

The Pros and Cons of Real Estate Investment Trusts



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The number of investment mechanisms available to companies and individuals vast, with trusts that encompass anything from traditional stocks and bonds to things like real estate and mortgages. This can represent a pretty big headache for those consumers who are just beginning to invest their money and simply are not sure where they should start, or which products they should engage in. One of the most common forms of investment undertaken by many of today's consumers is real estate investment trusts. These trusts allow people to invest in a pool of real estate assets or even mortgages, hitching their money's fate to the fate of the local or even national real estate market.

The obvious gains to be made from real estate investment trusts are pretty clear. As the real estate market goes up, which historically it has done for at least the past sixty years, the value of a portfolio increases dramatically. Recent economic turmoil, though, has shown that real estate downturns can be severe and prolonged, sometimes without very much hope that they will return to pre-downturn levels. While it's a rare event, it does happen and it can have a significantly negative impact on a consumer's financial position and their net worth.

Before engaging in real estate investment trusts as a solid investment tool, consumers should familiarize themselves with the definition and inner workings of these investment products. Furthermore, they should understand the pros and cons of real estate investment trusts and how each aspect

might promote or disadvantage their overall net worth. With a clear picture of what this key investment tool offers, it will be far easier to determine whether or not it's a good strategy to boost net worth, savings, retirement plans, and more.

Real Estate Investment Trusts: What Are They?

The best way to think about real estate investment trusts is to consider them a property-based type of mutual fund. A group of investors seek out properties or companies, or even mortgages, which they think will benefit them financially in the long run. This is generally based on the performance of a local market, a developer, or a set of mortgages in a given sector of the economy. Those assets that are pooled together as an investment in real estate are then tied together and linked to the value of the investments.

As property values or mortgage values increase, the real estate investment trust's worth increases in proportion. That's how people make their money from real estate investments. If the market goes through a downturn, of course, the value of the portfolio decreases and consumers may be forced to take a pretty steep cut to their retirement accounts or overall net worth.

Because real estate itself is quite a large and diverse industry, there are two main types of real estate investment trusts that most investors use when looking to hitch their fortunes to the building of commercial or

residential properties nationwide. These two types are significantly different in terms of how they derive their worth, largely because they depend on things that are either physical or theoretical in nature.

The Property-Backed Real Estate Investment Trust

Easily the most common of the real estate investment trusts available to typical consumers, proper-backed investment trusts are tied to specific properties or real estate markets around the country. This allows the financial fortunes of consumers to be tied to things like local property valuations in a given area, as well as things like completed sales and other transactions.

The trust itself constitutes a corporation, and that corporation invests in properties by buying them outright. Understanding this aspect of real estate investment trusts is a key way to understand exactly why the investment can be so risky. In 2007, for example, property values in the United States and in many Western countries dropped significantly. In the six years since the economic collapse that resulted from decreasing property values, many have not returned to their highest value. Real estate investment products nationwide have taken a major hit, though consumers new to the product can benefit from this factor.

The Mortgage-Backed Real Estate Investment Trust

The mortgage-backed real estate investment

trusts nationwide are a bit more controversial and hard to understand than the ones that are based largely on the value of individual properties or markets across the country. Instead of being tied to a property's value or a market's performance, the mortgage-backed option available to consumers and other investors relies on complex calculations that relate to the mortgage itself. While this offers a superior way to make money, it also poses the biggest risk to individual investors if the mortgages invested in fail to perform.

The mortgage-backed real estate investment trust product involves a corporation that will originate, underwrite, or purchase mortgages. When these corporations purchase mortgages, they're often heavily leveraged in order to make investors a significant amount of money. The value of a consumer's financial portfolio when they invest in mortgage-backed options is determined as the difference between the mortgage's short-term interest rate at the time of lending and the long-term interest rates that property owners are actually paying on the mortgage. Often, the difference between these rates is a significant percentage. It's enough to make investors a large amount of cash in a short amount of time.

The problem, of course, comes from things like unpaid mortgages, foreclosures, and other products that will invalidate the value of the mortgage completely. When that happens, the value of a portfolio can plummet quickly, leaving consumers with a

significant loss in assets, net worth, and retirement savings. For this reason, consumers should proceed with caution.

The Pros and Cons: What to Know About Real Estate Investment Trusts

With the two type of real estate investment trusts understood, consumers may now feel that the product offers them a great way to gamble and win with a larger net worth. That might be true in many cases, but it's worth understanding the unique benefits and disadvantages of each product. Before consulting with a financial advisor and consenting to a real estate investment trust as a central part of any portfolio, understand the pros and cons that relate to these crucial investment items.

PRO: Yearly Dividends Mean Quick Access to Investment-Based Earnings

For those consumers who have a so-called "instant gratification complex," it might be worth considering real estate investment trusts as a central item in any financial portfolio. One of the key federal financial regulations concerning this type of investment states that a full 90 percent of all of the profits earned by a real estate investment trust must be paid out to investor in the form of dividends. This is essentially guaranteed income during every year when the trust performs at, or above, expectations.

It's worth noting that financial regulations passed in the United States only set a minimum for the amount of profit that they

can pay out in the form of dividends. Consumers definitely will not earn less than 90 percent no matter what. Investment companies, though, must compete for consumers and they may offer dividend payout rates that are a bit higher than the 90 percent threshold. These rates differ in most cases by tenths of a percentage point but, when a consumer is significantly invested in real estates or mortgage-backed options, that can make a very large difference in the size and scope of the payout.

Rest assured that 90 percent of all profits earned from real estate investment trusts will land in a bank account at the end of the year. This is not a high-profit, low-return mechanism for financial advisors and investment banks, generally speaking.

CON: High Dividend Payouts Virtually Force Investment Arms to Take on Debt

While most consumers will be heartened to hear that a full 90 percent of their profits will be paid out as a dividend at the end of each calendar year, they need to consider how that is made possible. Most investment firms know that real estate investment trusts are a low-return, low-profit product on their side of the equation. Because they must find a way to make profits, even when they're selling real estate investments, those investment companies are generally more willing to take on risky debt in order to cover their financial needs.

The best example of how this can severely impact investment banks can be found in the

most recent economic crisis. Many companies were looking to cover their losses on real estate investment trusts with mortgage-backed securities and other shady, debt-related financial instruments that caused a financial crisis and panic. As a result, institutions folded and consumers were left with FDIC-insured leftovers. That threat was big then, and it will remain big when a large dividend payout is regulated by the government. Of course, most investors know that high risks can lead to high rewards, and so this might already be factored into their overall investment strategy. Do understand that a significant risk is represented by this behavior, however, before making any real estate investments.

PRO: Real Estate Investment Trusts Represent a Path to Diversification

For some reason, "investing" and "the stock market" seem to be intrinsically linked in many consumers' minds. The problem, of course, is that a failure to diversify any investment portfolio can lead to major losses whenever the stock market has a bad day or investors get a bit more bearish. That is a significant problem, but it's one that can easily be overcome by investing in real estate investment trusts. These trusts are generally not linked to the performance of the stock market or the value of individual

stocks, and that makes them more resilient in many cases.

Consumers absolutely must diversify their portfolio if they hope to have a sound investing strategy. Certainly, any financial advisor will emphasize this requirement over virtually everything else. When it comes to a solid performer that isn't likely to fluctuate nearly as much as the stock market's indexes, there are few options better than property-backed or mortgage-backed real estate investment trusts.

CON: Tax Inefficiencies Arise from High Dividend Rate

Once again, the 90 percent dividend payout rate associated with real estate investment trusts takes center stage. This is a complex matter, and one that should generally benefit investors. Even so, the simple fact of the matter is that high returns are highly taxed by the federal government. Those high taxes can mitigate many of the advantages associated with a high dividend payout at the end of each year.

Smart consumers will use their payout as a way to fund a tax-sheltered retirement account, like the Roth IRA and other products currently on the market. That's a great way to avoid paying a significantly higher tax rate, but it's not a foolproof way

Service. Indeed, those investors with a small retirement account and a large number of real estate investment trusts will find themselves immune from the benefits of tax shelters like retirement accounts and other products on the market.

When investing in a real estate trust, do be sure to pay attention to the government's tax rates and policies. Understand how money can be moved around to shield it from needlessly high tax rates, if that can happen at all. The approach is perfectly legal, and encouraged by most accountants and financial advisors, but it's just not available to every investor with property or mortgages in a portfolio.

PRO: In Many Minds, There is Nowhere to Go But Up

The economic downturn that began in 2007 was largely driven by a combination of collapsing home prices, rising mortgage interest rates, and stagnating consumer wages. Since the beginning of that economic collapse, American and world economies have struggled to return to strong annual growth. Property, though, has actually made a stronger recovery in the United States than many other economic indicators. In investment terms, that means that property investments are outperforming virtually all

The turn began in early 2010, when the first signs appeared that the real estate industry was improving in the United States. In the two full years that have followed, property values nationwide have gradually eased upward. Mortgages have become more stable, and sounder to invest in. No matter the indicator, real estate investment trusts have continued to outperform over the course of the past 22 to 24 months. This is largely due to the fact that property hit unimaginable lows just five or six years ago, and most people feel that property values and mortgage leverage are both destined to go up at this point. The downward trend in property, real estate, and mortgage-backed options, seems to be firmly in the past.

CON: Interest Rates Will Be Tied to Profits, in a Bad Way

One of the unique quirks associated with real estate investment trusts is that rising interest rates can actually reduce their overall profitability. This is especially true with those real estate investment trusts that use mortgage-backed options to determine the value of a portfolio. When the government raises interest rates, the prime rate gets closer to the rate that a homeowner is paying on their mortgage. Since the value of a real estate trust is calculated by

assessing the difference between these two rates, it's easy to see why annual profits fall as annual percentage rates rise.

Higher interest rates can also impact the property market in a real way, leading to a bit more hesitation when buying and affecting the value of most properties. Stagnation may reduce profits, and slower increases will lead to a lesser annual dividend than would be expected under lower interest rates. For those consumers highly invested in a real estate investment trusts, rising interest rates indicate a good time to sell, shift gears, or consider other products. Otherwise, they represent a good time to hold and wait. In the worst cases, they can reverse the value of a trust in a significant way over time.

PRO: Trusts are a Better Way to Invest than Buying Real Estate

Most consumers who are new to real estate investment trusts are confused as to why they would purchase a stake in a trust instead of simply purchasing an investment property close to their own home. Both are good strategies for investing money, but real estate investment trusts are actually a far superior way to make long-term profits without the hassle associated with buying and selling physical properties.

Consumers who buy actual properties near their home only make money when that property sells at a profit. That typically involves a significant investment of cash in a mortgage, as well as in home repairs and renovations. Then, consumers must wait for the property to sell. In today's market, that process can take months or even years. That's no way to make money, and it's not a guaranteed way to increase net worth. Real estate investment trusts and other property-backed tools offer one word that makes them superior: liquidize.

Instead of buying and selling property on their own, consumers can allow an investment corporation to liquidize properties on their behalf. This is how the value of their trust is determined throughout their time with the product. There are no up-front costs, no buy-and-sell hassles, and no headaches from reduced property values. Consumers who engage in trusts actually reduce their overall exposure to the market's fluctuations in a real way, and it all results from not having to liquidize on their own.

CON: On the Other Hand...

One of the strongest reasons for consumers to buy investment properties on their own comes from another one-word answer: control. When consumers invest in a real estate investment trust, they're ceding all

control over the purchase and sale of properties to the investment corporation that represents their investment and their best interest. Usually, that's not a deal-breaker. Some corporations, though, are keen on making particularly bad decisions and even worse bets. Without control over the properties that are bought and sold, consumers are at the whim of the company representing them.

Real estate trusts might not be for consumers who are astute about local property values and areas of opportunity. Those people would be far better served by managing their own purchases and sales, as this would likely allow them some measure of inner peace, long-term wealth-building and fiscal sanity. It's a crucial decision, and one that will probably be aided by the advice and counseling of a skilled accountant, financial advisor, or financial planning representative.

PRO: No Research, No Action, Just Profits

Consumers who do want to buy their own properties and sell them must, as mentioned earlier, be quite astute about the local market. Those consumers who aren't as well-versed in local properties will have to take the time to familiarize themselves with the local landscape, as well as with the rules and unique tax situations surrounding property investments made outside of a real estate investment trust. This represents a significant amount of time and, as the saying goes, time is money.

Real estate investment trusts require no such research from their investors. Instead, they allow investors to sit back while highly skilled individuals buy and sell properties or mortgages on their behalf. The details are taken care of behind the scenes, while investors can enjoy their regular profits and yearly dividends without spending a significant amount of time researching the pros and cons of each home or commercial property local to their own home.

Risks, Rewards, and a Great Financial Instrument for Consumers

Though words like "mortgage-backed" and "real estate investment" have been made to sound dirty over the past half-decade or so, real estate investment trusts actually offer great financial benefits to consumers. In fact, their unique nature makes them a great option for virtually all people looking to earn high dividends, dramatically improve their net worth, and even contribute a significant amount to retirement accounts. As always, consumers should make sure to consult with a professional before investing in real estate investment trusts and every product in order to protect themselves from the potential perils of investing.

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