset for many investors, particularly in light of the ongoing low yield environment. As with all investments, investors need to weigh the various risks against the potential rewards. However, they do pose some risks. While the additional incremental yield is appealing and can help to guard against losing purchasing power to inflation, REIT's price volatility and potential for capital losses should not be discounted.

TDAM does not have a consensus view on REITs. Instead, our portfolio managers independently review the sector and its offerings, evaluating key factors such as capitalization value, level of balance sheet risk, strength of the management team, types of properties or mortgages that underlie the REIT, geographic risk etc. They then determine whether or not REITs are suitable for inclusion within their particular mandates.

For more information, contact your Financial Advisor.

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