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### Through the Looking Glass

[November/December 2006]



Investment Professionals from Outside the World of REITs Provide Their View on Real Estate

By Mike Fickes

Want a fresh look at real estate investing? Yes? Then read on. *Portfolio* asked five veteran generalist investment professionals to offer their opinions on real estate investing. Each focuses on building intelligently diversified, strategically allocated portfolios for clients. They represent the ideas of investors that work outside of the real estate world, but every now and then take a hard look inside.

Our five panelists include: David A. DeWolf, a principal and co-founder of [Quantum Wealth Management](#), a financial planning firm; Mark Keller, chairman of the investment strategy committee of [A.G. Edwards & Sons, Inc.](#); Thomas Lawson Posey, a principal with the financial planning firm [Posey Capital Management, Inc.](#); Brian Wesbury, chief economist with [First Trust Portfolios, LLC](#), an investment fund management company; and Jeffrey J. Zures, a founding principal of [Sanchez & Zures](#), a personal financial planning and portfolio management firm.

All five work outside the real estate business and they provide insight to how they advise clients concerning overall investment strategies, allocations and alternatives.

In light of the performance of REITs and other real estate investments over the past 30



We view real estate as an essential asset class because of its diversification potential and try to work it into every client portfolio.  
—JEFFREY J. ZURES

years, what is your take on real estate as an investment option?

**Brian Wesbury:** In recent years, low interest rates have made REIT yields look attractive compared to bond yields. In addition, the performance of other stocks has trailed earnings growth because investors have priced in a higher perceived risk. The combination has created a fabulous environment for REITs and publicly listed real estate, and has attracted investors to the real estate market.

**Jeffrey Zures:** We view real estate as an essential asset class because of its diversification potential and try to work it into every client portfolio. We also like real estate because of its relatively low correlation to stocks and bonds. However, we have trimmed our exposure to real estate recently. We felt that the strong performance over the past several years coupled with rising interest rates pointed

toward a top in the real estate market. Our strategy to trim (instead of exit the asset class completely) has paid off in that the ICF (iShares Cohen & Steers Realty Majors Index Fund) index continues to post double-digit returns in 2006.

**David DeWolf:** We invest all of our clients in real estate via REITs, essentially REIT index funds. The amount of exposure, of course, depends on their risk tolerance, but the majority of client portfolios probably hold 5 percent to 7 percent of assets in listed real estate securities.

**Thomas Lawson Posey:** REITs correlate more with real estate than with stocks. In that regard, REITs make a good diversifier.

**Mark Keller:** Over the past few years, REIT stocks made a powerful upward move driven by extremely low valuations—valuations depressed by the tech/telecom bubble that sucked capital out of every corner of the market.

What REIT or other real estate investments have you made or recommended in the last 18 months? How does this advice reflect investment strategies that you favor?

**Posey:** We have not changed our recommendations this year, except to say that it makes sense to temper expectations for REITs going forward because of their strong recent performance. But, in my view, REITs are not a tactical bet. They are a good part of a diversified portfolio for the long term.

**DeWolf:** We focus on a REIT portfolio that is akin to an index and provides an inexpensive manner to diversify across the industry. Mostly we use DFA Real Estate Securities, ticker DFREX, and ICF, which is also an inexpensive broad index. Due to their low correlation to stocks and relatively high returns, there should be a component in almost any portfolio looking to minimize risk while seeking market returns.

**Zures:** We use ICF almost exclusively. We employ a passive indexed approach to our investment philosophy. The iShares exchange traded fund supports this discipline because of the broad



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—DAVID A. DEWOLF



Our goals for REIT investments include reducing volatility, and in some cases, enhancing portfolio returns.  
—THOMAS LAWSON POSEY

diversification, low expense ratio and tax efficiency.

**Keller:** Judging by its healthy valuations, real estate is well liked today. But healthy valuations mean that there is potential for the market to lower its valuation. From a strategic point of view, our advice is, "yes, now is the time to be concerned."

What real estate sectors interest you the most, and why?

**Zures:** Because of our passive approach, we do not try to find the needle in the haystack and pick the "hot" sector. Instead, we simply buy the entire haystack in the form of ICF.

**Wesbury:** Industrial, hotel and office sectors are the areas that are most attractive. As Internet retail grows, industrial and warehouse use will increase. In my view, hotel development has fallen way behind the market. For example, in the conference call related to its second quarter 2006 earnings report, Marriott International's CFO said that hotels in cities like Atlanta, Boston and New York are mostly full mid-week. Office, it seems, is more of a mixed bag. Some cities still have low vacancy rates. But other cities—like Chicago—are seeing a lot of office construction. I think the office sector may grow in the suburbs. As technology continues to push population and major businesses away from urban areas into suburban and smaller cities, we're going to need offices. That is where the returns will be higher.

**Keller:** In my personal opinion, and not necessarily the firm's, I am concerned about consumer spending, which has been the primary engine of growth, especially in housing. The decline in consumer spending could put pressure on retail REITs and hotels. We're already seeing some of this in restaurants.

That said, industrial REITs might fare better in a slowdown that is led by consumers instead of business—which was true of the last recession. Office buildings, too, might fare better this time around. Offices often get overbuilt going into a slowdown, but I don't sense that as a problem right now.

What real estate investments do you shy away from and why?

**Wesbury:** I think that the single-family marketplace has peaked at this point. About 10 years ago, we cut the capital gains tax rate on single-family homes. That provided a massive lift to that market. Then, extremely low interest rates turbocharged the housing market. Now that rates have moved back up, I think we've taken the edge off the market. I don't think it is a bubble about to burst, but I would argue that it is fully valued. For at least a few years, you will get average or slightly below average returns in that market.

**DeWolf:** We shy away from concentrated investments or pure speculation. Academic evidence supports the fact that investors are often not rewarded for risks they take within non-diversified investments. This holds true across all asset classes, including real estate.



There are more REITs for investors to choose from, and it is a more diverse sector than it used to be.  
—MARK KELLER



I'm betting that the Federal Reserve will be successful and that a repeat of what we have seen in real estate in recent years is unlikely.  
—BRIAN WESBURY

**Posey:** We do not invest in mortgage REITs because interest rates make them too volatile. I would rather own actual real estate (indirectly), so I limit investments to equity REITs.

**Zures:** We do not view our client's primary residences as investments earmarked for retirement. When developing financial plans, we assume that clients will not need to tap the equity in their homes to fund investment goals.

**When allocating clients' portfolios, what percentage do you allocate to real estate? How have your allocations changed over the past 10 years?**

**Posey:** We allocate about 88 percent to stocks, with the remainder going to bonds. We use bonds to reduce volatility, and bonds could range up to 50 percent of the portfolio. Within the stock portfolio, we allocate 15 percent to REITs. Our goals for REIT investments include reducing volatility, and in some cases, enhancing portfolio returns. We have used this approach for about 10 years now.

**DeWolf:** Allocation is always a factor of a client's risk level. For example, for a higher risk individual, we might have 15 percent bonds, 6 percent real estate, 6 percent commodities and 73 percent equities. A more moderate investor might have a portfolio with 45 percent bonds and 4 percent real estate. Most of our portfolios contain 4 percent to 7.5 percent REITs.

**Zures:** Currently, our aggressive portfolios (10 percent bonds; 90 percent equities) have 3 percent to 7 percent invested in real estate. Our conservative portfolios (40 percent bonds; 60 percent equities) have 1 percent to 3 percent in real estate. In addition to real estate, bonds and large and small U.S. stocks, we use commodities, emerging markets and international stocks.

**Keller:** In our three-year models, our allocations to real estate are at low ebb right now. In fact, real estate appears only in our two income-oriented models, at 5 percent and 4 percent. We don't allocate any real estate in our growth-oriented models because we think that valuations are on the rich side today. While we realize that publicly traded REITs as a class are not that expensive relative to private real estate investments right now, we regard private real estate investments as very expensive. We've had larger allocations to these models in the past. We wouldn't mind going back to that, but we're just not comfortable now.

**What concerns do you have when making real estate investments and why?**

**Wesbury:** My view is that we are going to have a strong building boom in the next few years. But will real estate outperform other investments? Will it perform well? That depends on what the Federal Reserve Board does. If it doesn't get ahead of the inflation curve and beat inflation back, then real estate will make sense. If they do beat inflation back, then real estate will be slow. I'm betting that the Federal

Reserve will be successful and that a repeat of what we have seen in real estate in recent years is unlikely.

**Zures:** As I noted earlier, we are passive investors. When performing due diligence on the real estate exchange traded funds we use almost exclusively for our equity investments, we are concerned with cost, tax efficiency and deviation from the underlying index.

**DeWolf:** Our focus is on historical market performance and allocating portfolios based on academic evidence that supports the fact that great returns are there for the taking and investors who time the market based on public information under-perform. For instance, many experts advised investors to be out of listed real estate in 2003 and 2004. Investors that listened to that advice missed out on phenomenal returns.

Generally, how do you advise clients to deal with real estate in their investments? What mistakes do you counsel them to avoid?

**Wesbury:** For REITs, the good news is that you can trade in and out of them. But you still have to pay attention to diversification. For direct real estate investments, don't chase the hot trend, and make sure that you have the liquidity and the resources to move through hard times when they come.

**DeWolf:** We provide real estate exposure to our clients through REITs. But probably 20 percent of our clients also have direct real estate that is out of our control. We advise them to be cognizant of how those assets fit into their overall financial plan, and to avoid significant concentrations or risks so that if there are significant downturns in those areas they will be able to withstand the pressure. If an investor can't do that, then that kind of real estate investment probably isn't right.

**Keller:** REITs have a few things going for them today. There are more REITs for investors to choose from, and it is a more diverse sector than it used to be. In addition, the market caps are bigger—that helps reduce volatility.

When things are going along on a smooth upward track, it is typical of management in that industry to presume that their world will continue that way. I've been watching industries and financial markets for 27 years, and I don't know of more than a handful of markets that don't have some level of cyclicity. There is cyclicity in real estate, if for no other reason than the importance of the cost of money to the performance of real estate. When the cost of money is low, real estate businesses perform better than when the cost of money is high. Right now, the cost of money is going up.

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*Mike Fickes is a regular contributor to Portfolio.*

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Real Estate Portfolio® is the magazine for REITs and real estate investment.

It is published bimonthly by the National Association of Real Estate Investment Trusts® (NAREIT),  
1875 I Street, NW, Suite 600, Washington, DC 20006-5413.

Phone 202-739-9400.