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REIT Preferred Stocks: Four Reasons to Consider Them Now.

by Burland B. East III, CFA | March 2019

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Introduction

With interest rates at relatively low historical levels—2.8% for the U.S. 10-Year Treasury versus its 55-year historical average of 6.7%—investors are left searching the investment landscape for alternate sources of higher yield.[1] Investors typically think of REIT preferreds as a compelling income-generation tool, but we believe 2019 presents a rare opportunity for REIT preferreds for a number of reasons:

- A relatively high risk-adjusted yield.
- A new tax benefit.
- An attractive valuation.
- Economic and industry tailwinds.

Defining Preferred Stock and REIT Preferred Stock

A preferred stock is a class of ownership in a corporation that has a higher claim on a company's assets and earnings than common-stock. Preferred stock combines the traits of debt (it pays fixed dividends) and equity (it has the ability to appreciate in price). Preferred stocks are typically issued by investment-grade companies and have the potential to provide significant current income, akin to high-yield bonds, but typically with lower overall credit risk and less likelihood of default.

A REIT preferred stock (REIT preferred) is a preferred stock issued by a real estate investment trust (REIT). REIT preferreds offer investors a handful of potential benefits, including tangible collateral and dividend prioritization.

- **Tangible Collateral:** Collateral is a tangible or intangible asset that a borrower offers a lender to secure a loan. Traditional REITs provide a preferred stock investor (the lender) with physical collateral—real estate property. Other preferred stock issuers provide non-physical collateral, such as licensing agreements, patents, or software. As compared to a hard asset like real estate, it's difficult to assign intangible assets a set value, due to the uncertainty of future benefits.

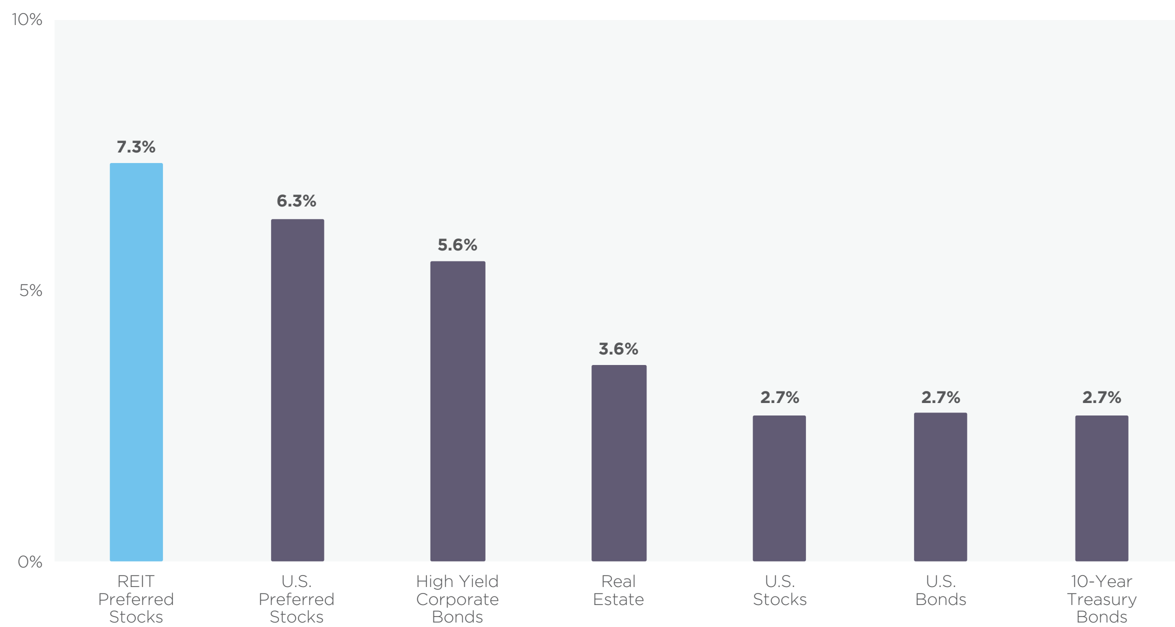
- **Dividend Prioritization:** REIT preferreds provide investors certain benefits regarding dividends. Preferred stocks have a higher claim on a company's assets and earnings than common stocks and typically provide higher yield. Due to their position in the capital structure, a preferred stock's dividend is more protected than a common-stock dividend. In the event of a dividend interruption, the payment of dividends to common stockholders is halted until all cumulatively-owed dividends are paid to preferred stockholders.

1 Relatively High Risk-Adjusted Yields

As of December 31, 2018, REIT preferreds yield stood at 7.3%, well above other major asset classes as shown in Figure 1 below.

Figure 1. **Annual Yield for Fixed Income and Preferred Securities**

As of December 31, 2018



Source: Bloomberg Markets.

Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits, or avoid losses. The referenced indices are shown for general market comparisons and are not meant to represent any particular investment. An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented.

INDICES: **Corporate Bonds (High-Yield Bonds):** Bloomberg Barclays U.S. Corporate High Yield Total Return Index; **Real Estate:** Dow Jones Real Estate Index; **REIT Preferred Stocks:** FTSE NAREIT Preferred Stock Index; **U.S. Bonds:** Barclays U.S. Aggregate Bond Index; **U.S. Preferred Stocks (Preferred):** S&P Preferred Stock Total Return Index; **U.S. Stocks:** S&P 500 Total Return Index.

2 A New Tax Benefit for 2019

The passage of the Tax Cuts and Jobs Act legislation in late 2017 now enables investors to exclude 20% of REIT preferred dividend income from taxation (Figure 2). Any advantages driven by this new tax legislation further enhances after-tax income for already significant REIT preferred stock yields, as shown in Figure 1.

Figure 2. **U.S. Tax Treatment of REIT Preferred Stock**

Old Tax Code versus New Tax Code

		Old Tax Code	New Tax Code
A.	**Hypothetical REIT Preferred Dividend Income**	$100	$100
B.	**Less 20% Pass-Through Income Deduction**	N/A	($20)
C.	**Taxable Income**	$100	$80
D.	**Highest Marginal Federal Rate**	39.6%	37.0%
E.	**Tax** (C x D)	$39.60	$29.60
F.	**REIT Preferred Dividend income Tax Rate** (E ÷ A)	39.6%	29.6%
	Tax Savings		**25% less tax**

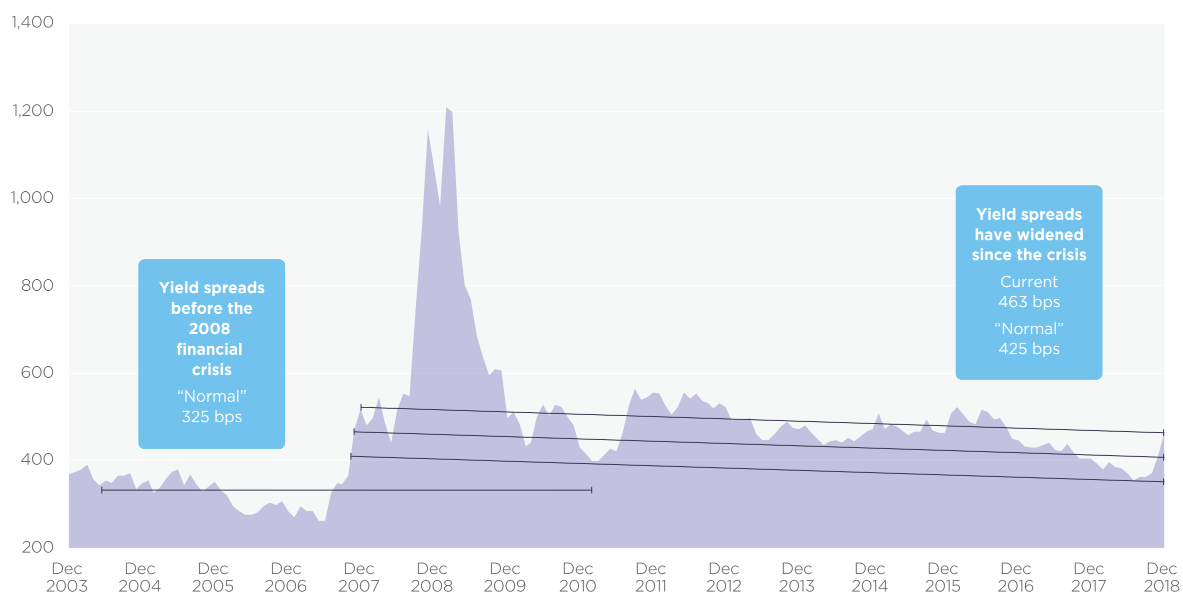
Source: "Hybrid and Preferred Securities REIT Index: Historical File" (Wells Fargo Securities, 2019).

3 REIT Preferreds Appear Undervalued with Price-Appreciation Potential

The yield spread between REIT preferreds and 10-Year Treasuries widened significantly in late 2018 (Figure 3). We expect the long-term historical trend to resume, and for spreads to narrow in the current interest rate environment. In addition to yield-related factors, the NAREIT REIT Index is trading at an 11% discount to net asset value (NAV), as of December 31, 2018. In fact, more than 85% of all market-tracked REITs were trading at a discount to NAV as of 2018 year-end. Between yield and NAV, we believe REIT preferreds currently offer investors value.

Figure 3. **REIT Preferreds Yield Spread to U.S. 10-Year Treasury**

Trailing 15 Years | December 31, 2003 – December 31, 2018



Source: "Hybrid and Preferred Securities REIT Index: Historical File" (Wells Fargo Securities, 2019). Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits, or avoid losses.

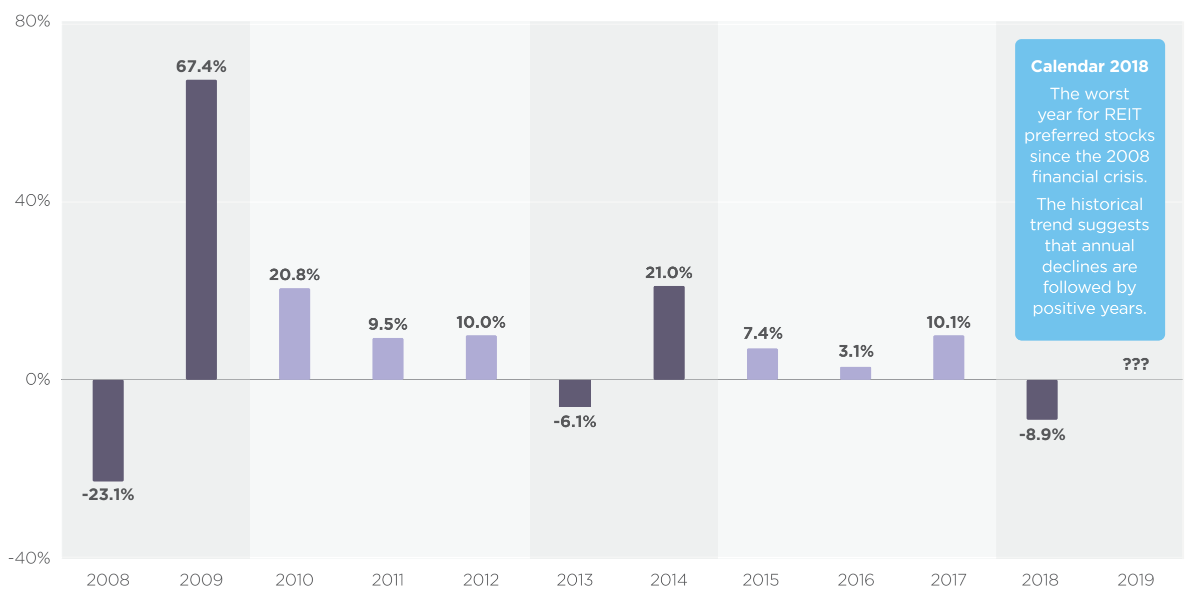
INDEX: REIT Preferreds (TFNPSI).

Additionally, annual declines in REIT preferreds have been followed by significantly positive years (Figure 4).

In 2018, REIT preferreds logged their worst year since the financial crisis of 2008. With REIT preferreds yielding more than 7.0% per year, any stock price appreciation whatsoever will increase the potential for a double-digit return on a total-return basis. Total return is calculated by adding the percentage increase in stock price plus the annual yield of the preferred stock. In an environment with low return expectations for stocks and bonds, the potential for a double-digit return, in our opinion, is worth noting.

Figure 4. **FTSE NAREIT Preferred Index (TFNPSI)**

Total Return Since Inception | December 31, 2007 – December 31, 2018



Source: "FTSE NAREIT Preferred Index Total Annual Returns" (FTSE Russell, 2019). Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits, or avoid losses.

INDEX: REIT Preferreds (TFNPSI).

4 Fed Policy, Economic Forecasts, and Industry Conditions are Creating Tailwinds

Three factors, in our opinion, should create positive momentum for REIT preferreds in 2019:

- **Federal Reserve Policy:** The Fed has signaled to the market that they are unlikely to raise interest rates further in 2019 and are pursuing an accommodative approach. This stance creates stability for fixed-income products like REIT preferreds.

- **Economic:** For 2019, GDP is forecast to grow 2%–3% with jobs numbers remaining strong. These conditions typically create demand for real estate.

- **Industry:** REITs are forecast to grow funds from operations (FFO) 4% in 2019, positioning them for continued expansion and growth.

In Conclusion

REIT preferred stocks have the potential to provide investors with relatively high current income and are a strong alternative to investing in traditional fixed-income securities. REIT preferred stocks currently offer investors more than 7.0% yield, are secured by tangible assets, provide the potential for price appreciation, and offer certain tax advantages, regarding dividends. We believe investors would be wise to consider these securities with the current yields offered by U.S. Treasury and other fixed-income securities.

About Burland B. East III, CFA
Chief Executive Officer, American Assets Capital Advisers (AACA)

Thirty years of experience on Wall Street as a Managing Director and as a NASD Broker-Dealer member-owner. Raised approximately $15 billion in capital (mostly equity) from sophisticated investors globally in 142 large-scale real estate transactions including 26 IPOs, 40 follow-on offerings, and 19 private equity transactions as well as numerous converts, preferred stocks, bond offerings, tenders, mergers, strategic advisory assignments, and mezzanine debt placements.

Burl serves on the Board of Advisors of Comunidad Realty Partners, a dynamic real estate investment firm specializing in multifamily apartment communities in densely-populated Hispanic neighborhoods. Previously, Burl served on the Leadership Council at USC's Lusk Center for Real Estate and the Board of Directors of Excel Trust, Inc., a NYSE listed equity REIT. Prior Board Associate for NAREIT. Burl spoke at over 250 large real estate industry events in the U.S., Europe, and Asia and chaired events like NAREIT's Annual Convention. Mr. East has been interviewed in the financial press and on TV dozens of times and authored numerous articles for major publications like *Barron's*.

Other significant investment experience includes: Dow Jones/Realty Stock Review Outstanding Sell Side Analyst, Honorable Mention, 1996, 1997, and 1998; Lectured at USC Marshall School of Business, Northwestern University, University of San Diego, and University of Wisconsin. Has authored approximately 20,000 pages of widely distributed research; MBA from Loyola University, Baltimore, MD; Chartered Financial Analyst (CFA); Series 24: General Securities Principal; Series 27: Financial Operations Principal; Series 7: Registered Representative; and Series 63: State Blue Sky. (The foregoing are currently in inactive status).

American Assets Capital Advisers

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Neither Artivest nor Altegris is affiliated with AACA.

Sources

1. Board of Governors of the Federal Reserve System (U.S.), "10-Year Treasury Constant Maturity Rate [WGS10YR]" (Federal Reserve Bank of St. Louis, February 19, 2019).

RISKS AND OTHER IMPORTANT CONSIDERATIONS

INDEX DESCRIPTIONS

The following indices are for informational and illustrative purposes only. It is not possible to invest directly in any index or benchmark. Indices and benchmarks do not reflect commissions or fees that might be charged to a similar investment product if actually acquired. Such commissions or fees are likely to materially affect the performance data presented by an index or benchmark.

Barclays U.S. Aggregate Bond Index. The Barclays Capital U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. These specific indices include the Government/Credit Index, Government Index, Treasury Index, Agency Index, and Credit Index.

Dow Jones U.S. Real Estate Total Return (TR) Index. The total return version of the Dow Jones U.S. Real Estate Index, which is calculated with gross dividends reinvested. The base date for the index is December 31, 1991, with a base value of 100.

Dow Jones U.S. Real Estate Index (IYR). Total return version of the Dow Jones U.S. Real Estate Index, and is calculated with gross dividends reinvested. The base date for the index is December 31, 1991 with a base value of 100.

FTSE NAREIT All REITs Index. The FTSE NAREIT All REITs Index is a free-float adjusted market-capitalization weighted index that includes all tax qualified REITs listed on the NYSE, AMEX, and NASDAQ National Market. The base date of index is December 31, 1999, with the base value of 100.

High Yield Corporate Bond ETF (HYG). The iShares IBoxx $ High Yield Corporate Bond ETF seeks to track the investment results of an index compose of U.S. dollar-denominated, high yield corporate bonds.

S&P 500 Total Return (TR) Index. The total return version of S&P 500 Index. The S&P 500 Index is unmanaged and is generally representative of certain portions of the U.S. equity markets. For the S&P 500 Total Return Index, dividends are reinvested on a daily basis and the base date for the index is January 4, 1988. All regular cash dividends are assumed to be reinvested in the S&P 500 Index on the ex-date. Special cash dividends trigger a price adjustment in the price return index.

S&P 500 Trust ETF (SPY). The ETF seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500® Index. The S&P 500 Index is a diversified large cap U.S. index that holds companies across all eleven GICS sectors.

U.S. Preferred Stock Index ETF (PFF). The iShares Preferred and Income Securities ETF seeks to track the investment results of an index composed of U.S.-dollar-denominated preferred and hybrid securities.

GLOSSARY

The definitions below are for informational purposes only.

Funds from Operations (FFO). A measure of cash generated by a REIT and a primary operating performance benchmark for the industry. The FFO-per-share ratio should be used in lieu of earnings per share when evaluating REITs. James Chen, “Funds from Operations” (Investopedia.com, March 19, 2018.)

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