

A Preferred Path To REIT Income

I'll put it to you plainly: REITs are overpriced. Many investors have bought into a broad recovery in this sector, but I am afraid prices have gotten ahead of themselves. Yes, I am aware that REITs, as measured by SNL's index, fell 15% in the third quarter. Still, I believe most are richly priced.

The problem, of course, is fading economic growth, and it's a bit of a vicious cycle. The weak economy and uncertainty at home is causing violent stock market gyrations. Things are even worse in Europe. This is gnawing away at banks' health and well-being, and they are reluctant to step up and make loans. Economic expansions that fill space in the real estate market require financing. With lenders under pressure and whining about woes, it's hard to imagine a speedy restart to the recovery.

It sounds pretty bad, but there are still a few compelling opportunities for investors willing to take a little risk. "Buying on bad news" or when a nervous market clouds valuations is one of the core strategies of successful value investing. When this economy and the REIT market turn, the forward momentum will be sharp: REITs have slashed their debt levels and stocked up on cash, which means that, barring total disaster, it is only a matter of time before the best among the group move ahead again.

In the meantime there is a somewhat safer place for weary real estate investors looking for big yields: REIT preferred shares. These securities are less well-known, but since they are

higher up in the companies' capital structure, they take priority over REIT common share owners when it comes to paying out cash dividends.

These days REIT preferreds tend to sell at a 10% to 15% discount to their par value, which is typically \$25. Oh, and did I mention that the dividend yields now are averaging about 8%? REIT preferreds tend to be less volatile than REIT common shares, but the downside of lower volatility is lower liquidity. Trading volume is low.

The higher yields mean that there is some risk that management could call in shares. But they can't do so for the first five years after issuance and, with their current discounts, an early call

MOST REITS ARE STILL OVERPRICED

translates into capital gains.

Buying individual preferred issues is challenging, though not impossible. You want companies with great balance sheets and a good track record. Long-time REIT watchers often cite the preferred shares of Public Storage as the gold standard. Today Public Storage's preferreds are trading slightly above par and have a current yield of 6.7%.

I recommend using funds to play the REIT preferred-yield game. My top pick is **FORWARD SELECT INCOME FUND (KIFAX, 21)**, a ten-year-old no-load mutual fund with \$1.1 billion in assets under management. Its current yield is 9.4%.

Another good bet just got better. Lazard Asset Management just

acquired the REIT mutual funds from Grubb & Ellis Alesco Global Advisors, still managed by Jay Leupp and David Ronco. Lazard is sure to add seed capital to bulk up these underfunded yet well-performing funds, which languished under prior sponsorship but still produced great results. Buy **LAZARD U.S. REALTY INCOME PORTFOLIO (LRIOX, 9)**, currently weighted about 60% toward preferreds. Among its holdings are the Glimcher Realty Trust Series F, a mall REIT, and Hersha Hospitality Trust Series B, a hotel REIT, yielding 9.4% and 9.2%, respectively. The tiny fund is offering a current yield of 6%.

COHEN & STEERS REIT & PREFERRED INCOME FUND (RNP, 13) is a closed-end fund that has just under \$1.2 billion in assets and is run by the 800-pound gorilla of REIT managers. If you want quality, New York City's Cohen & Steers has a sterling reputation, and this fund has a yield of 6.7%.

If preferreds are too slow and steady for you, here's a health care REIT whose common shares provide preferred-type yields as well as strong growth prospects. **LTC PROPERTIES (LTC, 26)** is the owner of a basket of long-term, net-leased properties devoted to senior care, from assisted living to skilled nursing. The 19-year-old southern California company has a \$790 million market cap and a dividend yield of 6.6%. LTC has 207 properties in 30 states, plenty of cash on hand and a solid management team. I expect it to continue growing despite the sluggish economy. 

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The Lazard U.S. Realty Income Portfolio commenced operations after all of the assets of an investment company advised by Grubb & Ellis Alesco Global Advisors, LLC, Grubb & Ellis AGA Realty Income Fund (the “Predecessor Realty Income Fund”), were transferred to the Portfolio in exchange for Open Shares of the Portfolio in a tax-free reorganization on September 23, 2011.

The performance of investments in real estate and real estate related securities may be determined to a great extent by the current status of the real estate industry in general, or by other factors (such as interest rates and the availability of loan capital) that may affect the real estate industry, even if other industries would not be so affected. The risks related to investments in realty companies include, but are not limited to: adverse changes in general economic and local market conditions; adverse developments in employment; changes in supply or demand for similar or competing properties; unfavorable changes in applicable taxes, governmental regulations and interest rates; operating or development expenses; and lack of available financing. An investment in REITs may be affected or lost if the REIT fails to comply with applicable laws and regulations, including tax regulations, specifically, the failure to qualify as a REIT under the Internal Revenue Code of 1986, as amended.

Fixed income and preferred securities are subject to credit risk, interest rate risk and call and reinvestment risk. A Portfolio’s investments in lower-rated, higher-yielding securities are subject to greater credit risk than its higher-rated investments. Junk bonds tend to be more volatile, less liquid and are considered speculative and a Portfolio may not be able to sell certain securities at the time and price it would like.

Non-domestic securities carry special risks, such as exposure to currency fluctuations, less developed or less efficient trading markets, political instability, a lack of company information, differing auditing and legal standards, and, potentially, less liquidity. A Portfolio may invest in a smaller number of issuers than other, more diversified, investment portfolios, and therefore the Portfolios’ net asset value may be more vulnerable to changes in the market value of a single issuer or group of issuers and may be relatively more susceptible to adverse effects from any single corporate, industry, economic, market, political or regulatory occurrence.

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For more information on the Portfolio’s characteristics, holdings and performance, please [click here](#) for the Portfolio’s quarterly fact sheet.

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