# REITS RIDING HIGH,

## *but for how long?*

WITH LOW INTEREST RATES AND FEW OPPORTUNITIES FOR INVESTORS TO SEE LARGE GAINS, PLENTY ARE FLOCKING TO REITS WITH THEIR HIGH RETURNS. BUT HIGH RETURNS OFTEN MEAN HIGH RISK. SHOULD YOU TAKE THE LEAP?

**IN TODAY'S** yield-starved investing environment, real estate investment trusts are a market standout with returns in excess of 10% in many cases. Plus, given the way they are structured, federal law mandates REITs pay out 90% of taxable income to shareholders, making them an attractive income investment. And most pay out dividends monthly. But with high yield comes risk. Here's our take on the pros and cons of putting your money in this high-return market.

### THE BEAR CASE

For all of the Bull's happiness about high yields, it's important to keep in mind that not only are REITs expensive to buy, they're also high risk (some more so than others). Sure, you'll do way better (in the short-term anyway) investing in REITs than in money market funds, bank CDs, or bonds, and if the safety of your dollars isn't an issue, by all means, risk away. But don't go putting money you'll need for retirement in these things. Yes, they offer dividend yields in excess of 10%, but those returns have been far from consistent the last few years.

And given REITs' sensitivity to rising interest rates, the current party these guys are having will likely end soon because there is no "if" with regard to rising rates, only "when."

REITs as an asset class lack a consistent and predictable dividend history, making them a complex buy and something that the average investor should perhaps avoid. Players like Annaly Capital Management, in particular, while they have a high yield, also exhibit a vulnerable business model with not enough diversification and too much sensitivity to interest rate fluctuation.

It's easy to be tempted by high yields. In the third quarter, Annaly saw $0.36 earnings per common share with a capital ratio of 15%. Common stock book value stood at $12.87, according to third-quarter reports from the company.

But before you invest in a REIT, don't just look at the often attractive dividend. Analyze the safety of that dividend as well as its ability to grow. Most REITs just don't have those two things.

And, unfortunately, REITs like Annaly rely heavily on short-term funding. For Annaly, that funding is provided by repurchase agreements, their largest source of funds, in fact. And given new regulatory requirements, repo trading is becoming increasingly expensive. Goldman Sachs Group Inc., Barclays Plc, Bank of America Corp., and Citigroup Inc. have all drastically reduced repo activity due to new capital requirements set in place by Basel III.

As funding sources becoming more expensive and/or decrease, REITs could experience a noteworthy reduction in the availability of credit. The result will be compression of the net interest spread and, hence, reduction in distributions to shareholders.

And while REITs like Annaly can borrow from Federal Home Loan Banks, that source of funding is probably going to dry up as well given that the Federal Housing Finance Agency proposed new rules Sept. 2 that would first limit and ultimately end the availability of FHLB loans to mortgage REITs.

## HOW REITS COMPARE TO THE S & P

| | STOCK REITS | S&P 500 |
|---|---|---|
| *Annual average dividends* | 3.13% | 2.0% |
| *2014 gain through Q3* | 17.9% | 9.5% |

And credit availability issues aside, it's hard for REITs to grow book value given the fact that their value is constantly reduced by dividend payments. This is not the place to put hard-earned capital, in our bear's view.

The bottom line is REITs as an investment class are, overall, pretty volatile. They certainly don't make for good retirement investments. These are income stocks and frankly, not an area of investment for the average consumer given their volatility and lack of solid income history.

### THE BULL CASE

With depressingly low yields in so many stocks and bonds these days, REITs stand out as a way to actually make some money off your money. Stock REIT dividends currently average just over 3% a year compared to around 2% for Standard & Poor's 500-stock index. REITs aren't the place to dump all your money, as they do come with risks, but they're a great way to diversify your portfolio.

Bears will likely argue against investing in REITs because they can be sensitive to interest rate increases, particularly those trusts with less diversified portfolios, but if rates rise in the coming years because of economic growth, then REITs will rebound, even if they fall with initial rate increases (as they did following the Federal Reserve's announcement in May 2013 that it would start backing off quantitative easing). They can be a good investment, both for a short-term investor with lots of extra cash on hand or someone willing to take the long view, buy, and hold.

As you shop for REITs, seek out those that don't have all their eggs in one or two baskets. Two Harbors Investment Corp. is one example. The company holds a highly diversified portfolio, including high-credit quality mortgage-backed securities with low default risk that are lower yielding and sensitive to interest rates. They also hold subprime mortgage-backed securities and residential mortgage loans not packed into securities, both of which offer higher yields with less sensitivity to interest rate fluctuations. Two Harbors consistently outperforms competitors because of its diverse assets. The firm also invests in mortgage servicing rights (currently about 10% of the company's portfolio).

And while Two Harbors will, no doubt, see some negative impact from interest rate increases that will likely start coming in mid-2015, this company has shown adaptability to market conditions, has maintained its book value, and will likely hold or retain that value through an episode of rate hikes. This is not true of all REITs, so it is critical for investors to carefully examine their underlying business models.

According to its report to shareholders, Two Harbors closed out the third quarter of 2014 with a book value of $11.25 per diluted common share, establishing a 3.8% total return on book value after accounting for a dividend of $.026 per share. Two Harbors' total return on book value for the first three quarters of 2014 was 13.9%, not a bad return at all. The firm's president and chief executive officer, Thomas Siering, wrote to clients, "In the recent quarter, performance was driven by strong returns on both our Rates and Credit strategies, despite our defensive portfolio positioning and low leverage profile."

Company Chief Investment Officer Bill Roth echoed Siering's sentiment, emphasizing the diversity of Two Harbors' portfolio as reason for its faith in continuing high-yield returns. "During the third quarter, our mortgage loan conduit continued to gain momentum," he reported to investors. "Specifically, we completed two securitizations and, subsequent to quarter-end, expanded our program to include a wider range of products that we believe improves the availability of mortgage credit."

Feared rate increases are likely to come slowly given the general slowdown in global economic growth, which means even the less diversified REITs could still have a good run for the immediate future. Credit Suisse predicts short-term rates to stand at 0.57% by the close of 2015 and 1.54% at the close of 2016, so there isn't going to be a dramatic climb. Hence the firm plans to keep investing in REITs and points to Two Harbors as well as PennyMac Mortgage Investment Trust as two of the most solid.

PennyMac reported third-quarter net income of $54.9 million, or $0.69 per diluted share. That's a drop of 26% from the second quarter, which had an all-time high in earnings for the REIT, according to the company's third-quarter report to shareholders. Net income was also down 27%, though book value of $21.42 per share was up slightly from the second quarter when it stood at $21.27. Return on average equity for the third quarter was 14%, compared to 19% from the previous quarter.

Like Two Harbors, PennyMac has been growing its investment in MSR and excess servicing spread investments. In the third quarter, PennyMac added $40 million in new MSR investments and $9 million in ESS.

PennyMac Chairman and Chief Executive Officer Stanford Kurland told shareholders in the company's third-quarter report that PMT's return on equity and increased dividends were the result of "our ongoing success in managing PMT's investment portfolio, which includes distressed mortgage loans, MBS, MSRs and ESS."

Annaly is a less diversified but still potentially attractive REIT investment. Ninety-four percent of the company's portfolio is in agency-backed securities, but it manages to trade at a substantial discount when compared to peers, trading at just below book value. Annaly executives have also been buying the stock, and when insiders buy, that can be a key indicator that stock is undervalued or that the expectation is that prices will rise.

Meanwhile, American Capital Agency, while it lost $0.72 per share in book value in the third quarter, saw an overall economic gain in the first two-thirds of 2014 of 14.9%. The REIT has also added a new low loan balance or Home Affordable Refinance Program category that will have loans with substantially decreased risk of prepayment, keeping the company's amortization costs down.

American Capital Chief Investment Officer Gary Kain wrote to clients at the close of the third quarter, "The clear consensus at the beginning of the year was that interest rates would rise and agency MBS would underperform. Instead, in response to the slower pace of global economic growth and lack of inflationary pressure, interest rates have fallen dramatically." He added, "Moreover, despite tapering of QE3, agency MBS have performed very well even after giving back some of their gains during the third quarter."

With pretty minimal interest rate increases in the near-term, due both to slow growth in China and Europe as well as a strengthening U.S. dollar, REITs are less risky in the immediate future. The key to investing in REITs is to be aware that you play high risk in return for high yields. Analyze individual REITs carefully, and look for those, like Two Harbors and PennyMac, that seek to diversify their portfolios as a hedge against negative impacts from interest rate hikes. ■

*Editor's note: Bull vs. Bear is a non-positional column designed to present both "bull" and "bear" cases surrounding a publicly traded stock representative of the U.S. housing economy. Analysis focuses primarily on macro economic factors, and the column is designed to allow investors to choose for themselves which case presented makes the most sense for their own investment objectives. HousingWire does not recommend any specific investments.*