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REITs in the S&P 500: What it Means for Investors

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September 2016 will mark a major change for both the Standard & Poor's 500 and the MSCI Indices, as both will create a new asset category for REITs instead of lumping them in with financial stocks. This new category represents a major step into the limelight for REITs and will likely result in an influx of new money into them.

REITs have been growing in popularity for several years, and their spinoff into a separate sector in the index shows how far they have come since the subprime mortgage meltdown in 2008. But what does this new sector in the index really mean for investors? (For further reading, see: *REITs: Still a Viable Investment?*)

REITs 101

Real estate investment trusts (REITs) are stocks that invest in residential, commercial and industrial real estate holdings. They are required to pass through at least 90% of the income that they generate to investors, which has made them attractive instruments for yield-hungry customers looking for a better return on their money than what they can find in the bond markets. They are not likely to be hit as hard as bonds when rates start to rise, because many of their operating costs are already fixed and their prices are not likely to take as hard a fall when bond prices start to drop.

REITs have also provided a measure of diversification from the stock market, which has made them popular alternatives for equity investors who are looking to diversify their portfolios, reap higher yields and still enjoy capital appreciation over the long run. But the primary buyers of REITs are still investors seeking higher yields.

"The base of buyers for these types of assets is different than the one for sectors that are primarily seen as capital appreciation plays," said Savita Subramanian, the head equity and quant strategist at Merrill Lynch, to *Financial Advisor IQ*. And while she conceded that REITs may see a temporary surge in popularity, "over the longer term our sense is that they'll remain fairly underweighted in the average portfolio and won't morph into much tighter stock market correlations." (For related reading, see: *How to Assess a REIT.*)

Gina Beall, the lead investment analyst at Savant Capital Management, says that the non-correlative aspect of REITs has steadily declined over the past decade. She agrees that REITs will most likely see a surge of new money from the indices this fall, but that they will most likely not exceed their 3% weighting by much. She told *Financial Advisor IQ* that “REIT correlations have risen enough to dilute much of their attractiveness to us—particularly in relation to the growth in the number of alternative funds coming to market with relatively low correlations.”

Many advisors who likewise see REITs as a subsector of equities rather than an alternative asset class are talking to their clients about these instruments as an aggressive stock holding rather than a high-yield play. Jim Holtzman of Legend Financial Advisers told *Financial Advisor IQ* that “We do hold REITs, but we’re careful to make sure our clients see them not so much as a diversifier as much as a tactical stock play on the edge of their current portfolios. We’re willing to give our clients exposure to real estate stocks. But we’re not willing to make any big market bets with these types of sector-specific funds." His firm only recommends that clients allocate anywhere from 5 to 7.5% of their assets to this sector.

The Bottom Line

REITs come with their own set of risks and rewards, but most advisors and analysts do not look to them for a major source of diversification from stocks. (For further reading, see: *5 Types of REITs and How to Invest in Them.*)