

Certain investors may find privately traded REITs to their liking

With both stock and bond market valuations at lofty levels, many investors are starting to wonder if they will be able to continue to earn the types of returns they have enjoyed over the past nine years. Continued gains in the stock market would push valuations to potentially dangerous levels, and bond yields aren't that far north of zero currently. That doesn't necessarily imply that major corrections are around the corner, but rather that future returns will be muted.

Yet most investors seem unwilling to accept the lower returns that strategists and academics predict. Pension fund managers still forecast returns well above what seems possible to achieve. Surveys of individual investors perennially show undue optimism about what the markets can produce. Are we doomed to disappointment?

Not necessarily. There are tools available today that either didn't exist in the past or were difficult to access for smaller investors. Often, these types of "alternative" investments can produce solid returns with acceptable risk profiles. What's more, because many have low correlation to the returns of traditional stocks and bonds, they may offer significant diversification benefits.

One such opportunity is private real estate. It is not possible for most of us to make direct investments in a diversified portfolio of real properties. However, real estate investment trusts (REITs) make it easy even for relatively small investors to make a single investment that does just that.

There are publicly traded REITs as well as private REITs. Both types are generally in the business of buying, leasing and managing properties. The only real difference is how they are traded. Since public REITs trade every day like stocks, their returns tend to be more volatile and more highly correlated to the stock market. Private REITs are generally only valued a few times per year, and not through an auction-based market, but rather through an appraisal process. This smooths out returns and leads to a returns stream significantly different from the stock market.

Over ten-year periods or more, there is evidence that returns converge for public and private REITs—after all they are in the same business—but the short-term volatility of public REITs still remains higher.

I want to point out that the mere mention of the term "private REIT" is often enough to send a shiver down the spine of many prudent investors, and with good reason. Until just recently, most private REITs were sold through



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brokers who earned large commissions for placing these investments. There was no secondary market for them, which meant investors could not get out unless the REIT was acquired or went public. And, year-to-year fees to stay in these investments were unreasonably high. Yet, investors poured money into private REITs, cajoled by their brokers and lured by the promise of high yields.

The combination of high costs and no liquidity usually is a recipe for investor disappointment and frustration. However, it doesn't have to be this way. There are private REITs that respect their investors and offer reasonable terms.

In fact, there are several private real estate opportunities right here in Rochester. Some appear to be very solid investments, others seem risky. Some are equity investments, others purchase debt instruments backed by real estate. Some require longer-term commitments, others are more liquid. The point is, private investments in any asset class are not homogenous beasts. The assets backing the investment, the terms offered and the fine print matter. Accordingly, much more due diligence is required when making this type of investment.

For those who find the right investment for their needs, the rewards can be substantial. From my perspective, expected returns for equity positions in private REITs are in the mid-to-high single digits. Realized returns for many local offerings have exceeded that over the past several years. Even more impressive is that these returns should come with relatively low volatility and little correlation with the stock market. Looking forward, returns such as these could go a long way toward meeting investors' goals, even if stocks and bonds fail to produce the high returns of the past.

Private REITs could also provide some downside protection if the stock market suffers a major correction. Both stocks and real estate are impacted by economic fluctuations, so REITs aren't necessarily a safe haven. However, historically they haven't suffered the same magnitude of drawdowns that

stocks have. For example, real estate data firm NCREIF maintains an index of private real estate returns. This index declined 24 percent during the 2007-09 financial crisis. Stocks fell over 50 percent and an index of public REITs fell more than 60 percent.

Even very good private REITs still have issues investors should be aware of. First, these investments are more expensive than owning stocks and bonds. It is more difficult to buy and manage a portfolio of properties than it is to buy a portfolio of stocks, so of course the costs will be higher. While the returns from private REITs may justify these higher costs, any fees should be scrutinized, as they reduce the amount of money investors actually take home.

Also, REITs can be tax inefficient. By law, they have to pay out at least 90 percent of their earnings to shareholders, and these dividends typically are not eligible for the lower "qualified dividend" tax rate. Often a portion of these dividends is deemed to be return of principal, which is not taxed, but as a rule REITs will be less tax efficient than a low-turnover, diversified stock portfolio.

Private REITs, by their nature, are less liquid than publicly traded investments. This means that there are often lock-up periods during which investors are unable to redeem their shares. It may also mean that even after the lock-up period, investors are able to retrieve their money, but with a discount to full value. A common provision of what we view as some of the best local private REITs is that you give up 5 percent of your value if you redeem your shares in the first five years. After five years, you may redeem any time at full value.

Additionally, minimum investments for private REITs can be higher than some investors are comfortable with. However, as with any private investment, only accredited investors may participate. Accredited investors meet certain financial requirements that show they have the ability to absorb losses they may incur from private investments. Supposedly, if you can meet these requirements, you can meet the minimum investment hurdles as well.

There is much to be aware of before investing in private real estate, but it can be a smart way to boost potential returns and reduce overall portfolio risk.

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