TURNER INVESTMENTS COMMENTARY

Hon. Garth Turner PC

Senior Vice President,
Private Client Group,
Financial Advisor

416-346-0086

Douglas Rowat

Senior Vice President,
Private Client Group,
Portfolio Manager

416-777-6403

Ryan Lewenza

Senior Vice President,
Private Client Group,
Portfolio Manager

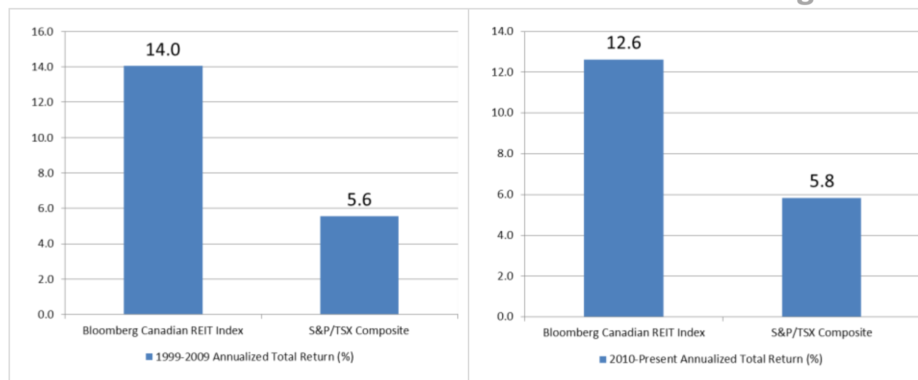
416-777-6416

THE RIGHT KIND OF REAL ESTATE

When investors think of Canadian real estate most picture the overheated, bubblicious Vancouver housing market where selling teardowns on postage-stamp-sized lots continues to provide owners with Trump-like riches. The online game 'Crack Shack or Mansion?' focused on the absurdity of the Westcoast housing market has even become part of our common lexicon. However, there's another highly effective—and far less risky—way for Canadians to get their real estate exposure: real estate investment trusts, or REITs.

REITs are publicly listed 'trusts' where the bulk of the trusts' business is derived from real estate (property development, property management, etc.). The REITs' assets may include apartments, hotels, industrial properties, office buildings, retirement residences and shopping malls. Under the trust structure, REITs are required to return the bulk their income back to unitholders in the form of regular distributions and are therefore primarily purchased as income-generating investments. While REITs have been around since the 1960s in the US, in Canada they are a relatively newer market entrant with Canadian REIT (REF.UN), Canada's oldest REIT, making its debut in 1993. However, the sector has expanded significantly and today there are more than 40 REITs with a combined market value in excess of $70 bln.

Canadian REIT Performance Has Been Outstanding



Source: Bloomberg

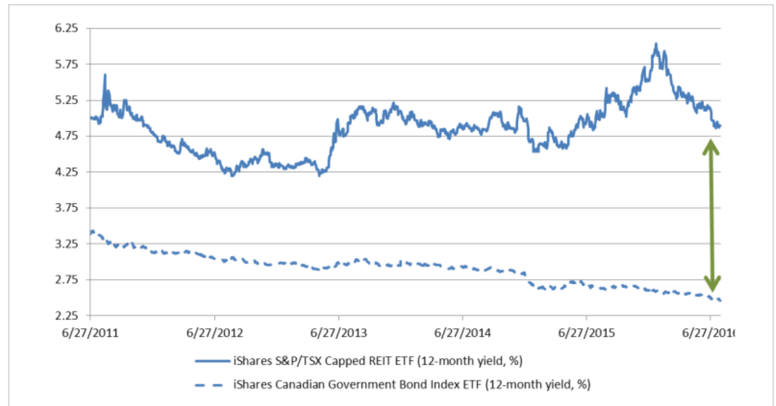
TURNER INVESTMENTS | RAYMOND JAMES®

WHY WE CONTINUE TO FAVOUR REITS

Performance and Yield

Canadian REITs have performed well this year and valuations are certainly less compelling than they were six months ago. However, we believe this is an investment that our clients should stick with. Firstly, REITs are exceptional long-term performers having outperformed the Canadian market substantially for more than 15 years (see charts above). But it's not just the long-term track record that attracts us to REITs, it's the impressive yield that they generate in a world where the Government of Canada 10-year bond yield (1.1%) doesn't even exceed our inflation rate (1.5%). In fact, REITs have maintained an attractive yield spread over federal and provincial bonds in general over the long term (see adjacent chart). Further, the current spread favours REITs as the yield pick-up sits at close to 2.5 percentage points vs. the historical average of about 2.0 percentage points. We think this attractive relative yield will continue to support investor interest. If you're looking for consistent and attractive income, REITs are one of the best games in town.

Yield Spreads Between REITs and Government Bonds Still Attractive

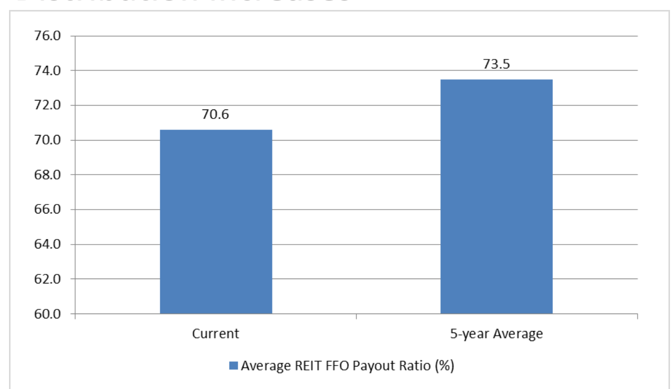


Source: Bloomberg

Distribution Increases

However, beyond their attractive current yields, REITs also consistently raise their distributions. For example, Canadian REIT, mentioned above, has actually increased its distribution every year for 14 consecutive years. The broad-based iShares S&P/TSX Capped REIT Index ETF (XRE-T), which most of our clients hold in their portfolios, has seen its distributions increase almost 4% annually over the past three years, more than double the inflation rate. What drives the growth and consistency of these distribution increases? A variety of factors, but the predictability of the REIT business model is key. For instance, REITs tend to lock tenants into long-term leases (for example, 5–10 year lease terms for shopping centres and even longer 10–15 year lease terms for office properties) which provides predictability of cash flow. REITs, in general, have also very

Low Payout Ratios Suggest Continued Distribution Increases

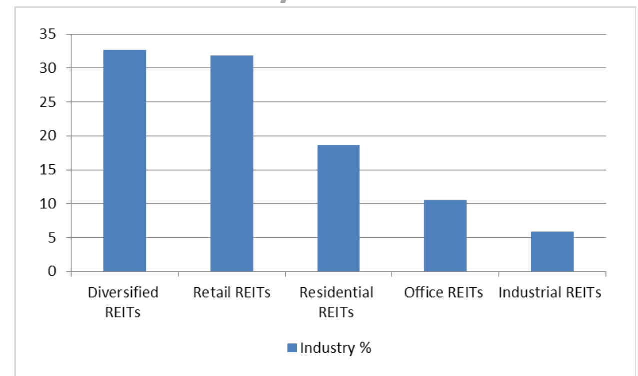


Source: Bloomberg; data adjusted to remove outliers. FFO = funds from operations, a benchmark REIT cash flow measure.

effectively managed their payout ratios—rarely overextending their distributions beyond what their businesses and the economy can handle. The current and historical funds from operations (FFO) payout ratios are above. FFO is the standard cash flow measure applied to the REIT sector. Payout ratios in the 90% range suggest a low likelihood of distribution increases and payout ratios above 100% put a distribution at risk of being cut. However, the average REIT payout ratio currently sits at only 71%, a conservative level and well below the longer-term average.

Diversification

Unlike a house or condo, which concentrates your wealth and assets in only one location and in only one class of real estate (residential), a diversified REIT exchange traded fund like the iShares S&P/TSX Capped REIT Index ETF, allows broad geographic exposure as well as varied exposure to all of the sub-sectors of the real estate market (see adjacent chart). Also, because the Canadian real estate market is not immune to downturns and volatility, we keep our clients' REIT weighting to a relatively modest 5–6% of their portfolio overall. In all likelihood, the house or condo you may own makes up a much more significant portion of your overall net worth, thus creating concentration risk.

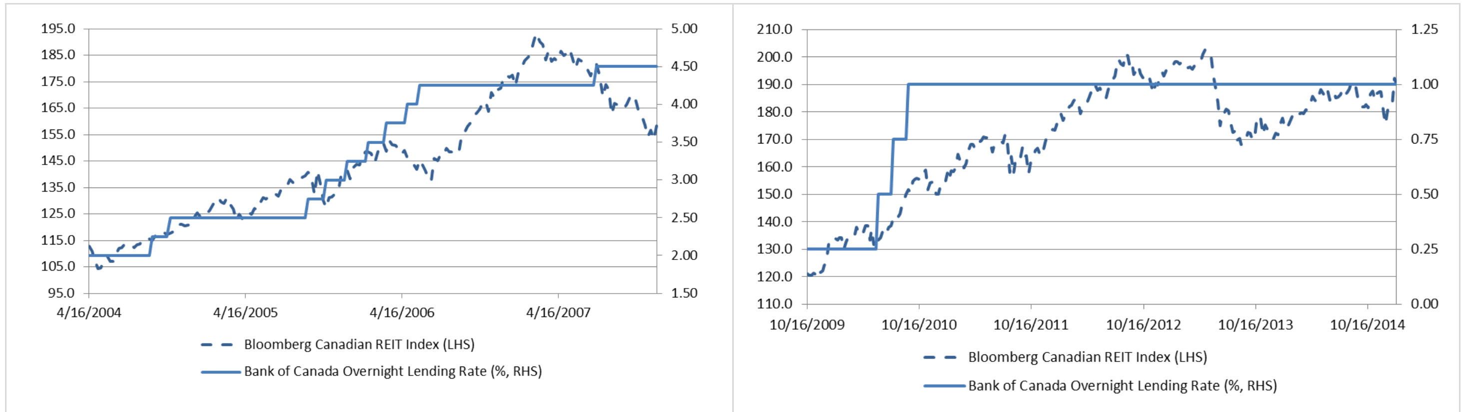


Source: iShares

Interest-Rate Risk Overblown

It stands to reason that there must be a trade-off for all of these positives. And indeed there is: REITs are likely to react unfavourably to rising interest rates. However, we believe that this risk is overblown. In fact, often when the Bank of Canada raises interest rates Canadian REITs perform quite well. Steady rate increases from 2004–2007 and a brief period in 2010, for instance, resulted in no negative impact to the REIT sector (see charts below). In fact, REITs had annualized total returns of 18% and 14%, respectively, during each of these periods (measured from date of first rate increase to date of first rate cut). While we do believe that interest rates are moving higher, we think this move will be gradual and we also highlight that the Bank of Canada will only raise interest rates if it believes the economy is doing well. And a stronger economy is usually positive for the values of fixed assets such as commercial real estate.

Higher Interest Rates Don’t Always Mean REITs Will Suffer

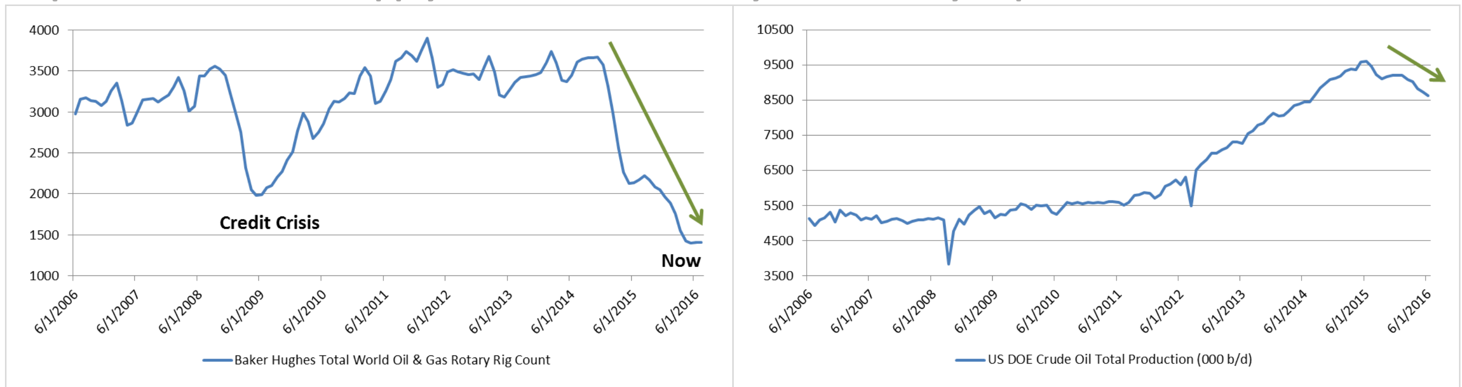


Source: Bloomberg

A Final Bright Spot: An Improving Energy Sector

One of the main current concerns surrounding REITs—and a legitimate one—is the slowdown in the Alberta office market, primarily as a result of the fall in the oil price throughout 2014 and 2015. While the higher-than-normal Alberta vacancy rate may continue to negatively impact REITs, there have been some bright spots for the energy sector. For instance, we’ve finally seen a supply-side response to lower oil prices as US production, a major contributor to the supply glut, has begun to decline and global oil rig counts, a clear indicator of potential future production, have absolutely cratered, sitting at levels well below the credit crisis lows (see charts below). We’re not prepared to say that the oil price is set to rally back to US$100/bbl because OPEC could, as it often has recently, refuse to adjust production quotas to support the oil price. Nevertheless, these supply-side developments are a clear positive for the energy sector and help reduce the concerns overhanging the Canadian REIT space.

Improvements In Oil Supply Fundamentals Likely to Positively Impact REITs



Source: Bloomberg

IF IT AIN'T BROKE

While the REIT rally since the start of year may be unsustainable over the short term, REITs have been extremely profitable long-term investments and we believe that the fundamentals strongly support continued ownership. Investors are stuck in an environment of historically low interest rates where simply beating the rate of inflation can be a challenge. Therefore the opportunity to own an investment offering an attractive ~5% yield with even more upside potential through capital gains should be not be missed. REITs are a part of your portfolio now and will likely continue to be long into the future. When it comes to real estate you can own a diversified REIT exchange traded fund with broad industry and geographic exposure or you can own a 'crack shack' in Vancouver, perhaps the most overheated property market in the world. We think the choice is easy.

TURNER INVESTMENTS OF RAYMOND JAMES LTD.

40 King Street West
Suite 5300, Toronto, Ontario M5H 3Y2
Tel: 416-777-7000 | Fax: 416-777-7020

www.turnerinvestments.ca

TURNER INVESTMENTS | RAYMOND JAMES®

This newsletter has been prepared by Turner Investments, and expresses the opinions of the authors and not necessarily those of Raymond James Ltd. (RJL). Statistics, factual data and other information are from sources RJL believes to be reliable but their accuracy cannot be guaranteed. This newsletter is furnished on the basis and understanding that RJL is to be under no liability whatsoever in respect thereof. It is for information purposes only and is not to be construed as an offer or solicitation for the sale or purchase of securities. RJL and its officers, directors, employees and their families may from time to time invest in the securities discussed in this newsletter. This newsletter is intended for distribution only in those jurisdictions where RJL is registered as a dealer in securities. Any distribution or dissemination of this newsletter in any other jurisdiction is strictly prohibited. Securities-related products and services are offered through Raymond James Ltd., member-Canadian Investor Protection Fund. Insurance products and services are offered through Raymond James Financial Planning Ltd., which is not a member-Canadian Investor Protection Fund.