HEMINGTON
WEALTH MANAGEMENT

INVESTMENT NEWSLETTER

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SHOULD I OWN (MORE) REITS IN MY PORTFOLIO?

With Real Estate Investment Trusts (REITs) posting unusually high returns so far this year – the S&P US REIT Index was up over 27% through October 31, 2019 – some investors have been asking whether they should own *more* REITs in their portfolios. Indeed, REITs are an excellent asset class to consider as part of a globally diversified portfolio, especially in tax-deferred accounts. Today, our goal is to provide empirically-based guidance on what percentage of your investments should be in REITs. But let's start with first things first.

What is a REIT?

A REIT is a company that owns, operates, or finances income-producing real estate. There are three major types of REITs: Equity REITs directly invest in and operate commercial properties; Mortgage REITs purchase mortgage obligations, and thus become, effectively, real estate lenders; and Hybrid REITs, which do both. REITs are corporations that do not pay federal income taxes at the entity level if they satisfy a set of conditions. This leaves more cash flows to pay dividends to investors (who do pay taxes on the dividends).

What are the benefits of REIT investing?

REITs can deliver competitive total returns, with high, steady dividend income and capital appreciation. But it's their comparatively low correlation with other equities and fixed income, which helps reduce a portfolio's overall volatility, that makes them an excellent candidate for an investor's portfolio. This is also known as a *diversification* benefit, which is one of the best things you can do to manage risk. Diversification across securities, sectors, and countries can help investors maintain their focus, typically allowing them to avoid extreme outcomes that may result from a more concentrated approach.

How do I invest in a REIT?

Investors can purchase REITs in two main ways: through individual publicly traded stocks or through mutual funds or exchange-traded funds. Examples of individual REIT stocks are Equity Residential Properties (ticker symbol EQR), which specializes in development and management of rental apartment properties, and Public Storage (ticker symbol PSA), which owns, operates, and develops self-storage facilities. An example of a mutual fund is the DFA Real Estate Securities Portfolio (ticker symbol DFREX), while Vanguard Global ex-U.S. Real Estate Index Fund ETF (ticker symbol VNQI) is an exchange-traded fund. There are hundreds of REIT companies globally, and to gain proper diversification, at Hemington we recommend the diversified route of owning a fund.

What is an appropriate allocation to REITs?

As with all asset allocation decisions, best approach is to start with a global market portfolio, then make adjustments as needed. For example, investors might overweight their home market for economic reasons, such as to hedge consumption risk or to offset tax disadvantages on international investments. Home bias can also be driven by behavioral factors.

Let's consider the total "opportunity set" or the total value of the global market, including REITs. As of September 30, 2019, the market value of the global equity market was $52.8 trillion, and the value of REITs universe was a rather small $1.9 trillion. Thus, the starting allocation to REITs in an all equity portfolio is 3.6%.

Should I own *more* than the market weight?

Generally, we do not see a compelling reason to significantly overweight REITs in a well-diversified equity portfolio. The risk profile of REITs is similar to other common stocks, and there is no evidence suggesting that REITs have higher expected returns. At Hemington, for the past few years, we have decided to slightly increase our clients' exposure to this asset class to 5% of equities because of their stable, predictable dividends, and relatively low correlation with stocks.

While REITs have had strong returns in some years, there are also periods of time when they performed quite poorly (for instance, in 2007, US Real Estate was the worst performing asset class).

ANNUAL RETURN (%)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Highest Return	34.2	34.5	36.0	39.8	8.8	79.0	28.1	9.4	20.1	38.8	32.0	5.8	31.7	37.8	2.1
	33.2	25.5	32.6	8.2	6.6	53.3	26.9	3.4	18.6	34.5	13.7	4.5	21.3	31.5	1.9
	29.9	21.1	29.6	7.9	4.7	51.4	24.9	2.3	18.1	32.5	13.5	1.5	17.3	28.6	1.5
	26.0	13.8	27.9	6.3	-28.9	37.2	24.5	2.1	17.9	32.4	4.9	1.4	12.0	21.8	-4.2
	22.4	13.1	23.5	5.9	-33.8	28.5	21.2	0.6	17.8	28.3	4.2	1.0	11.6	20.9	-4.4
	22.2	7.0	22.2	5.5	-36.8	27.2	19.2	0.4	17.5	26.0	1.9	0.9	8.4	14.6	-8.3
	18.3	4.9	19.8	3.6	-37.0	26.5	15.5	-4.2	17.1	21.7	1.2	0.2	8.0	13.7	-11.0
	16.5	4.7	18.4	2.5	-39.2	20.6	15.1	-5.5	16.3	1.2	0.2	-3.8	6.7	7.8	-12.9
	10.9	4.6	15.8	-0.2	-44.3	19.7	3.8	-10.6	16.0	0.6	-1.8	-4.4	4.7	3.8	-14.2
	2.7	3.1	4.3	-1.6	-45.6	2.3	3.7	-15.5	2.1	0.3	-5.0	-7.5	1.5	1.1	-14.5
	1.3	2.4	4.1	-9.8	-47.8	0.8	2.0	-16.4	0.9	-0.1	-5.4	-8.0	1.0	0.7	-17.8
Lowest Return	0.8	1.3	3.8	-17.6	-53.2	0.2	0.8	-18.2	0.2	-2.3	-5.6	-14.6	0.8	0.6	-17.9

US Large Cap · US Large Cap Value · US Small Cap · US Small Cap Value · US Real Estate · International Large Cap Value

International Small Cap · International Small Cap Value · Emerging Markets · One-Year US Fixed · Five-Year US Government Fixed · Five-Year Global Fixed

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In both US and non-US markets, there is little predictability in asset class performance from one year to the next. Studying the annual data reveals no obvious pattern in returns that can be exploited for excess profits, strengthening the case for broad diversification across many asset classes.

An investor's ability to achieve his or her investment goals often relies on maintaining discipline in their portfolio over the long term. When a particular asset class is doing better than other asset classes, it's important to be reminded of the benefits of maintaining a diversified portfolio and sticking with "underperforming" assets when other market participants are tempted to give up on them. Consider investors who abandoned global stocks or REITs at the end of the 90s in favor of investing in the S&P 500 that just had an amazing decade.

1990-1999

S&P 500: 18.21%

Global Stocks: 13.7%

US REITs: 6.7%

This is called a "recency bias," a phenomenon of a person most easily remembering something that has happened recently, compared to remember something that may have occurred a while back. In 1999, due to this recency bias, it was tempting to give up on REITs and international markets. But that would have been a mistake over the following decade:

2000-2009

S&P 500: -1%

Global Stocks: 7.4%

REITs: 13.6%

At the end of 2009, due to the same recency bias, it was tempting to give up on the S&P 500, but again, that would have been a mistake over the next decade:

2010-June 2019

S&P 500: 13.1%

Global Stocks: 10.3%

US REITs: 11.6%

The S&P US REIT Index has outperformed in the past year or so. Those tempted to increase their allocation to REITs now should take a lesson from history. Overweighting an asset class with recent outperformance is typically not a successful strategy. While certainly nobody knows what is going to happen in the future, we do know that an investor's ability to achieve his or her goals relies on maintaining discipline in their portfolio over the long run. A globally diversified strategy will always perform somewhere in the middle of its component asset classes. It will never be at the top of the performance chart. But the good news is that it will also never be at the bottom! Diversifying globally helps to enhance the stability of returns so you **avoid extreme outcomes**... providing a better investment experience over time.

About Hemington Wealth Management

Hemington Wealth Management provides high net worth individuals and families with a broad range of wealth management services including portfolio management. We are collaborative, accessible and responsive, making it easy for clients to work with our team.

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