

## Bond Basics

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### Bond Basics: Investing in Real Estate Investment Trusts (REITs)

*Investors searching for diversification and a potential source of above-market returns may want to consider investing in real estate. A Real Estate Investment Trust, or REIT, offers investors the opportunity to participate in commercial real estate and the potential to earn high income.*

#### **Q: What is a Real Estate Investment Trust (REIT)?**

A Real Estate Investment Trust, or REIT, is a company that either owns and operates or finances income-producing real estate, such as apartment buildings and shopping malls. Created as investment vehicles by Congress in 1960, REITs are designed to offer both institutional and retail investors the chance to invest in large-scale commercial real estate projects.

By law, REITs are exempt from corporate income tax and in return, they must pay out in dividends at least 90% of their profits annually. The vast majority of REITs are **equity REITs**, which own and manage properties and issue shares to investors. Some 6% of REITs finance real estate projects by making loans to owners or by buying mortgage-backed securities and are called **mortgage REITs**. A few REITs do both—own property and make real estate loans—and fall into a third category called **hybrid REITs**.

#### **Q: How big is the REIT market?**

Approximately 200 REITs are publicly traded in the U.S., with total equity market capitalization of \$379 billion as of March 31, 2006. The REIT market has seen tremendous growth in recent years; equity market capitalization is up from \$9 billion in 1990, and daily trading volume in REITs increased to \$1.5 billion at the end of 2005 from about \$400 million five years earlier, according to the National Association of Real Estate Investment Trusts (NAREIT).

#### **Q: Why has the market grown so much? What is the attraction of REITs?**

Real estate in general has attracted investors in the past several years as stock and bond market returns have moderated and real estate values have climbed.

As a way of tapping into the real estate market, REITs may provide several benefits. First, REITs can offer significant, steady dividends to investors. Over the past 20 years, dividends on REITs have averaged about 8% and never dropped below 4.8%, according to NAREIT. That steady income has appealed to investors over the past few years as stock and bond market returns have been moderate. In light of their historically high dividends—or yields—REITs tend to compete with higher yielding bonds for investors' dollars.

Second, REITs, like all stocks, can fluctuate in price, so investors also have the potential for capital gains when the share price of a REIT rises. In addition, most REITs

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are publicly traded and are therefore fairly liquid investments, which can provide a major advantage over owning actual real estate.

Finally, REITs, like other real estate investments, can offer diversification away from stocks and bonds within an investment portfolio, adding a potential source of return as well as minimizing the effects of downturns in other markets.

### **Q: What are the risks of investing in REITs?**

As with other equity securities, if investors need to sell their REIT shares when prices are down, they can lose money. To put it simply, REITs are companies: some are better managed and more successful than others, and some hold better quality assets than others. Their share prices will reflect that. REIT selection is therefore crucial to investment success.

However, analyzing REITs is complex, in part because of the need to evaluate the underlying properties. Real estate values are affected by many factors from interest rates and property tax rates to rent regulations and zoning laws. Also, REIT shares can react to developments in the real estate market, such as changes in supply and demand, and in the local, regional and national economies.

Many investors therefore choose to invest in REITs through funds; some 75 public mutual funds are devoted to or significantly invested in REITs. Other investment strategies can offer indirect exposure to REITs without purchasing shares. (Please click [here](#) for more information on [PIMCO's RealEstateRealReturn Strategy](#).)

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**Past performance is no guarantee of future results.** The value of real estate and portfolios that invest in real estate may fluctuate due to losses from casualty or condemnation, changes in local and general economic conditions, supply and demand, interest rates, property taxes, regulatory limitations on rents, zoning laws, and operating expenses. The use of derivative and real estate-linked derivative instruments may subject a portfolio to greater volatility than investments in traditional securities. Derivative instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Investments in a real estate-linked derivative instrument that are linked to the value of a REIT may be subject to additional risks such as poor performance by REIT manager, adverse changes to the tax laws or failure to qualify for tax-free pass-through of income. Portfolios investing in derivatives could lose more than the principal amount invested. Diversification does not ensure against loss.

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