Income with Real Estate

Understanding Real Estate Investment Trusts (REITs)

AZZAD ASSET MANAGEMENT WHITE PAPER SERIES

INTRODUCTION

Investors in search of manageable income from real estate may want to consider a real estate investment trust, or REIT. A REIT is a company that buys, sells, develops, and manages real estate such as office buildings, apartment complexes, shopping malls, self-storage units, and housing developments. Rather than investing directly in a piece of real estate, REIT investors put their money into a professionally managed portfolio of properties. REITs make money from rental income, services to tenants, and profits from the sale of properties. They also receive special tax considerations: REITs do not have to pay taxes as long as they pay out at least 90% of their net income to their shareholders. Because of this, successful REITs can offer investors high yields, current income, and moderate growth. This paper outlines important considerations for REIT investors.

READ THIS BEFORE YOU BUY PROPERTY

Oftentimes during extreme stock market volatility, investors may start idealizing investing in real estate property. They put a down payment on a property and assume that the association fees, taxes and mortgage payments will be equal to what they could get in rental income. What many investors underestimate are the risks and expenses associated with being landlords.

To evaluate if a property will make a sound investment, consider the following: 1) The expenses you will pay as a landlord. These will include higher interest rates, insurance premiums, taxes and annual maintenance of the property. 2) The time you will need to spend acquiring, maintaining and managing the property. You could always pay someone else to manage the property on your behalf, but that will eat into your investment returns. 3) Successful real estate investing requires a level of expertise and skill necessary to avoid unpleasant surprises like unexpected vacancies or buying property in a bad location.

Enter the real estate investment trust, or REIT.

REITs were created by the U.S. Congress in 1960 to give all Americans, not just property owners, the opportunity to invest in income-producing real estate.

WHY REITS MIGHT BE A GOOD INVESTMENT?

One reason REITs may be right for you relates to **diversification,** or the idea of not putting all your eggs in one basket. REITs are an often overlooked and underexploited asset class for investors. They represent exposure to properties in a variety of geographic areas, not to mention a variety of commercial properties. These can include apartment buildings, storage facilities, shopping centers and other types of equity REITs. Allocating a sizeable portion of assets to a REIT can help improve a portfolio's overall risk-adjusted return.

Next, REITs can provide **current income.** Because REITs are required to pay out 90% of their annual income in the form of dividends, you can expect to receive income from your REIT investment. Of course, be mindful that this is often taxed as ordinary income.

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Azzad's REIT portfolio invests primarily in equity REITs to avoid companies that derive income from interest, as mortgage REITs do. Potential investments are screened according to Azzad's ethical investing guidelines to screen out REITs involved in lines of business that cause societal harm or that have high levels of debt.

Another advantage of investing in REITs is **liquidity.** If you need cash in a hurry, it is much easier to liquidate shares of a publicly traded REIT than it is to sell rental property, office buildings, or other real estate. Because REIT shares are typically traded on major exchanges, it is easier to buy and sell shares than to buy and sell properties in the private market.

Another positive characteristic of all REITs is **professional management.** Once you have purchased shares in a REIT, your investment is in the hands of people who make their living by buying, selling, and managing real estate. You do not have to be an expert real estate trader because trained professionals decide.

Last, but not least, REITs offer access **to new investment opportunities.** Because you are pooling your money with the funds of many other investors, your initial cash outlay is much less than for other types of real estate investments. This makes REIT investing accessible for many people who cannot afford to buy office buildings and apartments on their own. And because your money is pooled with that of other investors, your personal exposure to risk is lower than if you were investing directly in real estate.

WHAT ARE SOME OF THE RISKS?

Supply/demand risk: REITs depend on an adequate supply of tenants and/or buyers to occupy their properties. During certain periods (e.g., a building boom or an economic downturn), the supply of available space may exceed the demand by significant margin, leaving REITs with property that is vacant or less than fully occupied. During these periods, it may also be difficult to make profits on rents because the excess supply of rental property will drive rental prices down. These factors can reduce a REIT's profitability.

Interest rate risk: When interest rates increase, a REIT's borrowing costs increase. This can affect a REIT's bottom line. However, gradually rising interest rates can imply an improving economy, which is favorable to REITs, in general.

Real estate risk: REITs are also subject to the risks associated with the general real estate market, including possible declines in the value of real estate, changes in overall economic conditions, and the potential lack of availability of mortgage funds.

OWNING A HOME VERSUS REIT INVESTING

Many people have been conditioned by realtors to view their home as an investment. In some ways, this is true. The advantage of owning your own home is that you do not have to pay rent to live somewhere else. A home should be viewed as a consumption good that requires various expenses and, of course, does not generate income. By contrast, owning REITs generates continual rental income. Furthermore, since your home is in a single location, its investment risk is not diversified. Your home's value is dependent on the housing market in your area. By contrast, owning REITs offers far greater diversification because they represent exposure to a diversified investment with properties in a variety of geographic areas, not to mention multiple commercial properties.

Ask your Azzad investment advisor if investing in the Azzad REIT portfolio may be right for your financial situation.

ABOUT AZZAD ASSET MANAGEMENT

Since 1997, the mission of Azzad Asset Management, advisor to the Azzad Mutual Funds and sponsor of the Ethical Wrap Program, has been to provide investment performance without compromising their values.

Azzad is proud to serve as investment advisor to the Azzad Wise Capital Fund, the first Halal, socially responsible fixed-income fund investing in:

- Sukuk
- Islamic Bank Deposits
- Ethical Dividend-Paying Stocks

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