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EMERALD ASSET ADVISORS, LLC

Investment Strategists for **Successful Families**

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Thank you for reading GreenThought$. It is our privilege to provide you with our insight on current financial market events and our outlook on topics relevant to you.

Earning Real Income With Real Estate

The oldest mantra about investing in real estate holds that the key to success is location, location, location. While there is always the chance that real estate investments will produce capital gains (or losses), we believe a better reason to consider real estate investments is for income, income, income.

That's especially true in today's ultra low rate environment. Today, 10-year Treasury bonds yield around 2% and Fed Chairman Ben Bernanke has vowed to keep rates low through at least 2013. As we discussed in our October 2011 Green Thought$, real estate securities such as Real Estate Investment Trusts (REITs) generally provide attractive yields and the ability to grow distributions over time, which helps offset the impact of inflation. By law, REITs must return 90% of their taxable income to shareholders to avoid corporate income taxes. As a result, most REITs offer attractive yields, as evidenced by the current 4.40% yield on the FTSE NAREIT All REIT Index. Preferred securities issued by REITs generally offer even higher yields.

To gain exposure to this income opportunity, we recently allocated assets to a compelling manager with a demonstrated expertise in this space. The fund invests primarily in securities of companies in the real estate industry, such as REITs, master limited partnerships, and other real estate firms. However, unlike virtually all other real estate funds, the majority of this fund's assets are allocated to preferred securities, which recently comprised more than 80% of the fund's total assets. These preferred securities have higher yields than the common units of the identical issuers because in a REIT's capital structure they are subordinated to the debt, yet senior to the common shares. The preferreds trade in a secondary market but usually with less liquidity than the common shares.

In addition to the potential for high income, this manager believes we are in the early stages of a new positive cycle for commercial real estate that may offer opportunities for capital appreciation. They share this view despite the fact that REIT prices have already rallied more than 200% off the lows of March 2009, and more recently posted a respectable 7.3% total return in 2011.

While the words "real estate" conjure images of the woeful state of the residential real estate market, the commercial real estate market is in much better fundamental shape. As the manager of this fund explained in a recent white paper, easy credit and lax lending standards led to the collapse of the residential real estate market, and this trend shows no signs of ending any time soon. The Case/Shiller Index of US home prices is down 33% since 2006 and the average price for a U.S home declined another 3.8% in last year's final quarter.
In contrast, the commercial real estate sector did not experience the same debt-fueled bubble. While valuations fell and vacancy rates rose, they never reached the same level as during the last major downturn in 1990-92 (17% vs. 19%).

Looking at today's commercial real estate market, one of the most startling facts is that supply has simply not kept pace with demand. The credit crisis of 2008-09 put a halt to many new construction projects for offices, retail space, and apartments. Normal population growth and a slowly growing economy have led to increased demand, lower vacancies, and higher rents. This income eventually makes its way into the pockets of real estate investors.

The apartment sector appears to be experiencing the most significant supply/demand imbalance. According to a recent report from NAREIT, "construction of multi-family units plunged as much as 70% during the recession to a nearly 20-year low." Although the pace of construction has since rebounded a bit, it's still 60% below the long-term average, according to NAREIT. This means that the current level of unmet demand could be as high as two million households.

"It will take several years to bring enough new apartment stock to the market to meet the pent-up demand, and that gap will create a continuing tailwind for apartment REIT operating fundamentals," said Calvin Schnure, NAREIT's vice president of research and industry information. The National Association of Realtors (NAR) is forecasting that rental rates for multi-family apartment rates will rise 3.8% in 2012, while they expect office rates to rise 1.9%.

However, fundamental attractiveness is not limited to the apartment REITs. Selected malls, offices, industrial, and hotel REITs among others offer investors compelling risk-return metrics.

While it appears that commercial real estate could offer some opportunities for capital appreciation, we want to stress that steady income—backed by real assets—is the reason we believe investors should consider adding exposure to commercial real estate at this time. In an economy that remains fragile, REITs may provide steady income that has the potential to keep pace with inflation. That income is a big part of why the FTSE NAREIT All REIT Index has delivered average annual total returns of 10.51% over the 30-year period ended February 29, 2012.

As an added benefit, REITs also exhibit the lowest correlation of any equity sector to the S&P 500 over holding periods of 5 years or more, moving in tandem only 7.1% of the time. That compares favorably to the consumer staples sector, which had a five-year correlation of nearly 88%.

We also believe that a diversified approach, such as that provided by the manager we recently hired, offers the best downside protection. The fund also offers some geographic diversification by investing in international REITs, which provides an additional hedge against a declining dollar.

REITs currently provide many of the characteristics that are paramount to our risk-averse style, yet still may offer significant growth in terms of appreciation and dividend growth. So far, we've elected to allocate to an unconventional sub-sector (preferred securities) in an attempt to generate solid and steady total returns for our investors. We believe this recent addition will make significant contributions in this regard and we are excited to include it in our Hybrid accounts.

Disclosure

Green Thought$

About Emerald

Emerald Asset Advisors, LLC is a Registered Investment Advisor (RIA) founded in 1998. For more information, please visit our website.

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