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REITs Hold Their Own Vs. Bonds

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REIT stocks continue to exhibit strength, even as the yield on 10-year Treasury note this week hit the highest level since June 2004.

REITs are often viewed as an investment alternative to bonds because of their healthy dividend yields. So far this year, the MSCI US REIT Index is up nearly 12% on a total return basis. At the same time, the yield 10-year note has been rising, hitting 4.78% Friday, up from roughly 4.4% at the start of the year.

Meanwhile, the average dividend yield for all equity REITs is 4.2%, according to NAREIT, unchanged from the start of the year. Premium REITs have even lower yields.
For example, **Federal Realty Investment Trust** (FRT:NYSE - news - research - Cramer's Take), which owns high-end shopping centers mostly in the Northeast and California, has a dividend yield of 3.1%. Investors like the company's internal growth story, which is driven by redevelopment and boosting rents within its portfolio. "We're not dependent on acquisitions and ground-up development," says Federal Realty CEO Don Wood.

In the fourth quarter, Federal Realty achieved a 19% gain in same-store rents on a cash basis -- one of the highest growth stories in the industry. As a result, the REIT trades at 21.5 times projected 2006 funds from operations.

Besides strong rental growth, part of the reason for REITs' overall strength is the continued strong pricing for private-market property sales in all commercial real estate sectors. Accordingly, price-to-earnings multiples have gotten richer for REITs.

"This whole thing about where multiples are at today has to do with the fact that we've seen a shift with the way real estate has been priced," says Kelly Rush, a director and portfolio manager for the Principal Real Estate Fund. In the last two years, most notably, cap rates, or initial rates of returns on property purchases, "have dropped significantly lower than most of us have ever seen," he says.

"If a dollar of cash flow is really worth more (today) ... then multiples have to go up significantly as well," Rush says. The real question remains, however: "Is real estate repricing going to be temporary or is it going to stick?"

The other reason REITs continue to perform well is that long-term interest rates, though rising, are still low historically. Many also believe long-term rates will not shoot up dramatically this year.

"If I'm wrong and if rates go up say another 50 to 75 basis points, I think it's very adverse for REITs," Rush says.

But until then, look for the REIT train to continue rolling.

"Look at the last 12 years," says Wood. "It's incredible to me what is happening in terms of the maturation of our business ... The public investment community in terms of REITs is broadening significantly."