

Special Research Paper

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Real Estate Investment Trusts (REITs): an Overview

Introduction

Real estate investment trusts were created in 1960, via a special provision in the federal income tax code. The REIT provision allowed formation of special entities that are in the business of owning income-producing real estate (equity REITs), or real estate mortgages (Mortgage REITs), or both. By far, the dominant publicly-owned type invests in equity ownership of a group of properties. At the end of 2004, there were 150 of this equity type, involving \$273 billion of market value, versus only \$24 billion of mortgage-owning REITs and \$7 billion of the hybrid type.

The most important feature is that the REIT must distribute at least 90% of its net income, in cash to the REIT's shareholders; in doing so, the REIT is exempt from income tax on the distributed income. For a tax exempt investor, such as an employee benefit plan, a foundation or endowment, this means that *the investment is held without any reduction for income taxes* (unlike an investment in a taxable corporation).

Good Equity Diversifier

REIT shares are traded on major stock exchanges and a number of them are included in popular market benchmark indexes. The average market capitalization of equity REITs was recently about \$1.8 billion, which puts them near the top end of the small cap bracket. Not surprisingly, their returns have behaved very much in tune with small cap market indexes, such as the Russell 2000. That said, equity REITs have a surprisingly low correlations with, not only small cap US stocks, but also with other equity securities categories, as indicated below:

**25-year correlations with REITs,
measured quarterly**

Large cap US	0.57
Small cap US	0.69
International	0.49

Performance History

The return history of equity REITs is both lengthy and impressive. Below are returns for various periods ended June 30, 2005 of the Equity REIT Index published by the National Association of Real Estate Investment Trusts.

Year	Total Return	Price Return	Income Return
1 year	32.7%	25.9%	6.8%
3 years	20.6	13.5	7.1
5 years	20.5	12.7	7.7
10 years	14.9	7.3	7.5
15 years	14.0	6.3	7.7
20 years	12.2	4.2	8.0

Returns for periods longer than 1 year are annualized

High Yield Stocks

The requirement for REITs to distribute nearly all of their net income (without paying income taxes) virtually assures that, compared to nearly all other common stocks, their dividend yields will be quite high. In fact, the average equity REIT typically has a dividend payout that rivals or exceeds the current interest yield on the 10-year US Treasury note.

Year	Dividend Yield
1999	8.70%
2000	7.52
2001	7.14
2002	7.05
2003	5.52
2004	4.66
2005	4.60

Besides the diversification benefits, this high ratio of cash turnover in REIT investments can be useful for a number of situations involving tax exempt investors.