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Why Investors Should Consider Real Estate

by JEFF D. OPDYKE

Though Many Flee, Strength In Some Segments Makes Case For REITs and Other Vehicles

With housing prices softening and subprime lenders tanking, investors have been running from anything that smells of real estate. But they may be bailing too quickly, as some parts of the sector are still doing well.

New money going into mutual funds that own real estate has plunged to just \$2 million a week, on average, from nearly \$400 million a week as recently as mid-February, according to AMG Data Services. Investors in droves are also selling off their shares in real-estate investment trusts, the publicly traded stocks of companies that own everything from apartment buildings to medical centers and shopping malls.

But in some cases, jittery investor sentiment isn't a good proxy for the strength of the underlying assets. It is true that residential real estate is struggling

in many parts of the country. But commercial real estate is driven by job growth and the economy, and both are relatively healthy. In fact, commercial-building occupancy is growing nationally, while rents are up about 4.25% in the past year, according to Los Angeles-based CB Richard Ellis Group Inc. Midtown Manhattan set a record in March for the city's highest rents ever: \$69.99 a square foot, on average.

There is another reason to think twice before fleeing the real-estate sector. From a financial planning

perspective, real estate is an asset that investors should have in their portfolios over the long term. That is because real estate serves as a counterweight to inflation, while REITs, according to data from research firm Ibbotson Associates, have a low to moderate correlation with stocks, meaning Wall Street's trends tend not to impact REIT trends.

Investment pros routinely agree that a portfolio should have between 5% and 20% invested in real estate that isn't a primary residence. But "real estate" encompasses everything from single homes and duplexes, to skyscrapers and apartments, to strip-malls, medical offices and assisted-living centers scattered around the country.

So where to invest, given the meltdown in some parts of the sector? The options are growing. Just last year, the Chicago Mercantile Exchange began trading futures and options tied to the movement of the S&P/Case-Shiller Metro Area Home Price Indices that track housing prices in the U.S. as well as a variety of cities, including New York, Miami, Chicago and Las Vegas.

Meanwhile, just last month, Santa Monica, Calif.-based Dimensional Fund Advisors launched an international real-estate fund that provides investors access to markets where REITs are growing in popularity, including Singapore, Hong Kong, Japan and Turkey.

Here are some of the options to consider:

Real-Estate Mutual Funds and ETFs

The easiest means for creating instant diversity across regions and property styles is to buy a real estate index mutual fund such as Vanguard's **REIT Index** fund, or an exchange-traded fund such as the iShares Dow Jones U.S. Real Estate Index fund. Both are low-cost options for owning broad exposure to various types of REITs, and both have fared well over the past year, though each has fallen off in the past couple of months as real-estate woes have mounted.

The drawback: You won't see the potentially big price pops you could by owning individual REITs or even the stocks of home builders.

Sector REITs

Not all real-estate sectors fire on the same cycle, since different sectors play off different economic drivers. Office properties, particularly in urban

locations, currently offer the best opportunities, says Bob Gadsden, portfolio manager at New York's Alpine Woods Capital Investors, which runs the Alpine mutual funds. He says companies such as **Vornado Realty Trust** in Paramus, N.J., and **Boston Properties Inc.** are examples of the REITs investors should consider.

Those companies operate in land-restricted markets such as New York City, San Francisco, Boston and Washington, D.C., cities "where there's limited ability to create new supply," says Ken Heebner, portfolio manager for the Boston-based CGM Realty Fund who singles out the same two REITs.

Apartment REITs also offer some potential, as former homeowners slip back into the rental market in the wake of the subprime debacle and the exploding number of foreclosures. The increasing legion of renters is pushing demand higher, allowing apartment companies to raise rents. That is a good combination for leading apartment REITs such as **Home Properties Inc.** in Rochester, N.Y., and Denver's **Archstone-Smith** says Mr. Gadsden.

Yet the foreclosure woes are dumping increasing numbers of homes into the residential property market at marked-down prices, and some are certain to land in the hands of real-estate investors who will turn them into rental properties. That means affordably priced rental homes will be competing against apartments for tenants. That is potentially bad for apartment REITs, says Mr. Heebner. Moreover, once the subprime crisis abates and interest rates fall again, renters will again become homeowners.

International REIT Mutual Funds

These operate just like domestic REIT funds, but they own real-estate trusts in various countries. A number of financial planners are now including them in client portfolios because "they provide another level of diversification," says Lance Alston, vice president at JWA Financial, a Dallas planning firm that in the past month has begun putting about half of its clients' real-estate exposure in the Dimensional Fund Advisors' International Real Estate Securities Portfolio.

Just like the U.S. commercial property market, commercial real estate globally is doing well amid a strong world economy. CB Richard Ellis global data show that rents are moving up by as much as 30% in some markets, while vacancy rates are falling.

Jeremy Mitchell, a financial planner in Sun City, Ariz., says his firm this year has been buying shares in Cohen & Steers International Realty Fund for clients because "you're putting a ceiling over yourself by focusing just on domestic REITs."

The risk: The REIT market in many countries is nascent, as is the local real-estate market. If global economies crumble, real-estate prices — and REIT prices — will come down.

Private REITs

Unlike REITs that trade on Wall Street, private REITs are generally available only through financial planners, advisers and brokers. These REITs

typically maintain a constant share price — often \$10 a share. And they generate income through their yield, often in the 5% to 7% range, and provide capital gains only when the portfolios are liquidated, sold to other real-estate companies or go public.

Dean Harman, a financial planner in the Woodlands, Texas, has been putting clients into a handful of private REITs, such as KBS, Wells and Hines real-estate investment trusts.

The benefit: income as well as price stability. When the Dow Jones Industrial Average fell more than 400 points in February, "the value of my clients' REITs didn't move," Mr. Harman says.

The drawback: a lack of liquidity. Private REITs allow withdrawals only occasionally, often once a quarter. Moreover, they generally require a holding period of at least one year, and for a few years after that the REIT generally redeems the shares at a discount to the original purchase price.

Home-Builder Stocks

These stocks have been hammered in recent months, yet companies like **D.R. Horton** Inc., Toll Brothers Inc. and

It will take some time, but once the subprime and foreclosure shakeout has passed, the builders' stocks — all down roughly a third in the past year — could be fashionable again, says Ernie Ankrim, chief investment strategist at Russell Investment Group in Tacoma, Wash. "If housing prices stay soft, you'll see price declines in land and raw materials, giving the builders stronger margins."

KB Home might not be such a bad play for long-term investors. Their business doesn't need escalating home prices to succeed. They just need volume.

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