Real estate: Performance and asset allocation

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Mark Twain once uttered the now-famous quote, "Rumors of my death are greatly exaggerated." The same line can be applied to the real estate securities market. Investment pundits have been writing eulogies over the past few years, yet these stocks continued to generate strong performance and show signs of good health.

Despite the negative journalistic hype, real estate securities continue to be a solid choice within a well diversified investment portfolio. The characteristics that make real estate an important piece of your asset allocation remain.

Diversification

Real estate stocks can help provide strong diversification benefits. The performance of real estate stocks does not necessarily move up or down in lockstep with securities in the broader equity market or with fixed income investments. This is likely due to the "hybrid" nature of real estate stocks; they have an income component through their dividend, as well as potential equity upside through increases in rents and values of the companies' underlying properties.

Income can be significant with real estate investment trusts (REITs), comprising a significant part of their total return. The average dividend yield of a REIT at the end of December 2006 was 3.7 percent, according to the National Association of Real Estate Investment Trusts. That compares favorably with the dividend yield of the Standard & Poor's (S&P) 500 Index — 1.8 percent — and that of other fixed income investments. Some REITs may build up more cash flow than the dividend paid, which can provide a very predictable source of current income and the upside potential of the stock market.

Hedge against inflation

Real estate investments are also known for their "inflation hedge" potential. In recent years, costs of building materials, construction labor and land have risen at a much higher pace than inflation in the broader economy. Valuation of real estate often captures this inflation. Investment in a broad array of real estate can become a useful hedge against inflation in a portfolio.

Each of these characteristics help provide the foundation for a strong investment.

Outlook

Some market followers proclaim that real estate stocks are overvalued. While the stocks are trading at premiums to historical levels, real estate securities remain a solid investment opportunity in 2007. The real estate cycle lags behind the economic cycle, and steady economic growth in 2005 and 2006 has translated into occupancy and rental rate improvements for most property types. Continued slow, steady growth in the economy and jobs should provide a strong foundation for real estate stocks to maintain its pattern of strong earnings growth.

In addition, inflation in building and land costs should keep new supply in check, generating confidence in improving real estate market fundamentals. Capital flows remain robust and should continue (absent a capital market shock), which should build confidence in current valuation levels. While the significant performance of real estate markets make the stocks look expensive by historical standards, earnings growth should remain robust.

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For the past five years (through December 2006), the S&P 500 has generated an annualized return of 6.19 percent and the Lehman Brothers Aggregate Bond Index, a measure of the broader fixed income market, delivered 5.06 percent. During the same period real estate stocks delivered annualized return of 23.99 percent (as measured by the Dow Jones Wilshire Real Estate Securities Index).

The potential for growth and income, combined with diversification benefits, may make real estate securities excellent additions to a well-diversified portfolio.

Risks

Investing in real estate securities involves some of the same risks you will find with all types of stocks. Other investment risks associated with investing in real estate can include potential fluctuations in rental income, depreciation, changes in property tax values and differences in real estate markets.

As with any investment portfolio, it is important to diversify real estate holdings among several geographic regions and different types of real estate companies. In seeking to diversify real estate investments, many investors can benefit from the assistance of professional investment managers.

Investment risks associated with investing in real estate, in addition to other risks, include rental income fluctuation, depreciation, property tax value changes and differences in real estate markets. This article contains forward-looking statements, based on expectations and assumptions that are subject to risk and uncertainties. Actual results could differ materially because of changes to these expectations and assumptions.

The Dow Jones Wilshire Real Estate Securities Index is a market capitalization-weighted index, based on equity securities whose primary business is equity ownership of commercial real estate investment trusts (REITs). The Standard & Poor's 500 index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq; the weightings make each company's influence on the performance of this index directly proportional to that company's market value. The Lehman Brothers Aggregate Bond Index is market-weighted to cover the U.S. investment grade fixed rate bond market. It includes government and corporate securities, agency mortgage passthrough securities and asset-backed securities. You cannot invest directly into an index. Indices, unlike investments, do not carry expenses that would reduce performance.

Diversification does not guarantee against loss. It is a method used to manage risk.

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