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Need diversification? Look to REITs

Study shows that REITs have low correlations with equity indices

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Financial advisors looking to enhance the diversification of their clients' portfolios need to consider real estate investment trusts. Based on an historical analysis (in Canadian dollars) by Toronto-based Tacita Capital Inc., an allocation to REITs has improved the risk-adjusted performance of portfolios held by long-term investors.

The FTSE NAREIT U.S. equity REIT index had an annualized compound rate of return of 11.8% from January 1972 through December 2009, outdistancing the 10.1% return of both the S&P/TSX and S&P 500 composite indices and the 10.4% return of the MSCI EAFE index. Only the Ibbotson U.S. small company stock index's return of 13.1% exceeded U.S. REITs. Similar to bonds, REITs undoubtedly have benefited from the protracted decline in inflation since the early 1980s, which has driven down mortgage costs and capitalization rates.

In terms of volatility, U.S. REITs have had an annualized volatility of 18.5% matching that of the Canadian stocks but slightly higher than international and U.S. stocks. Investors have been well compensated for this risk. On the important reward/variability ratio, as measured by the Sharpe ratio, U.S. REITs came in a close second to U.S. small-company stocks but well ahead of Canadian, U.S. large-company and international stocks.

Canadian REITs have also been a strong-performing asset class. From the commencement of the S&P/TSX capped REIT index in January 1998 through December 2009, that index enjoyed a 11.3% return, well ahead of the S&P/TSX composite index's return of 6.9% and substantially higher than all the other major equity indices. Canadian REITs also led in terms of reward vs variability.

Most important, REITs add diversification to portfolios because of their lower correlation to equity indices. Whereas the S&P/TSX composite index had correlations of 0.62 and 0.67 with the S&P 500 and MSCI EAFE indices, respectively, over correlations with U.S. and Canadian REITs were 0.60 and 0.28. Investors in REITs also enjoy the benefits of global diversification; Canadian REITs have only a 0.55 correlation with U.S. REITs.

In an optimization analysis, both historical and forward-looking, REITs consistently earn a role in a broadly diversified portfolio. This is particularly true for portfolios that have limited exposure to small-company stocks. Also, the higher yield of Canadian REITs (currently ranging from 5% to 10%) and their tax-advantaged nature (with an average 50% of distributions as a return of capital) make them ideal for affluent retirees.

You can access REITs for clients through both mutual funds and exchange-traded funds. Mutual funds vary as to geographical focus and allocations to REITs vs real estate companies, such as land developers.

You should review fund holdings to make appropriate selections. Sentry Select REIT Fund, managed by Toronto-based Sentry Select Capital Inc. , is one of the oldest and largest funds in Canada. Although it can invest globally, its focus is primarily on Canadian REITs with some U.S. REIT exposure. DFA Global Real Estate Securities Fund, managed by Dimensional Fund Advisors Canada ULC, is one of the few global real estate mutual funds with an express mandate to emphasize REITs and companies with REIT-like characteristics.

ETFs offer access to a growing selection of REIT funds. In Canada, iShares CDN REIT Sector Index Fund, managed by Toronto-based BlackRock Asset Management Canada Ltd. , focuses on Canadian REITs by replicating — to the extent it can — the performance of the S&P/TSX capped REIT index.

Claymore Investment Inc. of Toronto provides global exposure via Claymore Global Real Estate ETF. In the U.S. there is a variety of REIT ETFs focusing on different regions and property sectors. Vanguard REIT ETF, managed by U.S.-based Vanguard Group Inc., is the largest ETF focused on the U.S. market and is both inexpensive and extremely liquid. **IE**

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