Reducing portfolio volatility without moving into cash and CDs

November 14, 2008 - Financial Digest

The wild fluctuations in the stock market of late have investors scrambling to find safer havens for their retirement savings. For those on a fixed income and those about to retire, the 20% plus downturn in the Dow Jones Industrial Average over the past 52 weeks has been especially hard hitting. Stories of retirees, grandmothers and grandfathers, going back to work at places like Wal-Mart, McDonald's, and Home Depot are particularly discouraging.

It can be difficult to ever recoup gains lost in down markets like these for those who are so close to retirement age. The question is, for those who have some time left, how do you avoid a situation like this when it's your time to retire?

It can be a tough decision between having your money making money for you, or putting it somewhere that you know it will be safe. In our current low interest rate environment positions in cash, money market accounts, savings accounts, and even CDs are not going to get most of us back to par, let alone where we need to be to retire.

The term diversification is often used, but rarely put into practice. A retirement portfolio, rounded out with equity, debt, real estate, and other alternative investments has been shown to produce stronger historical returns with significantly less volatility than in an all-equity invested portfolio alone.

Generally speaking, classes of investments (aka asset classes) are divided into two broad groups: correlating or non-correlating. A correlating asset class tends to have movements that mirror or closely track those of another index. For example, a mutual fund comprised of large-cap stocks will typically have a value or share price that is up when the greater equity markets are up and down when they are down. Non-correlating asset classes on the other hand, aren't affected by swings in the traditional equity and debt markets. A prime example of this would be a non-trade real estate investment trust (REIT for short). A non-traded REIT is a company that buys commercial real estate assets and sells shares of the company to investors in the stable share price (typically $10 per share). Many have developed market niches by investing in particular geographic areas or in specific property types (i.e., apartments, medical office, etc.).

REITs were created in the U.S. in 1960 as a method to allow mainstream investors the ability to invest in large-scale income producing real estate properties. To qualify as a REIT, the company must have a majority of their assets invested in real estate, must derive a majority (75%) of its income as rents for real property (or interest for mortgages on real property), and must distribute at least 90% of its taxable income to the shareholders in the form of dividends annually. Real estate investment firms, who sponsor and manage REITs, have specialized staff and skills including professional acquisitions teams and the ability to locate and underwrite institutional-grade assets. Additionally, these sponsor companies either own or hire professional third-party property managers that perform day-to-day tasks from rent collection to janitorial services. More importantly, they

respond to the problems (both physical and tenant related), large and small, that inevitably occur with ownership of real property. Professional property management helps to preserve the asset and increase its value for the investors over time.

Many investors may be familiar with traditional exchange-traded REITs that are listed on regular stock market exchanges such as the NYSE and AMEX. The primary difference between non-traded and traded REIT is the fact that one is listed on an exchange and the other is not. Commercial real estate is a hard asset, and, as such, is not typically prone to large changes in valuation over short periods of time. When real estate assets are bundled into a traded REIT, however, an equity investment is created that is still tied to the emotionally charged stock market and is subject to the numerous ups and downs the exchanges endure. By removing the day to day price fluctuations, one forgoes easy liquidity for stability of share price. By making a 10-20% portfolio allocation to an asset class such as non-traded REITs, the typical investor can reduce the overall volatility of their investment account, and often improve the overall return.

Non-traded REITs are certainly not the only choice for investors seeking these kinds of investment attributes, but are certainly one of the most accessible. Minimum investments are frequently as low as $1,000 and can typically be purchased inside of an existing brokerage retirement account. These days, distribution rates are in the range of 6-7% annually ($6,000-$7,000 per $100,000 invested). Most investment offerings also allow the investor a choice of taking their distributions in the form of cash payments or the ability to reinvest them and purchase additional REIT shares at a discounted price.

Many other real estate programs, such as LLC's private REITs, secured notes, debentures, and other private placement investment programs can also provide investors stability of share price and predictability of income. In these times of market fluctuation in economic uncertainty, investors should consider diversification options they may not have previously. For more information about the REIT marketplace, please visit www.REIT.com by the National Association of Real Estate Investment Trusts (NAREIT). Investors are encouraged to consult with their tax professional and/or financial advisor to gauge the risks and potential benefits of various non-traded REIT and similar illiquid investment offerings mentioned herein prior to making any financial commitments.

Josh Slaybaugh, president & CEO of Trade Up 1031, Inc., West Chester, Penn.