Investment Overview

At Edward Jones, we view real estate as a good way to improve portfolio diversification while protecting, if not enhancing, investment returns. For long-term-oriented individual investors, in particular, real estate investment trusts (REITs) are a good way to add that real estate exposure, in our view.

Investing in REITs can provide several advantages:

- **Asset-Class Diversification**. Many clients hold a balanced portfolio of U.S. stocks and bonds. Real estate is one of several other asset types, including commodities, high-yield bonds, and international stocks and bonds, that can diversify a portfolio. Diversification can potentially reduce volatility and enhance long-term investment returns.

- **Small Investment Size**. Direct commercial real estate investments, such as a motel or apartment building, can require a sizable one-time investment. REITs, which trade like stocks, can be purchased in almost any dollar amount.

- **Industry Diversification**. The purchase of REITs across several different subindustries (building types) can also provide better diversification than buying individual properties.

- **Liquidity**. Most U.S. REITs trade on public exchanges, offering good liquidity. There are currently almost 200 publicly traded REITs, and more than 30 are included in the S&P 500 Index.

- **Regular Income**. REITs generally offer attractive yields, and most pay regular quarterly dividends.

Deciding which REITs to own can be a daunting task. We recommend that investors first consider the type of real estate the REIT owns. This will help identify the risks of owning the REIT itself, as different types of real estate have different risks and demand drivers. Later, we will describe several sectors in detail.

Industry Background

REITs are unique companies because they do not pay U.S. corporate income taxes. They were created in 1960 by a change in the tax laws to give individuals a way to invest in a diversified portfolio of real estate. In exchange for not paying taxes, REITs must distribute at least 90% of their taxable income to investors in the form of dividends. These dividends are generally taxed at the investor's individual tax rate. However, REITs qualified as a pass-through entity under the Tax Reform Act that passed in
December 2017, which allows individuals to lower their taxes paid on dividend income by 20%. For example, if the shareholder's marginal tax rate is at 35%, under the new law that individual would pay taxes of 28% (35% x 80%) on the dividend income. If a REIT pays out more than 100% of its taxable income, then a portion of the dividend in excess of taxable income is considered a return of capital. The return-of-capital component is not taxed in the year it is received, but rather is taxed when the REIT shares are sold.

Analyzing REITs

When analyzing individual REITs, we look for companies that can add value through the day-to-day operations of the properties. For instance, we look for shopping center REITs with strong tenant relationships. Location is always important for real estate, and large, coastal cities probably offer the best demographic trends for REIT properties. In addition, the scarcity of available land in big cities can provide a barrier to new competition.

REITs typically report funds from operations (FFO) in addition to traditional profit measures such as net income and earnings per share (EPS). FFO is essentially net income prior to noncash and nonrecurring items, such as depreciation expense and amortization, and gains and losses from property sales. Unlike buying a computer, which declines in value in a matter of months, well-maintained real estate tends to appreciate over time. As a result, REIT analysts look at net income prior to depreciation and other noncash and nonrecurring items to determine the amount of cash available for paying dividends. Most REIT investors and analysts use FFO as the primary earnings measure for REITs. In our opinion, FFO provides investors with a more accurate assessment of the recurring cash flows being generated by a REIT than EPS.

The economic cycle, both up and down, can also present challenges for REITs. During a downturn in the economy, job growth slows and so does overall demand for office space, retail stores, and other real estate. During economic expansion, competition can emerge from newly constructed buildings. Given REITs pay out most of their income in dividends, they typically need outside funding to grow and expand. As a result, REITs are frequent borrowers from banks, insurance companies, pension funds, and public bond investors. When looking at REIT investments, we would pay close attention to corporate credit ratings from agencies such as S&P and Moody’s. While the goal of REITs is to increase the dividend over time, we also note that REIT common dividends can be reduced should earnings decline.

Major REIT Property Types

We believe the seven real estate classes described below will serve the long-term interests of REIT investors. They typically offer investors good current dividend yields, combined with the potential for growth in dividends over time.

1.) Apartments

Apartment REITs are probably the easiest type of REIT for individual investors to identify with, since most of us have paid rent to a landlord at some time in our lives. Over the long term, we expect apartment REITs to benefit from changing demographics, particularly the maturing of the baby-boom echo (millennial) generation, which tend to rent longer and should positively impact apartment demand. In our opinion, overbuilding of apartments in local markets is the biggest risk of investing in apartment REITs. In addition, other risks include a slowdown in the national employment picture and a decline in single-family home prices, making single-family home ownership more affordable. We recommend large and geographically diversified apartment REITs, not just focused on the biggest cities, to help reduce the risk of one market becoming overbuilt.

2.) Shopping Centers

Shopping centers historically comprised one of the most stable REIT sectors that we recommend. Most of the major tenants in shopping centers sign leases in the 10- to 15-year range, while smaller tenants’ leases are in the three- to five-year range. However, high-profile tenant bankruptcies and struggling department stores, combined with inroads by e-commerce, present near-term risks to occupancy levels. Conversely, little new supply is being built, which we believe is helping support rent growth and may eventually facilitate consolidation toward the higher-quality operators. As a result, we recommend REITs that have properties within numerous states and a diverse base of tenants in different industries in order to help diversify the risk of one tenant going bankrupt.

3.) Industrial Properties

The stability of industrial properties has historically been similar to that of neighborhood shopping centers. They also have longer-term leases with the potential for internal rent increases. However, compared with shopping centers, we view industrial properties as more susceptible to cyclical downturns. When looking for REITs in this sector, we focus on companies that have strong financial positions.
These REITs will likely be able to take advantage of lower property prices in downturns. Over the long term, we believe growth will be driven by the demand for quality distribution facilities as e-commerce and international trade expand.

4.) Office Properties
The office sector has many pluses and minuses. Strong job growth, particularly in professional services, can lead to strong rental demand. REITs positioned in large coastal markets, such as New York and San Francisco, also have high barriers to competition due to the scarcity of available land. On the other hand, suburban markets have risk of overbuilding. We believe the cost and extended time to build new office properties is an additional risk for office owners. This time frame requires developers to predict the demand for a project a couple of years down the road. In addition, demand for office space is strongly impacted by employment, particularly white collar employment. To help reduce the risk of overbuilding, we recommend REITs that are invested in more than one market.

5.) Self-Storage
The Self-storage industry has evolved over time with more amenities, convenient locations, climate control, and enhanced security. The sector benefits from increased consumer spending and relocation. Self-storage properties tend to generate high operating margins relative to other real estate sectors because operating costs and real estate taxes are often lower. In addition, capital-expenditure requirements for self-storage properties are modest versus other real estate sectors; there are normally no tenant improvements and leasing commissions paid, and there are only minor annual recurring asset preservation costs (roofs, painting, and paving). In our view, the biggest risk with respect to self-storage is the entry of unsophisticated competitors given the relatively modest cost to develop and maintain a self-storage facility. This risk is mitigated to a degree by local zoning and entitlement requirements that often make the development of self-storage difficult.

6.) Health Care
Health care REITs have historically been viewed as a long-term financing source to the health care industry (because the health care REITs lease many of their properties to health care providers under long-term leases). We note that over the past several years many health care REITs have worked diligently to increase their ownership of medical office buildings, assisted/independent living facilities, and life science properties. We believe these properties have attractive internal growth prospects as well as less exposure to changes in Medicare and Medicaid reimbursements.

For most health care real estate, demographic factors, rather than economic forces, tend to drive demand. There is currently some concern regarding new supply of senior living facilities entering the market that would compete with existing facilities. Ultimately, we believe that REITs with high-quality properties located in attractive markets will benefit from increased demand for senior housing over time. We anticipate demand for most health care real estate to increase as more baby boomers reach retirement age.

7.) Wireless Communication Towers
Infrastructure is a relatively new category of REIT, pioneered by companies operating wireless and broadcast communication sites leased mainly to cellphone service providers. These companies have attracted significant investor interest due to the rapid growth of wireless communications. In addition, growth opportunities have emerged in many international markets. Revenues are relatively predictable due to long-term lease contracts. Compared with U.S.-focused REITs, wireless communications REITs do face more foreign currency and geopolitical risk. Any industry consolidation among cellphone-service providers could also present future challenges.

In addition, we believe selective investments in other nontraditional real estate sectors may add to portfolio diversification. These sectors include computer data centers, billboards, and single-family home rentals.

**Why do we not recommend many of the other sectors that our clients ask about?** We believe the sectors we identified above will outperform the rest of the industry over time and be less susceptible to downturns. Edward Jones also cautions against the ownership of REITs in very cyclical businesses, such as owning timberland. Below is a discussion of the risks and misconceptions associated with some other REIT sectors.

**Mortgage REITs**
As a whole, due to interest rate risk, we consider mortgage REITs too risky for individual investors to own. Although these companies can invest in high-quality mortgages, they do so using a lot of borrowed money. In essence, mortgage REITs are buying mortgage securities on margin. Using margin to buy investments can boost returns if the price of your investment goes up; however, they also...
magnify losses if the price of the assets decline. This makes the earnings, dividends, and stock prices of mortgage REITs very susceptible to rising interest rates. According to the National Association of Real Estate Investment Trusts, total returns for mortgage REITs have trailed equity REITs by approximately 4% annually for the past 10 years. For additional information regarding mortgage REITs, please see our sector report "Mortgage REITs – High Yield but High Risk."

Hotels
Most hotel REITs do not operate hotels. Instead, the REIT leases the property to a hotel operator who then conducts the day-to-day operations of the business. As a result, by purchasing and leasing hotels to operating companies, hotel REITs essentially serve as providers of capital rather than hotel operators. Many of the hotel REITs lease the properties to the affiliates of senior management of the REITs. As a result, the potential exists for conflicts of interest between the REIT and the hotel operator when signing leases. The hotel industry is also cyclical, characterized by very short-term leases (often one to two days) and considerable risk of overbuilding. As a result, the REITs in this sector have greater risk than we feel investors seeking exposure to the Growth & Income investment category should assume.

Private REITs
In addition to publicly traded REITs, there are also a number of private- and publicly registered nontraded REITs. While these private/nontraded REITs are generally required to meet the same general rules and regulations as publicly traded REITs (including payout of taxable net income as a dividend, holding at least 75% of its total assets in real estate assets, and deriving at least 75% of its gross income from rents from real property or interest on mortgages financing real property), there are also important differences between public REITs and private/nontraded REITs. These differences include very limited liquidity compared with publicly traded REITs, high selling commissions, dealer management fees and offering expenses, significant property and asset management fees paid to affiliates of the private REIT, and less transparency and public market scrutiny compared with publicly traded REITs.

We suggest clients consult with their financial advisor regarding any private REIT holdings. Edward Jones currently does not provide our clients with secondary market prices and/or assist in the sale or reregistration of private/nonpublicly traded REITs currently held outside of Edward Jones.

Conclusion
Although there may be REITs in some sectors that are considered solid companies, we feel individual investors are best served investing in REITs leading the apartment, shopping center, industrial, office, self-storage, and health care property sectors, along with select niche sectors such as wireless communications towers. We feel these companies will provide appropriate total returns for investors seeking exposure to the Growth & Income investment category.

For more information, please see your financial advisor.

Required Research Disclosures

Analyst Certification
I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Kyle Sanders, CFA; James Shanahan, CFA
Analysts receive compensation that is derived from revenues of the firm as a whole which include, but are not limited to, investment banking revenue.

Other Disclosures
All investment decisions need to take into consideration individuals' unique circumstances such as risk tolerance, taxes, asset allocation and diversification.

It is the policy of Edward Jones that analysts or their associates are not permitted to have an ownership position in the companies they follow directly or through derivatives.

This opinion is based on information believed reliable but not guaranteed. The foregoing is for INFORMATION ONLY. Additional information is available on request. Past performance is no guarantee of future results.

In general, Edward Jones analysts do not view the material operations of the issuer. Diversification does not guarantee a profit or protect against loss in declining markets.

Special risks are inherent to international investing including those related to currency fluctuations, foreign political and economic events.

Dividends can be increased, decreased or eliminated at any time without notice.

An index is not managed and is unavailable for direct investment.

U.S. only: Edward Jones - Member SIPC