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Marc A. Hebert's 'Money $ense': Real estate for income and diversification

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ABOUT 145 million Americans own real estate investment trusts (REITs) for the income they generate and the diversification they may add to a portfolio. Maybe you are one of them. Here is a look at some of the characteristics these investments have to help you decide if REITs might be appropriate to include in your portfolio.

At their most basic level, REITs are publicly traded securities (just like stocks) that combine money from investors to allow them to invest in real estate. REITs give investors of all sizes the ability to have real estate exposure in their portfolio without needing to own and manage investment property directly. Since REITs are publicly traded, they can be easier to buy and sell than owning real estate. There are no big down payments that need to be made on the property or other hassles involved in the purchasing process. These responsibilities are left to the REIT management team.

There are different types of REITs, but the most common investment vehicle is called an equity REIT. The term refers to REITs that derive most of their income from rents. The property involved could be residential, commercial and/or industrial. The REIT could have a very narrow focus, but it could be broad in nature. The types of property that a REIT may own range from shopping malls and hotels to cell towers to timberland and beyond.

To fall into the category of a qualified REIT, the security must meet certain tax requirements. One is that 90% of the REIT's taxable income must be paid to shareholders in the form of dividends. According to the National Association of Real Estate Investment Trusts (NAREIT), in January of 2021 equity REITs paid on average dividends of 3.55%. Be aware that dividends may be taxable. Investors can buy shares in individual REITs or through mutual funds and ETFs.

While equity REITs can generate income, the share price may be sensitive to changes in interest rates. This is somewhat due to the fact that companies may use debt to acquire properties. Interest rates may also impact property values. As interest rates rise, the dividend paid by a REIT may become less attractive. Given their stability, bonds may be more appropriate for investors with a lower risk tolerance or shorter investment time horizon.

REIT share prices may not follow the same movement as stock or bond markets. This makes them a helpful tool as they can be used to diversify a portfolio.

Diversification is a means to manage investment risk. Keep in mind that diversification isn't a guarantee of profit and also does not protect against investment losses. Investment results will vary.

We have mentioned interest rates as a risk inherent in REIT investments, but there are others. If local economies deteriorate, this can affect the property values of any real estate in the area. This is true nationally all the way down to the local level. REITs that rent property are exposed to the risk that a tenant may not pay their rent when due. Another risk is that the supply of rentals may become so great that rents come down.

The reverse is also true, if the supply of properties in a given area isn't adequate, then rents could increase. The property may be mismanaged. Perhaps operating costs, such as insurance, utilities, and real estate taxes, could increase unexpectedly. Increasing expenses could all play a part in the investment results. Laws and regulations could also change, which could affect an investment's value.

Given all this, it is worth taking your time in evaluating a REIT investment. Consider the risk and rewards before you do. Not all REITs are created equal and they can be complicated securities, so it may be a good idea to discuss your situation with a certified financial planner or an investment professional.

Marc A. Hebert, MS, CFP, is a senior member and president of the wealth management and financial planning firm The Harbor Group of Bedford. Email questions to Marc at **mhebert@harborgroup.com**.