The Globe and Mail – November 23, 2023

Higher interest rates have investors rethinking REITs' role as a portfolio staple

DALE JACKSON || NOVEMBER 23, 2023

REITs provide better after-tax returns than GICs over the long-term, says an expert.CHRISTINNE MUSCHI/THE GLOBE AND MAIL

It's been a rough couple of years for real estate investment trusts (REITs). In the wake of a 475 basis point hike in interest rates since March 2022, the benchmark S&P/TSX Capped REIT Index has lost more than 30 per cent of its value.

To make matters worse, retail investors who have come to rely on REITs for steady income flow to see them through retirement have had to suffer through a flurry of distribution disruptions as the period of low borrowing costs came to an end. That, in turn, has led to more redemption requests from investors, which REITs have declined as they have been unable to fulfill them.

“If you want to make a redemption and they have no cash to redeem from, they close down redemptions,” says Peter Andreana, partner at Continuum II and investment funds advisor with Investia Financial Services Inc. in Hamilton, Ont.

“The thing to understand about REITs is they actually own physical property. How do you get you your money? Will they have to sell the building?”

As interest rates and fixed-income yields languished over the past three decades, REITs became the de facto income alternative in many portfolios. It was just a matter of time until higher and safer fixed-income yields would compete with more volatile REIT dividends.

While the lure of decent yields in an income drought might have blinded retail investors to the coming storm, Mr. Andreana says advisors should have seen it coming.

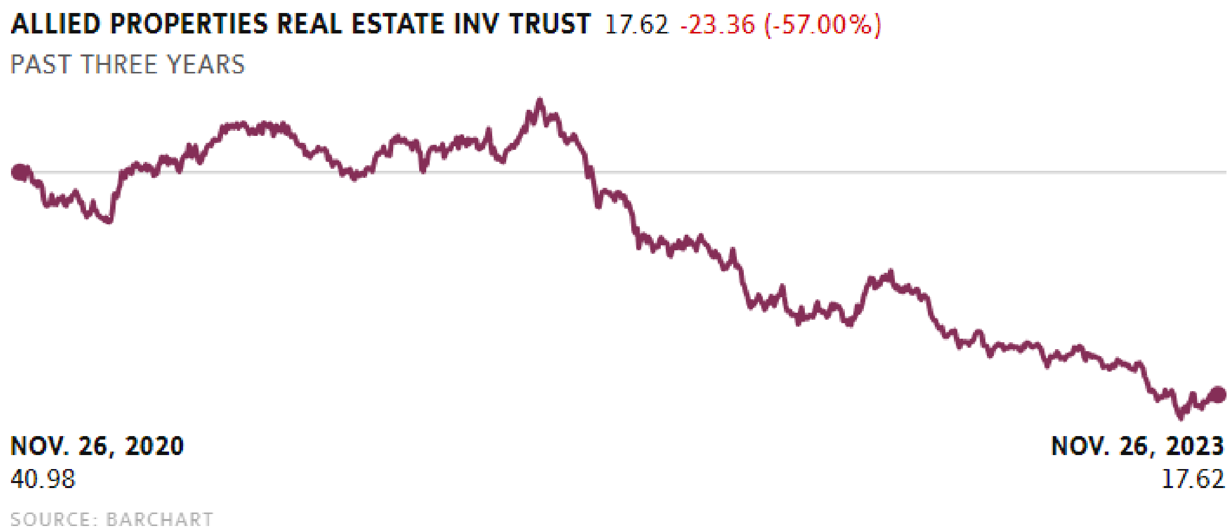
“When redemptions were suspended, [some investors] weren’t able to maintain their lifestyle and keep their income because they couldn’t get their money out,” he says.

Although Mr. Andreana adds that REITs should still play a role in generating income and capital gains in retirement portfolios, he limits them to 5 per cent of total assets for clients.

He suggests splitting those REITs among the basic real estate asset classes (residential, commercial and industrial) with a focus on ones that generate steady cash flow through electric grids, toll roads and utilities.

“A lot of it comes down to a well-diversified portfolio, in general, but if you’re looking for something specific, infrastructure is often a good opportunity,” Mr. Andreana says.

He cautions investors to remain wary of office REITs beaten down by the work-from-home trend that was established during the pandemic. Occupancy rates for Allied Properties REIT AP-UN-T +1.09% increase, for example, remain below pre-pandemic levels as shares reel from a 70 per cent loss in value since the start of COVID-19.



"Office buildings are really having a hard time getting tenants because everyone is saying, maybe, working remotely is what the future holds for us," he says.

As an income replacement for REITs, he suggests guaranteed investment certificates (GICs), which currently pay yields well above 5 per cent.

"It's very simple. One year of cash and one-year and two-year GICs, so you have three years of guaranteed income," he says.

"You still need long-term returns. You can't ignore that, but you also need to take out the short-term volatility."

Factoring in rate risk

Dennis Mitchell, chief executive officer and chief investment officer at Starlight Capital Inc. in Toronto, disagrees that GICs are a viable alternative to REITs.

"What do you do a year from now when those yields come down," he says. "People who bought one-year, 5 per cent GICs expose themselves to an enormous amount of interest rate risk."

He says REITs provide better after-tax returns than GICs over the long-term beyond interest rate cycles, and it would be foolish to sell now in a down market.

"Our approach to investing in REITs doesn't change based on the environment because we've already factored in the risk of [interest] rates going up, he says.

"Leverage is something we consider when we're making the investment, not when interest rates start to go up."

Mr. Mitchell has managed to keep the year-to-date loss for his firm's flagship Starlight Global Real Estate Fund at 7.4 per cent following a 22.3 per cent loss in 2022. It currently has an annualized yield of 7.6 per cent.

"Our companies have low leverage, high-quality assets, and management teams that have demonstrated their ability to allocate and compound capital," he says.

The fund focuses on residential and commercial real estate but he says he's also finding new opportunities in infrastructure. He has been adding to the top holding, American Tower Corp. AMT-N +0.95% increase – a communications infrastructure provider.

Shares in American Tower have fallen by almost 35 per cent since their all-time high in September 2021 (well before the interest rate increases had begun). Mr. Michell says the company is a bargain with plenty of dividend growth potential.

"We've moved to 5G with the rise of artificial intelligence, social media and e-commerce," he says.

"The demand for cell towers is almost insatiable as the population grows, technology improves and more activity moves online."

Other potential bargains on his radar screen are seniors housing REITs as the influx of baby boomers continues to head into retirement, and REITs that can grow in higher interest rate environments.

"If rates are high, acquisitions don't make as much sense. Maybe you might pivot towards development," he says.

"It doesn't impact the quality of our companies and their ability to continue to grow their cash flows and distributions."