In the current investment landscape, investment portfolios that are limited to standard exposures of popular asset classes may fall short in providing the diversification and returns required for most investors to help meet their long-term goals. As a result, TDAM continues to stress the importance of thinking outside of the traditional fixed income and equity box to access a greater variety of exposures and factors in order to improve the risk and return profile of investment portfolios.

One way of accomplishing this is by adding REITs to a portfolio. REITs can provide a number of strategic benefits to investors over a full market cycle including increased diversification, strong income generation and inflation protection.
What is a REIT?

A REIT is a professionally managed company that owns income-producing real estate across a range of property types including commercial, industrial and residential. Most REITs consist of a pool of dozens, or even hundreds, of properties which are all bundled together and offered as a single security in the form of “unit investment trust”.

REITs come in both public and private forms. Public REITs trade on the major stock exchanges worldwide like traditional equity stocks and, as a result, provide investors a liquid opportunity to invest in the real estate sector. Private REITs do not trade on an exchange, are typically only offered to accredited investors and, as a result, are illiquid. For the purpose of this paper we will be focusing solely on public REITs.

What types of properties do REITs invest in?

REITs invest in a wide array of property types and sectors. The most popular and well known of these would include office buildings, apartments, shopping malls and hotels. However, certain REITs also operate in some less well-known sectors such as timberland, data centers and even outdoor advertising sites. Most REITs will focus on a specific property type or sector where they have a certain expertise or knowhow.

For example, Simon Properties Group in the United States is solely focused on ownership and management of retail real estate such as large malls and shopping centers. Nevertheless, there are some large REITs which hold several property types and are diversified across several sectors and these REITs are classified as “Diversified REITs”.

How REITs generate revenue

There are many types of REITs in the investable universe with various drivers of real-estate related revenue, but typically, the business model of REITs is relatively straightforward and easy to understand: REITs will own a portfolio of real estate properties, will lease those properties to tenants and those tenants will pay rent to the REIT.

The income generated by the REIT will be, in most cases, classified as rental income and will make up the largest source of revenue for the company. REITs also make money from property management, appreciation of their properties value and, in some less known cases, from operations that relate to the underlying property such as Tower REITs earning revenue from leasing out the usage of their tower properties to major wireless carriers.

Investor benefits

Over the last 2 decades, REITs have grown to become a desirable addition to investment portfolios due to several benefits:

Stable Dividends

For a company to be classified as a REIT, they must distribute a significant portion of their taxable income to their shareholders. If a REIT is successful in generating stable and reliable cash flows from their underlying properties (generally in the form of rent), the REIT is legally bound to distribute a large majority of this income in the form of dividends to shareholders. This has resulted in REITs consistently providing above market dividend yields and stable and predictable income for their investors.

Real Estate vs U.S Equity Dividend Yield Comparison

**Capital appreciation potential**

Real estate has a strong trend of appreciation over time, and as such, REITs have also demonstrated a capacity to achieve capital appreciation over the long term. Capital appreciation in the REIT space is tied to the contracted rental streams generated by the underlying properties. Many of these properties are providing essential services to the broader economy (i.e. - office space, living accommodation, wireless infrastructure etc.) where rental rates often include embedded escalators which are usually tied to the rate of inflation.

As a result, high quality assets that are strategically located in high demand areas with well capitalized tenants will likely see long term capital appreciation tied to an economy’s inflation rate. In addition, property appreciation can also depend on other factors such as location, the physical structure of the property and redevelopment opportunities. Consequently, REITs have several strategies at their disposal to create additional value such as building renovations, property redevelopment and redeployment of capital which make REITs an excellent total return investment and hedge to inflation.

**Property appreciation** can also depend on other factors such as location, the physical structure of the property and redevelopment opportunities.
**Diversification**

REITs offer a unique diversification benefit. Not only do they offer asset class diversification relative to equity and fixed income, but due to the diverse sectors and geographic regions within the REIT industry, they also offer low correlation amongst each other. As REITs trade on the public stock markets, they are subject to the same conditions that can cause stock prices to gain and lose value. However, real estate is a different asset class with different return drivers than traditional stocks. Typically, the underlying returns of REITs will be driven by the income collected from property rents and the real estate market cycle whereas most other companies on the stock market will be driven by the business cycle and corporate profits.

![Yearly Returns | Correlation = 0.49](chart.png)


**Access to Commercial Real Estate**

Lastly, REITs allow everyday investors the ability to invest in commercial real estate assets that would ordinarily be outside their purchasing power. As private commercial real estate can be very expensive investments which require a great deal of time and effort to manage, REITs can provide a liquid and inexpensive alternative whereby ordinary investors can own a slice of large commercial real estate properties and portfolios.

**Real Estate** is a different asset class with different return drivers than traditional stocks.
Performance dynamics

Within the REIT industry itself, performance can vary considerably across the different sectors and property types at different points in time. Economic shocks and changes in human behavior can affect certain property types much more than others given the various idiosyncrasies and characteristics across property types.

If we take the 2020 COVID-19 pandemic as an example, with government mandated shutdowns and citizens forced to work and stay at home, the REIT industry experienced significant divergences in performance across sectors.

The retail and hospitality sectors took the largest hit to performance whereas sectors such as residential apartment buildings, industrial warehousing and cell towers remained quite resilient.

The same can be said in terms of geographical performance of real estate. Therefore, having the ability to be exposed to real estate across geographies and sectors is a very powerful diversification tool for an investor’s portfolio.

REITs provide a liquid and inexpensive alternative whereby ordinary investors can own a slice of large commercial real estate properties and portfolios.

Investing in REITs through Exchange traded funds (ETFs)

With hundreds of different individual REITs to choose from, it can be difficult for investors to narrow down and select the ones that are right for them. Detailed due diligence on single REITs can be burdensome and challenging while performance in the industry can vary widely due to differing management teams and various property sectors.

As a result, REIT ETF’s have become an increasingly popular method for investors to gain exposure to the real estate market, diversify across a large portfolio of REITs and remove single stock REIT risk in one investment ticket.

Passive v Active REIT ETFs - While REITs have many attractive qualities, they are not all made equal. Most REIT ETFs are passively or rules-based managed meaning they are generally simple products that attempt to mirror the returns of an underlying index.

In these funds, little to no active management or investment decisions are made to improve performance or lower volatility relative to the index or benchmark. These passively managed REIT ETFs, while beneficial to certain investors, offer little differentiation from each other and can lead to missed opportunities in the sector.

In recent years, there has been an emergence of "actively managed" ETFs, including REIT ETFs. These funds, in contrast to passively managed ETFs, have dedicated portfolio managers who strive for improved risk-adjusted returns by making independent investment decisions within the portfolio. Generally speaking, these funds have a greater ability to identify and select high quality stocks and, in turn, a greater potential to outperform over a long time period.
Accessing the market with TD Asset Management

In order to strive for the best risk return profile for our investors, it is critical that thorough due diligence and portfolio management be completed by a team that has extensive experience in this space. This is where we believe that the TD Active Global Real Estate Equity ETF (TGRE) is a great tool for investors.

The TGRE ETF, is an actively managed REIT ETF which leverages TDAM’s alternative investment team’s expertise in the real estate space to actively manage a portfolio of between 40-70 public REITs. Our portfolio managers employ a rigorous three-step investment process that utilizes quantitative screens, qualitative analysis, and, most uniquely, team-based decision making to select the highest quality names in the space.

In contrast to other passively managed mandates, our approach is designed to outperform our benchmark (MSCI World Real Estate Index CAD) over the long term while ensuring we focus on delivering a total return for clients, where they receive consistent income combined with capital appreciation potential.