June 27, 2010

# Gains surprise real estate trusts

## Average fund up about 11 percent

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*USA TODAY*

You could hold a rodeo clown convention in most office buildings these days without disturbing the few workers left inside. So why are real estate investment trusts, which buy and sell commercial property, doing so well?

The average real estate fund - most of which invest solely in REITs - has gained 11 percent this year, vs. a 1.1 percent loss for the Standard & Poor's 500-stock index, including reinvested dividends. The average REIT has gained 14.7 percent, says the National Association of Real Estate Investment Trusts (NAREIT), a trade group.

Those are swell numbers in a distinctly not-so-swell environment. "It's been a bit of a surprise," says Ken Heebner, manager of CGM Realty fund.

One reason for such big gains: Investors may think things can't get much worse. They have a point. The unemployment rate in May was 9.7 percent, down slightly from its 10.1 percent peak in October. Nevertheless, 15 million people were looking for work at the end of May, a situation that doesn't argue for rising demand for office space or shopping malls.

Walk through the average office building, and mostly what you'll hear is the sound of your own footfalls. Office vacancy rates were 15 percent at the end of the first quarter, vs. 14.7 percent at the end of 2009, according to Cushman & Wakefield, a global real estate firm. Rents are down 6.6 percent from a year ago, to $36.88 a square foot.

Commercial leases tend to be relatively long-term ones, Heebner says. Even if the economy were to turn around tomorrow, office REITs might not feel the benefits for another two years.

What has improved? Credit. At this time last year, Wall Street viewed REIT borrowers the way slugs view salt, which meant that REITs had a hard time raising money for purchases or acquisitions. The supply of new commercial real estate is low, which is unusual for a real estate cycle. Just as the top of the stock market is marked by a flood of dubious new issues, the hallmark of a toppy commercial real estate cycle is hundreds of unnecessary office parks. Were commercial real estate developers so wise and prudent that they cut back their building as the top approached?

Of course not. But the boom in residential real estate drove the price of construction laborers up, slowing new commercial construction projects. The dizzying rise in the price of raw materials in 2007 and 2008 also made new commercial construction expensive. So new supplies of office space were somewhat restrained.

"The expectation is that we're at or near a bottom" in occupancy levels, says Steve Shigekawa, co-manager of Neuberger Berman Real Estate fund. "If the economy continues to improve, we expect that vacancy rates will start to come down and see occupancy picking up."

The problem: After a strong run, "These are relatively expensive stocks," Heebner says.

Both Heebner and Shigekawa favor lodging REITs, which invest in hotels. "Demand is picking up for lodging, travel is improving, and we're seeing group bookings pick up as well," Shigekawa says.

If you're going to buy individual REITs, look for strong balance sheets. Nearly all REITs are borrowers; look for REITs with lots of cash and multiple sources of capital, Shigekawa says.

REITs distribute nearly all of their income to investors, and the average REIT yields 4.6 percent, say NAREIT. If you're an income investor, make sure the REIT is paying cash dividends. Some cash-strapped REITs are making their payouts with stock.

The top-performing REIT funds are in the chart. Index fans should consider the Vanguard REIT Index fund (ticker: VGSIX) or its exchange-traded cousin, the Vanguard REIT ETF (VNQ).

A commercial real estate boom could be years off, so don't look for outsize returns anytime soon. Nevertheless, you can earn decent income while you're waiting for the office to fill back up.