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New Real Estate Sector Puts Equity REITs in the Spotlight

Breaking real estate out of the Financials sector acknowledges that the industry's business models and ties to underlying property markets produce a distinctive risk-return profile, including a relatively low correlation to the rest of the stock market.

S&P Dow Jones Indices and MSCI recently moved publicly traded equity real estate investment trusts (REITs) and other listed real estate companies from the Financials sector into a new, separate Real Estate sector effective September 1, 2016. (Mortgage REITs remain in the Financials sector, along with banks and insurance companies.) There are now 11 headline sectors instead of 10. It's the first time a new sector has been added to the Global Industry Classification Standard (GICS®) since it was created in 1999.[1]

The move has implications for investors, because S&P and MSCI indexes are common benchmarks for investment performance, and the GICS is often used as a framework for portfolio construction. By some estimates, fund managers could shift as much as $100 billion to the Real Estate sector in a collective effort to follow the market weightings of various indexes.[2]

The change could also affect the asset allocation decisions of some individual investors by drawing more attention to equity REITs as income-generating assets with the potential for capital appreciation.

Fixed-income appeal

An equity REIT is a company that combines capital from investors to buy and manage income properties such as apartments, shopping centers, hotels, medical facilities, offices, self-storage units, and industrial buildings. Publicly traded REIT shares can generally be bought or sold on an exchange at a moment's notice, making them more liquid than physical real estate investments, which involve transactions that can take months to complete.

Many REITs generate a reliable income stream regardless of share price performance, primarily because they are required by law to pay out 90% of their taxable incomes as dividends to stakeholders. In the second quarter of 2016, the S&P REIT index had a dividend yield of 3.73%.[3] *The performance of an unmanaged index is not indicative of the performance of any specific security. Individuals cannot invest directly in an index.*

REIT share prices can be sensitive to interest rates. As rates rise, steady dividends may appear less attractive to investors relative to the safety of bonds offering similar yields. On the other hand, current fundamentals, including modest economic growth, lower unemployment, and rising rents, are generally seen as positive conditions for REITs and other real estate businesses.

Diversification tool

Breaking real estate out of the Financials sector acknowledges that the industry's business models and ties to underlying property markets produce a distinctive risk-return profile, including a relatively low correlation to the rest of the stock market.[4] Because the share prices of equity REITs don't rise and fall in lockstep with the broader stock market, including them in your portfolio could help reduce the overall level of risk.

The return and principal value of all stocks, including REITs, fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Diversification and asset allocation do not guarantee a profit or protect against investment loss; they are methods used to help manage investment risk.

REIT distributions are taxable to the extent they include any ordinary income and capital gains. Some REITs may not qualify as a REIT as defined in the tax code, which could affect operations and negatively impact the ability to make distributions.

There are inherent risks associated with real estate investments that could have an adverse effect on financial performance. Such risks may include a deterioration in the economy or local real estate conditions; tenant defaults; property mismanagement; and changes in operating expenses (including insurance costs, energy prices, real estate taxes, and the cost of compliance with laws, regulations, and government policies).

1, 3) S&P Dow Jones Indices, 2015-2016

2) *Investor's Business Daily,* March 18, 2016

4) FinancialAdvisor.com, March 1, 2016

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