Retirees: It Pays Massive Dividends to Consider This 1 Crucial Metric When Hunting Down High-Income REITs

Description

When it comes to REIT investing, many retirees (and soon-to-be retirees) are all about the upfront yield. We all want to give ourselves a fat raise so we can spoil the grandchildren, but the fact of the matter is that by chasing yield without a careful consideration of the fundamental factors, you could be doing your income stream and retirement portfolio a considerable disservice over the long term.

Most retirees think that REITs are “completely safe” compared to stocks, and while that’s true to an extent since REITs are required to pay out a majority of their taxable income back to shareholders, I believe a vast majority of retirees forget that with REITs, there’s still a trade-off between risk, safety, and reward, just like there is with the stocks.

Thus, constructing your retirement portfolio and its intended income stream isn’t as simple as going for the higher yields. By doing so, you could be compromising on future distribution growth or setting yourself up for a future distribution reduction in the event of a worst-case scenario if you go out of your way to invest in extremely high +9% yielders.

Like stocks, REIT yields go up when share prices go down. When they go down, there’s a pretty good reason for the decline, and you need to understand the reasons to formulate a thesis for why you believe the marginally higher yield is worth the potentially higher risks involved.

The 90% rule isn’t as it seems

You’re probably aware that REITs are required to distribute 90% of taxable earnings back into the pockets of its shareholders. With that in mind, why on Earth wouldn’t a prospective retiree just shoot for the highest upfront yield possible, since all REITs are on a seemingly equal footing?

As you may have noticed, payout ratios among different REITs differ in spite of the 90% rule, and in most cases, the payout ratio is substantially lower than 90%. That's because the 90% rule applies to taxable earnings, not cash inflows. There's a massive difference between an entity's earnings and its cash flows, even though most beginners assume them to be the same thing.

In a previous piece, I brought it to the attention to investors that earnings are subject to adjustments at a management team's discretion. There are judgement calls, and often, it's better to go straight for the cash flow statement if you're analyzing the health of a security's dividend or distribution stability.

Earnings are a solid accounting metric, but they're not a substitute for actual cash flows. Cash is king, as it's what pays for dividends and distributions. So, instead of the payout ratio, investors should be looking at the adjusted funds from operations (AFFO), which can be thought of as the operating cash flow in the world of REITs.

Consider the following REIT

For example, consider **SmartCentres Real Estate Investment Trust** (TSX:SRU.UN) with its 89% TTM payout ratio, which may imply little to no wiggle room after shareholders receive their slice of the profits. When you consider the TTM cash payout ratio is just 48.4%, however, it's more evident that SmartCentres has a lot more wiggle room than an earnings-based payout ratio would imply.

Thus, SmartCentre's distribution is not only very safe, but there's room for additional raises down the road, and there's more than enough wiggle room to fuel growth projects that will drive long-term AFFO through the roof!

Foolish takeaway

While REITs may seem 100% secure from distribution reductions because of the 90% rule, this is not the case. Earnings-based payout ratios aren't a fool-proof metric for judging the health of a REIT's ability to pay distributions, as they're subject to subjective decisions from management.

With that in mind, it literally pays dividends to ensure proper due diligence to go beyond shallow metrics like payout ratio to get a better picture of how much wiggle room a REIT actually has given its current distribution payout.

If there's plenty of wiggle room (a low AFFO payout ratio) on a consistent basis, a distribution may be seen as "safer," and the REIT may be more likely to hike it at some point in the near future.

Stay hungry. Stay Foolish.

CATEGORY

1. Dividend Stocks
2. Investing
3. Stocks for Beginners

TICKERS GLOBAL

1. TSX:SRU.UN (SmartCentres Real Estate Investment Trust)

PARTNER-FEEDS

1. Msn
2. Newscred
3. Sharewise
4. Yahoo CA

Category

1. Dividend Stocks
2. Investing
3. Stocks for Beginners

Date
2025/08/27
Date Created
2018/08/22
Author
joefrenette