Profit Like the Landlord-in-Chief:

How You Can Mimic Trump's Success With REITs

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By Jim Pearce and the team of analysts at Investing Daily

We all know you can make a fortune in real estate. Donald Trump is perhaps the best known real estate mogul in the United States, making much of his money in the Manhattan real estate market in the 1980s, but he's hardly the most successful.

Taking the top honor is Donald Bren who, with a $10,000 bank loan, built his first house in 1958 in Newport Beach, California. Using the profits from that house, he built and sold dozens of homes, cashing in on California's real estate boom in the 1960s. Bren leveraged that success into a property portfolio of more than 110 million square feet that included hotels, office and apartment buildings, and marinas—a portfolio now worth an estimated $17 billion.

Then there's Rick Caruso, the son of Dollar-Rent-A-Car founder Henry Caruso. Instead of joining the family business, Rick went to work as a real estate attorney. Not particularly happy in the law, Caruso bought and renovated a Los Angeles duplex and, like Bren, used those profits to build an empire. Among his holdings are the Grove in Los Angeles and the Americana at Brand, two of the most productive shopping malls in the country based on sales per square foot. As one of America's newest real estate billionaires, 57-year-old Caruso is now worth an estimated $3.5 billion.

David Lichtenstein is another self-made real estate titan. He grew up playing stickball in a working-class Brooklyn neighborhood, and attending college wasn't an option. In an effort to make some fast money, he maxed out his credit cards to buy his first house to flip. It was a success, and his real estate development company, Lightstone Group, was born. It now owns 11,000 apartments, 3,200 hotel rooms and 6 million square feet of commercial property in 22 states. His estimated net worth: $1.4 billion.

Although all four men were certainly in the right place at the right time, they have something else in common. They all used real estate investment trusts (REITs) to build their empires and protect them from taxes, but you don't have to be a billionaire to enjoy those same advantages.

An All-Weather Investment

REITs invest in real estate, either by owning properties or the mortgages on them. What makes REITs special is that they are required by law to pay out at least 90% of their cash flow as dividends. As long as that golden ratio is maintained, the investment trust itself is generally exempt from federal income taxes, freeing up more cash to pay you—which is why REITs usually offer higher yields than stocks.

Just as the REITs enjoy tax advantages, their unit holders do, too. The funds from operations that the REIT distributes are usually taxable as ordinary income for the unit holders, but because some of the payout often comes from depreciation or other expenses, that portion is considered a nontaxable return of capital. This reduces your cost basis in the shares, which aren't taxed until you sell them.

REITs are also all-weather investments. Although the occasional bust from a financial crisis does happen, REITs generally hold their value well in a down market because the rents their tenants pay are contractual obligations. Rents also tend to rise with inflation, helping to offset its corrosive impact on purchasing power.

That makes REITs the ultimate total return investment. You can collect higher- than-average yields for years, even as the value of the units rise along with the value of the REIT's property portfolio. And although you should always consult a tax expert about your situation, you could end up selling your investment at a tax loss because of depreciation if you hold the units long enough. That's one reason young real estate developers grow into billionaires. Not a bad deal, huh?

What to Look For in a REIT

While REITs do offer special advantages, there are winners and losers just like any other business. When you're considering REITs, look for those that are consistently growing their funds from operations (FFO), which is how a REIT reports earnings, instead of the more familiar earnings per share. Because FFO doesn't include gains or losses on property sales, nor depreciation, FFO gives you an idea of how a REIT is doing on a real cash basis.

You also want REITs that are in stable markets, where rents aren't falling and vacancy rates aren't high. Are the REIT's tenants sticking around or is there a constant churn? If you can find a REIT that is in a stable to growing market but its average rents are below the average market rate, you've got a real golden goose there. Those REITs can create FFO growth by steadily raising their rents without scaring tenants off. Plus, they're more recession-resistant because tenants know that they have a good deal.

The REIT's management team is also an important consideration. Is it making sensible deals or buying properties that the REIT isn't making any money on? Is there a steady deal flow as management reinvests available cash, or is the team resting on its laurels? When management has demonstrated a steady stream of profitable deals, your money is in good hands.

REITs We Like

Easterly Government Property (NYSE: DEA)

With 99% of its income backed by the federal government—U.S. government agencies lease most of the space in Easterly's 46 properties—this REIT is a safe bet that its tenants will stick around. That's especially true now that the FBI and Immigration and Customs Enforcement are Easterly's main tenants, accounting for about a quarter of the REIT's income.

Because of these tenants' security concerns, their space must be designed to strict specifications, so they can't just move on a whim. All of the REIT's properties are currently leased for seven-year terms.

While the REIT has only traded publicly for about three years, management has been turning in solid FFO growth through a series of 18 property acquisitions since the initial public offering.

Most of those properties were already occupied by a law enforcement agency, while the rest was owned by some other government agency. Given that track record of successful acquisitions and the current trend of government leasing rather than buying space, it's a safe bet management can find more profitable deals to maintain its 5% yield.

Realty Income (NYSE: O)

Realty Income has delivered a compound annual total return of better than 15% since going public in 1994 and declared more than 80 consecutive dividend increases. That track record should speak for itself, but as a savvy REIT investor, you'll want more information than that.

The REIT owns more than 5,100 properties across the country and has about 250 tenants, roughly 80% of which are retailers. It uses a particularly favorable lease structure called long-term triple net, which means the tenants are responsible for all property taxes, maintenance and insurance on their buildings, dramatically lowering Realty's operating costs compared to those for other REITs.

About 98% of its properties are currently occupied, and even during the depths of the recession, Realty Income's occupancy rate never slipped below 96% despite the REIT being a steady acquirer of new properties.

Given Realty Income's long history of success and its current 5.2% yield, it would be tough to find a better run REIT. About a quarter of its distribution is also considered a nontaxable return of capital, helping to reduce your tax obligation when you sell the shares.

NorthWest Healthcare Properties (OTC: NWHUF)

Another interesting feature of the REIT market is that you can pick the type of real estate you want to hold in your portfolio. There are REITs that specialize in apartment buildings or offices, self-storage facilities and data centers, or hotels and amusement parks. One particularly attractive niche is healthcare-related REITs.

Healthcare REITs have been up and down lately, mostly because of the uncertainty surrounding the Affordable Care Act's fate. That's why we think you should look outside the boundaries of the United States to make a play on the aging baby boomer population since it's not only Americans that are getting older.

NorthWest Healthcare Properties, based in Toronto, owns senior living facilities in Canada (35%), Brazil (24%), Germany (6%), and Australia/New Zealand (34%). For that reason, it is not overly reliant on the health care politics of any nation with respect to its income.

That formula seems to be working. Its trailing annual dividend yield of 6.9% is higher than most of its peers and is paid monthly to create more predictable cash flow. And since it is governed by Canadian tax laws, it is able to shield some of that income from immediate taxation (similar to an MLP). Therefore, American investors should consider the tax implications of owning this REIT before making a purchase.

IMPORTANT NOTES:

Guidance concerning the stocks highlighted in this report is believed to be accurate and represent our best advice at the time of writing. However, market conditions change constantly and guidance at the time of this writing may not reflect our latest advice. For our current take on any stock in this report, it is vitally important that you check the Portfolio tables on the website and confirm that the stock still earns a buy rating. Furthermore, confirm that the stock trades below our current buy limit. Do not buy any stocks above our recommended buy limits. If a stock's price exceeds our buy limit, wait for a pullback or invest in another Portfolio holding that trades below our buy limit. Any advice in the Portfolio tables, a recent issue of the publication, or our email alerts always trumps older advice in this special report. We reserve the right to substitute special reports as market trends dictate.

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