MUTUAL FUNDS

Does Your Portfolio Need an Addition? Think Real Estate Funds

By John Markese

Real estate—and the mutual funds that invest in real estate—have had quite a run over the last five years. Is this bull market run just about over for real estate mutual funds?

Perhaps.

Does the five-to-10-year horizon and beyond hold promise for these funds?

Most likely.

These funds hold some charm for investors beyond just the potential for high raw returns:

- Income (although most dividends paid out from these funds would not qualify for the 15% federal tax treatment),
- Low correlation with stocks,
- Easy diversification into the real estate sector,
- Diversification of real estate investments geographically,
- Investment selection by professionals in difficult-to-evaluate investment vehicles, and
- Liquidity in a sector often known for its lack of liquidity.

These funds should also hold particular interest for investors who do not have significant direct or indirect investments in real estate.

The Real Estate Sector

Traditionally, real estate in general does well in inflationary periods—a valuable hedge for any portfolio.

But the portfolios of real estate mutual funds are not quite as straightforward as the real estate investments most investors have made in a residence or vacation home. They may include not only different types of real estate holdings, but also both real estate equity and debt instruments.

For example, investments representing interests in apartment complexes, offices, malls, and industrial buildings made by these funds tend to do well in inflationary periods, as rents fairly quickly reflect inflation pressures. And if any increase in inflation does not slow consumer demand or economic growth, then leisure properties do well.

However, rising inflation also lifts interest rates, and real estate fixed-income investments—mortgage-backed debt or other securities that produce significant income—will be adversely affected.

Table 1 breaks down the portfolios of the real estate sector mutual funds tracked by AAII's *Quarterly Low-Load Mutual Fund Update*.

Two real estate sector mutual funds—Fidelity Real Estate Income (FRIFX) and Third Avenue Real Estate Value (TAREX)—report primarily by the type of financial security

Table 1. Real Estate Mutual Fund Portfolio Breakdowns

By Security Type	Common Stock (%)	Preferred Stock (%)	Fixed Income (%)	Mortgage Securities Backed (%)	Other (%)
Fidelity Real Estate Income (FRIFX)	11.0	36.3	22.1	20.5	10.1
Third Avenue Real Estate Value (TAREX)	72.6	0.9	26.5	0.0	0.0

By Real Estate Sector	Apartment (%)	Industrial (%)	Shopping/ Regional Malls (%)	Office (%)	Leisure (%)	Other (%)
American Century Real Estate (REACX)	14.4	7.6	25.0	24.8	6.0	22.2
Brazos Real Estate (BJRSX)	15.9	6.9	28.3	18.6	4.2	26.1
CGM Realty (CGMRX)	0.0	0.0	0.0	0.0	22.7	77.3
Cohen & Steers Realty Focus (CSSPX)	16.4	3.3	18.9	27.8	10.9	22.7
Cohen & Steers Realty Shares (CSRSX)	19.1	9.9	24.0	23.3	7.6	16.2
Columbia Real Estate Equity (CREEX)	0.0	23.0	18.6	12.8	16.5	29.1
Fidelity Real Estate Investment (FRESX)	8.7	24.5	32.9	14.2	7.3	12.4
Stratton Monthly Dividend REIT (STMDX)	14.8	5.9	14.8	24.5	5.1	34.9
T. Rowe Price Real Estate (TRREX)	19.4	10.6	26.0	19.0	7.3	17.7
Vanguard REIT Index/Inv (VGSIX)	16.0	15.0	27.0	17.0	5.0	20.0

they invest in: common stock, preferred stock, fixed income (bonds, convertibles, notes), or mortgage-backed debt. The other real estate mutual funds report by the sub-sectors of real estate represented in their portfolios: apartment, industrial, shopping/regional malls, office, leisure, healthcare, manufactured homes, storage.

For example, the Fidelity Real Estate Income fund, according to its prospectus (required reading for potential investors), invests primarily in the common and preferred stocks of real estate investment trusts (REITs) and the debt of real estate entities.

What Are REITs?

Real estate mutual funds invest primarily in REITs, and it's useful at this point to explain what REITs are all about.

REITs are publicly traded real estate companies—most are listed on NASDAQ and the New York Stock Exchange—that own and operate real estate properties. Some REITs specialize in different real estate categories and geographic regions, while others are diversified.

Like most public companies, REITs are financed through stock and debt. They are required by law to distribute to shareholders at least 90% of their taxable income, and because of this pass-through to shareholders [in contrast to a public corporation whose income is taxed before being distributed to shareholders], dividends from REITs do not qualify for the 15% federal income tax rate on dividends.

The performance of equity REITs (those that own properties directly rather than those that hold mortgages) over the last 10 years reflects the five-year bull market in real estate. Figure 1 shows the one-, three-, five- and 10-year performance of equity REITs (based on the NAREIT Equity Index) compared to other equity benchmarks, including the S&P 500, the Russell 2000 and NASDAQ. The 10-year performance of the NAREIT Equity index beats the S&P 500, but not the NASDAQ. However, in more recent years the NAREIT Equity index far surpasses the other equity benchmarks: Investors whose portfolios were diversified in REITs over this time period would have seen their portfolios buoyed by this sector as their other equity holdings were sinking.

Although REITs are a primary holding of real estate mutual funds, the group of real estate mutual funds that offer a breakdown by real estate sector are far from uniform in their REIT emphasis.

At one extreme is CGM Realty (CGMRX): It has 22.7% of its portfolio invested in hotel REITs, and 76% of its portfolio invested in the individual common stocks of housing and building materials companies such as Centex, Lennar, Pulte Homes, and Toll Brothers.

At the other extreme is the Vanguard REIT Index fund with 100% invested in a diversified portfolio of REITs that tracks the Morgan Stanley REIT Index.

Fund Performance

Table 2 details the performance of these real estate funds annually for the last full five years, and for 2005 to date, along with other pertinent performance statistics.

Clearly, while the last five years have been extraordinary for these funds, so far 2005 has not. Third Avenue Real Estate Value fund has bucked the trend in 2005 due to its significantly different portfolio composition and heavy emphasis on home-builder stocks.

What is striking for this group is that not a single real estate fund has had a down year over the full five years. Three years—2000, 2003, and 2004—contributed to the strong five-year average returns rather than just one overwhelming big year, as is often the case in other sector funds such as technology.

Part of this consistency of performance is the higher average dividend yields of these funds. Stratton Monthly Dividend REIT fund has a current dividend yield of 5.4%, and the Vanguard REIT Index fund is in the same neighborhood, with a 5.0% dividend yield. These yields compare more than favorably with intermediate-term U.S. government bond yields, which are currently in the mid-4% range.

Before their surge in values, REITs were bought as income-producing investments that also had some total return potential.

Correlation to Stock Market

Real estate mutual funds have demonstrated low correlation with common stocks historically, making this type of investment valuable in diversifying a portfolio and reducing overall portfolio risk.

For example, the Vanguard REIT Index mutual fund has a correlation with the S&P 500 index of only 0.36. In contrast, most common stock mutual fund correlations are in the 0.90s, which is very close to 1.00, which indicates perfect positive correlation.

Third Avenue Real Estate Value has a higher, but still low, correlation with the S&P 500 of 0.56 due to its stock holdings among real estate operating companies.

Total Risk

While the correlation to other investments in your portfolio is paramount in evaluating investment risk, getting a grasp on just how risky an individual investment is—how it bounces around compared to other investments—will prepare you for the inevitable ups and downs of any investment.

The total risk measure provided in Table 2 is telling: This index compares a mutual fund to all other mutual funds—bond, stock, domestic, international, diversified, and concentrated.

For this index, a value of 1.00 would be average. Third Avenue Real Estate has a value of 0.67, which is quite a low value, indicating risk of only two-thirds the average. In contrast, CGM Realty Fund has a very high total risk index value of 1.66, indicating 66% more risk than the average mutual fund.

Figure 1. Long-Term Performance of Listed U.S. Equity REITs vs. Other U.S. Benchmarks

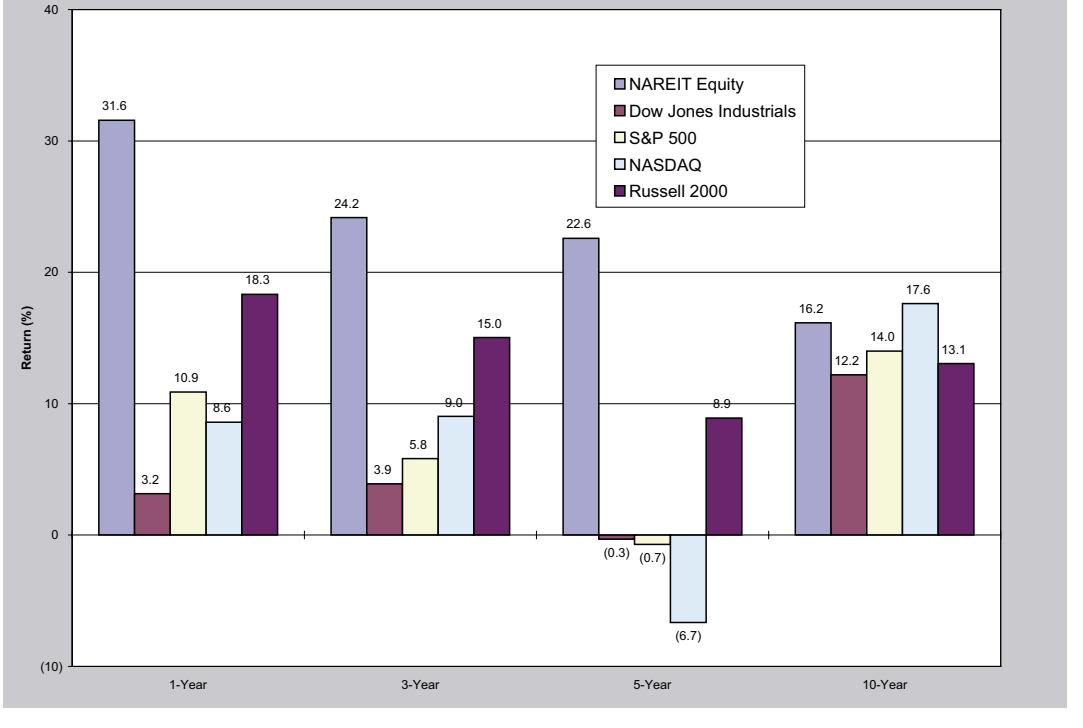

Table 2. Real Estate Mutual Fund Portfolio Characteristics

Fund	Year to Date* (%)	Average Annual Returns (%) 2004	2003	2002	2001	2000	5 Yr Avg.	Yield (%)	Risk Index (Tot)	Exp Ratio (%)
American Century Real Estate (REACX)	–1.3	29.6	39.7	5.5	10.5	27.1	21.4	1.9	0.98	1.17
Brazos Real Estate (BJRSX)	–2.3	29.9	33.6	4.4	10.3	25.8	19.2	1.9	1.00	1.16
CGM Realty (CGMRX)	0.0	35.2	89.7	3.5	5.1	29.1	32.1	0.3	1.66	1.02
Cohen & Steers Realty Focus (CSSPX)	–1.5	40.9	46.8	7.7	4.3	3.3	19.7	2.3	1.03	1.50
Cohen & Steers Realty Shares (CSRSX)	–1.4	38.4	38.0	2.7	5.7	26.6	20.7	3.2	1.04	1.07
Columbia Real Estate Equity (CREEX)	–3.9	31.0	35.4	3.1	5.4	28.8	19.0	3.8	0.90	0.97
Fidelity Real Estate Income (FRIFX)	0.3	11.7	na	na	na	na	na	4.2	na	0.85
Fidelity Real Estate Investment (FRESX)	–1.1	34.1	33.7	5.7	9.5	31.3	21.5	2.3	1.00	0.83
Stratton Monthly Dividend REIT (STMDX)	–3.7	22.1	32.3	6.4	22.9	20.1	19.6	5.4	0.97	1.00
T. Rowe Price Real Estate (TRREX)	–1.7	36.8	34.8	5.3	8.8	31.9	21.7	3.5	0.97	1.00
Third Avenue Real Estate Value (TAREX)	2.2	28.1	37.3	4.2	18.2	30.9	23.2	0.7	0.67	1.15
Vanguard REIT Index/Inv (VGSIX)	–1.9	30.6	35.6	3.7	12.3	26.3	19.9	5.0	1.02	0.24

As of 4/30/2005.

CGM Realty earned this on the upside, with an 89.7% return for 2003.

Total risk is measured over three full years and is determined by monthly variation in fund returns. Although it may seem unfair to award a higher risk rating to funds that have had large variations due to some outstanding returns, a greater upside usually goes hand-in-hand with a greater downside. CGM Realty had the highest five-year average annual return—and also the highest risk.

But, surprisingly, even with these eye-popping returns, most of these funds cluster around the average or below-average total risk index compared to *all* funds. A contributing factor to this average risk rating is the consistency that is produced by dividends from the REIT investment vehicle.

Expense Ratios

The last statistic for these funds is the expense ratio, expressed as a percentage of fund value.

To give you perspective, the average domestic stock fund has an expense ratio of about 1.00%, and domestic bond fund expense ratios average 0.75%.

Index funds have the lowest expense ratios: The Vanguard REIT Index fund, at 0.24%, is a good benchmark for low expense.

While expenses are captured in the total return numbers, a very high expense ratio is cause for alarm. It is too difficult for a fund manager to overcome extremely high (above 1.50%) expenses over the long term without compensating by taking on higher risks than the mutual fund category average.

The only fund pushing the high end of the expense ratio range among this group of real estate funds is Cohen and Steers Realty Focus fund, at the 1.50% brink. It may seem like only a small difference at first glance, but a 0.5% difference in return over many years will produce a dramatic divergence in total ending wealth.

Real Estate Reality

Should you consider adding a real estate mutual fund to your portfolio? Probably, but don't go overboard—it would not be appropriate to make your real estate mutual fund holding more than 25% of your total portfolio value, particularly if you own significant real estate directly.

An additional consideration is that, while most of the dividends from these funds may not qualify for 15% federal tax treatment, you can hold them in your IRA and other retirement accounts to shelter the income. And keep in mind that real estate mutual funds are one of the few practical and allowed methods of investing in real estate in your tax-sheltered accounts (other than individual REIT holdings or real estate stocks).

Don't rush into real estate mutual funds with the idea that the next five years will be a duplicate of the last five years.

However, over the long term, this vehicle is hard to argue against as a prudent addition to your portfolio on the basis of risk, income and diversification.

Just make sure you read the fund's prospectus, study the fund's investments and real estate sub-sector weightings and understand precisely what you are investing in before you put that check in the mail. ▲

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