Why Higher Rates Aren't Like Kryptonite for Monthly Income Investors

Description

Many retirees who rely on the monthly income payouts from their investments know that a rising interest rate environment is bad news for asset classes like REITs, telecoms, and utilities. While still suitable for defensive investors who value safety and high dividend/distribution payouts, these sectors are poised to treat rising interest rates as a headwind due to the cap ex-intensive nature of their respective businesses. Steadily climbing borrowing costs may stand to eat into the growth of some firms; however, that doesn't necessarily mean that they're no longer attractive plays and should be dumped to the curb.

REITs, in particular, are among the most popular of securities among retired investors, not only because they're stable, but also because of their remarkably high upfront yields. REITs are required to distribute 90% of their taxable earnings back into the pockets of its shareholders, which results in a large (but safe) yield.

What you see is often what you'll get with high-yield REITs. Although the high yields are safe, the distributions typically aren't raised by the same magnitude of frequency versus stocks. That's the nature of the business. With higher rates, one would assume that the rate of such distribution increases will become even less frequent and less generous.

While higher rates may seem like an insidious headwind for the REITs, investors should really think of it as more of a double-edged sword.

Higher borrowing costs are a negative for funding ambitious growth projects, but one must remember that higher rates are typically accompanied by stronger economic growth. That means a higher demand for real estate, which implies higher rents can be charged, which is typically enough to offset the negative impact on borrowing costs for the REITs.

Moreover, residential REITs like **Canadian Apartment Properties REIT** (TSX:CAR.UN) or CAPREIT may be tempted to put their wallets away when it comes to low ROIC "nice-to-have" renovations, as many prospective renters are likely to rent out such a unit anyway, even if the unit has a cheap linoleum floor that hasn't been replaced in decades!

I've looked at several of the older CAPREIT apartments in Richmond, B.C., area and some of the units are in dire need of renovation. Creaky floors aren't attractive to prospective renters, but they're not a top priority for management, especially when the demand for such rental units are off the charts despite the lack of renovated subtleties.

As the economy continues to strengthen, non-critical renovations in existing units will continue to drop, and in most cases, the implied savings and more favourable opportunity costs will probably be more than enough to offset higher borrowing costs that come with rising rates.

Management can instead use its free cash to finance higher ROIC projects like the production of new residential properties in order to get investors a better bang for their buck, which means the distribution may have room to grow with its climbing FFO and falling payout ratio. Not even marginally higher interest rates can stop CAPREIT from being a top pick for retirees and seekers of monthly income!

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