feature

Portfolio Treatments for the Long Run

Real estate investment trusts

In the aftermath of a brutal 2008, and a sharp recovery in 2009, many investors wonder when their investment portfolio will recover lost ground.

As I've discussed in prior articles, it is critical that investors treat their investment portfolio much the same way they would approach running a business; that is, with a focus on profitability and maintaining a stable cash flow.

One such sector that continues to perform well, and pay investors a handsome tax-efficient monthly income, is Canadian real estate investment trusts (REITs).

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Canadian REITs were first introduced in 1993 as a way for investors to participate in real estate, without actually owning the real estate itself. They have since grown in scope and popularity. REITs own and manage the properties, while investors collect a regular stream of predictable income along the way. REITs operate in such diverse sectors as apartment properties, commercial, shopping malls, industrial, senior living and grocery stores, to name a few.

With an economic recovery that remains uncertain, it is crucial to be able to understand how the companies operate and how to pick the winners from the remainder of the pack.

Investors can own these companies directly on the stock exchange, through an

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actively managed mutual fund, or through a passive exchange traded fund (ETF). It is important to note that with ETFs – such as the iShares REIT ETF – companies are ranked by size, and as such, the ETF's heaviest weighting is in Canada's largest REIT, RIOCAN, which is a retail REIT. Perhaps this 25 per cent weighting is unjustified for most portfolios, given Canadians have altered their spending habits.

THE BENEFITS OF A REIT

The number one thing REITs provide is very tax-efficient, monthly income with the opportunity for income growth. A portion of the income may represent a repayment of the principal investment with most of the income being classified as return of capital, which is generally not taxed when the investor receives it. Rather, a return of capital reduces the investor's cost base and is taxed as a capital gain (i.e., only 50 per cent is included as income) when the investment is ultimately sold. This benefit provides both tax efficiency and tax deferral.

With a diversified REIT portfolio, investors gain a number of significant advantages. Beyond the opportunity for capital appreciation, REITs offer a much higher degree of liquidity than traditional real estate as they trade on major stock exchanges. Also, REITs are currently yielding between four per cent and 11 per cent per annum. For example, a $100,000 investment in a diversified basket of REITs yielding seven per cent will generate income of $7,000 annually.

REITs stand to benefit from an aging population, as the leading edge of baby boomers is 64 years of age this year and they are keen to replace lost employment income with income earned from their investment portfolio. Further, many experts predict REITs will benefit from the demise of income trusts at the end of this year as many income trusts are forced to cut their distributions when they convert back to corporations. REITs are exempt from this tax change. As such, well-managed REITs could be a huge beneficiary as large inflows of cash support this sector even further.

THE CANADIAN MODEL

The Canadian model is very different from U.S. REITs in a number of ways. Most notably, the U.S. real estate market relied heavily on securitized mortgages to fund their source of capital. Securitization is the process whereby a lender packages loans as assets and sells them to investors. U.S. lenders had minimal direct exposure to any bad loans, and, being extremely lucrative, they continued to make dubious loans. When the securitization market screeched to a halt in 2008, U.S. REITs saw their cost of capital rise dramatically at the precise time they needed to access capital.

This was not the case in Canada. Canadian lenders are inherently less willing to take risks and did not rely on securitization as their main source of capital. Canadian REITs also have long established relationships with lenders in this country.

CANADIAN REITs AND RETIREMENT INCOME PLANNING

Income seeking investors facing the reality of shortfalls in their retirement income planning should consider the importance of a REIT segment in their portfolio. As all investment decisions pose an element of risk, and past performance does not guarantee future returns, it is best to seek professional advice to ensure the right fit for your portfolio. •

REITs provide tax-efficient, monthly income with the opportunity for income growth.

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