Long-Term Investors: Consider Interest Rates With REIT Purchases

Description

A common question investors have with respect to Real Estate Investment Trusts (REITs) is, "Why do the stock prices of REITs tend to move in an opposite direction to interest rates?"

With speculation about whether the Fed will continue to raise interest rates two or three times in 2017, and if the Fed will continue to raise rates at a consistent or faster-than-expected pace moving forward, REITs will likely be a category that experiences some turmoil based on how the market reacts to movements in interest rates in the coming quarters.

The most common answer to why REIT prices move in line with interest rates (at least at an industry level) is that REITs are largely considered substitutes for bonds and other interest-sensitive securities. As such, as interest rates move up, the principal value of the REIT or bond sectors should decrease, as the higher interest rates offered by newer bonds will attract money away from the older, lower interest rate securities.

How to assess if a REIT is right for your portfolio

Probably the best thing to do when considering a REIT, such a **Boardwalk REIT** (TSX:BEI.UN), as a long-term position is to assess the underlying fundamentals of the company. As with any other security, it is important to understand how free cash flow is generated by the company, and what the components of the business are. While many investors may look only at the high-level ratios, I suggest digging into the notes within the financial statements to get a better picture as to the financial health of the REIT.

Independent of the interest rate environment, three of the most important fundamentals of a REIT to check are

- The average life span of the loan portfolio,
- The average life span of the lease agreements, and
- Any one-off or large leases/mortgages that could affect the holdings of the firm materially should an adverse shock take place.

Each REIT is constructed differently with different geographical areas of focus, different types of real estate in the investment pool, and different management teams and management philosophies, leading to different levels of efficiency within each REIT.

This sort of firm-level analysis, while time consuming, is probably the most beneficial asset an investor has in their tool kit. Taking a look at the parts, not just the sum of the parts, is one of the best risk-management tools investors have at their disposal and is something I recommend to any investor considering a REIT as a long-term position.

Stay Foolish, my friends.

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