REITs: The Good, the Bad, and the Undervalued

Description

For income investors, REITs have proven to be perennial favourites. Offering high distributions, steady income streams, and potentially high capital gains, they're one of the few ways to invest in real estate without borrowing money. Not only that, but historically, North American REITs have outperformed direct real estate investments, with a 9% annual return for REITs compared to 8% for homes (according to data from *Forbes).* Factoring in the fact that most home buyers have to take out mortgages and pay interest, the REIT advantage becomes even more substantial.

But all this comes with a catch: compared to other stocks, REITs do not necessarily shine. Since 2006, REITs as a class have returned just 14%, compared to 28% for the TSX. Granted, there have been some exceptions: in 2018, REITs solidly outperformed the benchmark, for example. But over a long-term time frame, REITs are not the biggest growth sector around.

On the whole, REITs are a diverse sector with both good and bad features. First, let's take a look at the good.

The good

The most obvious thing REITs have going for them is high income. Canadian REITs offer above-average yields that can reach as high as 14%, while 5-6% is the norm for the sector. Many REITs also pay monthly distributions instead of conventional quarterly dividends, so the payout frequency can be higher than average. However, REIT payout ratios tend to be higher than in other sectors, so earnings misses can easily drive yields lower. If you're looking for safe income, it's better to go for a REIT like **RioCan REIT** (TSX:REI.UN), which yields a "low" (by REIT standards) 5.82% but has a steady payout history.

The bad

The main disadvantage of REITs is that their returns tend to lag relative to other classes of stocks. Interestingly, this has not been the case for Canadian REITs over the past 12 months: the **iShares Capped REIT ETF** has beaten the TSX over that time frame, with a positive return of about 8%. But over a very long-term time frame, the reverse is the case, with the TSX having solidly beaten REITs over 12 years. With that said, the slight disadvantage REITs have in terms of returns is more than made up for by dividend yields, which, in this sector, can easily approach double digits.

The undervalued

A final thing REIT investors should be aware of is that valuation is more important for this sector than others. Because REITs don't offer frothy growth, they're especially hard to justify at huge price/earnings multiples. Warren Buffett once said in a speech to a group of MBAs that he preferred direct commercial real estate investments to REITs, with the only exception being if a REIT can be found for an extraordinarily cheap price. This makes sense given that REITs have overhead costs (payroll costs, etc) that direct property investments don't. So, if you're going to invest in REITs, it pays to buy them cheap. This, incidentally, is another argument in favour of RioCan, which currently trades at just 11.5 times earnings and 0.99 times book value.

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