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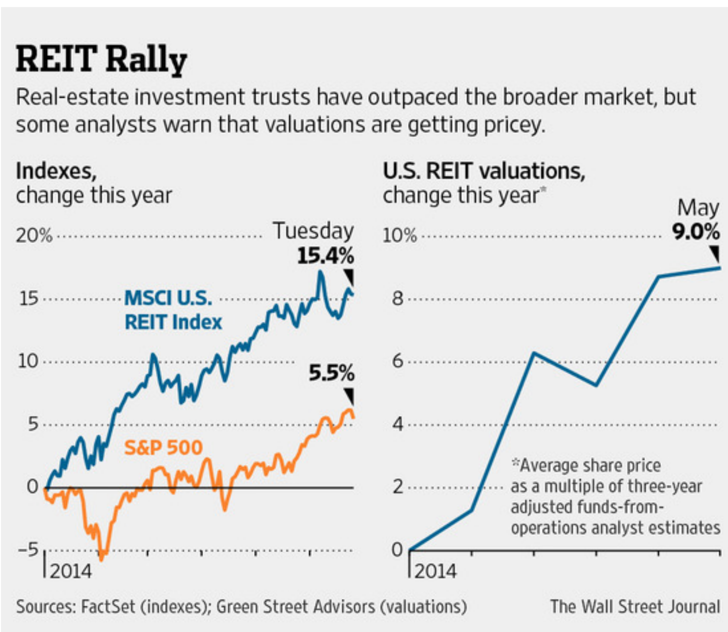
MARKETS

Real Estate's Rise Calls for Inspection

After Dizzying Rally, Real-Estate Investment Trusts May Be Overheating



By ALEXANDRA SCAGGS
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After a dizzying rally, real-estate investment trusts may be overheating. As investors flock to these shares in search of high payouts, some fund managers are worried that a repeat of last year's sharp selloff could be in the making.

REIT stocks are one of the top-performing groups within the stock market this year. The MSCI U.S. REIT Index has gained 15% this year, far outpacing the S&P 500's 5.5% rise.

But investors are warning that REITs are vulnerable to a reversal if interest rates rise and investors seek out higher yields from bonds, without having to take on the risk of price swings that come with stocks.

That is what happened last summer. Bond yields jumped as investors worried about the Federal Reserve's plans for paring back the asset purchases it has been using to try to stimulate the economy. In the span of roughly a month, the MSCI U.S. REIT Index fell 16% from its postfinancial-crisis high, reached May 21, 2013.

REITs are shares of firms that own and operate real-estate properties and generate revenues largely through rents. To qualify as a REIT, a company must pay at least 90% of its taxable income to shareholders as dividends. That high payout means some investors view REITs as a substitute for bonds that can generate income in their portfolios.

For now, with the Fed pledging to keep rates low well into next year, few investors see a jump in interest rates as an immediate concern. But the latest rally in REITs has even investors who specialize in the sector waving a yellow flag.

"You need to be a bit cautious," said Scott Crowe, who manages about $12 million for the Resource Real Estate Diversified Income Fund.

Mr. Crowe doesn't expect a repeat of last spring's selloff, but he has been having a hard time finding shares he feels are attractively priced. As a result, he has been letting cash build up in his portfolio.

"I don't think the market's particularly cheap," he said.

Green Street Advisors, which specializes in REIT research, says the group is trading at about 18 times its adjusted funds from operations, the widely used metric for valuing REITs. That compares with an average of 15 over the past 20 years, according to the firm. Last year, before the Fed started discussing cutting back its bond purchases, they traded as high as 20 times their adjusted funds from operations.

"REITs are still a little expensive versus stocks," said Jason Moore, an analyst with Green Street. However, he adds, "versus bonds, they look cheap."

Measuring dividends paid by REITs against their share prices, the MSCI U.S. REIT index was yielding 3.8% as of the end of May, according to MSCI. In comparison, the 10-year U.S. Treasury note yields about 2.6%, and the S&P 500 yields 2%.

The rise in REITs has come as investors have renewed a hunt for stocks that provide a steady stream of income, as government bonds have staged an unexpected rally, pushing their yields down. The yield on the U.S. Treasury 10-year note has fallen to 2.586%, from 3% at the start of the year. Yields on junk bonds, meanwhile, aren't far from record lows.

Against this backdrop, utilities stocks in the S&P 500—which sport an average yearly dividend that is 3.7% of their share price—are up 14% this year.

But some investors have concerns about what happens to REITs when bonds reverse direction, making them more attractive to yield-hunting investors.

"We like the real-estate area, but we want exposure that's not quite as sensitive to interest-rate movements," said Curtis Holden, chief investment officer with Tanglewood Wealth Management Inc., which oversees about $830 million.

Still, some investors say that, while higher bond yields are a short-term issue, more important from a long-term-investment perspective is the health of the real-estate market. An improving economy and rising real-estate prices and rents, they say, will provide a supportive business environment for REITs.

"Higher rates normally happen when the economy is on better footing," said Jerry Braakman, who manages about $1.1 billion as the chief investment officer of First American Trust. "Everything from wage growth to inflation would help rental properties."

And others say the higher yield is worth the risk of higher rates. Sandy Villere, who helps manage $1.2 billion in the Villere Balanced Fund, recently bought shares of American Realty Capital Properties, attracted to the stock's 8.1% annual dividend yield. Plus, many of his other holdings are in stocks that are more closely tied to economic growth, so if those stocks fall, American Realty should hold up better, he said. "It's a good place to hide," he said.

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