Alternatives

REITs—the Rodney Dangerfield of Asset Classes

John Corcoran
Vice President,
Client Portfolio
Manager

Many investors we speak to don't know that much about REITs, which is why we call this the forgotten asset class. For example, they don't know that REITs have outperformed the S&P 500 Index, Russell 2000 Index and the Nasdaq Composite over the last 1-, 10-, 20- and 30-year periods.[1] They don't know that REITs are doubly tax-advantaged, with most able to avoid federal and state taxes by distributing 100% of income to shareholders annually as dividends. They don't know that REITs own hard assets that have generated cash flow under long-term leases, often for five years or more, which provided both visibility and stability to the distribution stream. Finally, they don't know that REITs currently offer yields ranging from 70%–100% higher than those of the Barclays Capital U.S. Aggregate Bond Index, the S&P 500 Index and the 10-Year Treasury Note.[2] But after the Fed's announcement on January 25 that short-term rates would stay near zero for another three years (making a good yield harder to find for even longer), we bet they are anxious to learn.

Basics of REITS

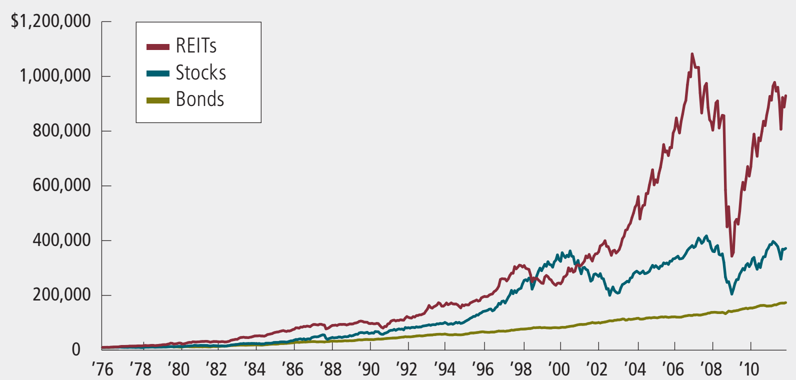
Real estate investment trusts (REITs) are companies that own and, in most cases, operate commercial real estate. They are specially designed to enable individual investors to own income-producing commercial property in a tax-efficient manner.[3] To qualify as a REIT, a company must pay at least 90% of taxable income to shareholders annually as dividends, and must have at least 75% of its total assets and gross income tied to real estate investment, among other things. Companies meeting these criteria can deduct dividends to shareholders from taxable income—thereby avoiding federal taxes at the corporate level—which is a major benefit over many other asset classes. Of course, shareholders pay taxes on any dividends and capital gains they receive. This is why REITs typically pay out 100% of their taxable income each year. Most states honor this federal tax treatment and do not require REITs to pay state income tax either. As a result, REITs have been high income-producing vehicles that individual investors can use to potentially generate attractive total returns while diversifying their portfolios. Nonetheless, large sector holdings (such as real estate) may expose investors to greater volatility and special risks associated with that sector. Investments in securities of real estate and small-cap companies may be especially volatile.

Strong performance over three decades

Although past performance is no guarantee of future results, it's worth noting that REITs performed well in the difficult market environment of 2011, generating a total return of 8.35%, almost four times that of the S&P 500 Index.[4] More broadly, REITs have outperformed the S&P 500, Dow Jones Industrial Average, Russell 2000 and Nasdaq Composite indices over the last 1-, 3-, 10-, 15-, 20-, 25-, 30- and 35-year periods (see Chart 1).[5] In this regard, REITs have generated an average annual return of 10.2% over

CHART 1

REITs Have Outperformed Over Time
Growth of $10,000 for Three Asset Classes (as of December 31, 2011)



Source of chart data: FactSet, 12/31/11. REITs are measured by the FTSE National Association of Real Estate Investment Trusts (NAREIT) Equity REITs Index, which consists of certain companies that own and operate income-producing real estate that have 75% or more of their respective gross invested assets in the equity or mortgage debt of commercial properties. Stocks are measured by the S&P 500 Composite Stock Index, a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Bonds are measured by the Barclays Capital U.S. Aggregate Bond Index, an index of U.S dollar-denominated, investment-grade U.S. corporate government and mortgage-backed securities. Each index includes reinvestment of dividends but does not include fees, expenses or taxes. Each index is unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. **Past performance does not guarantee future results.**

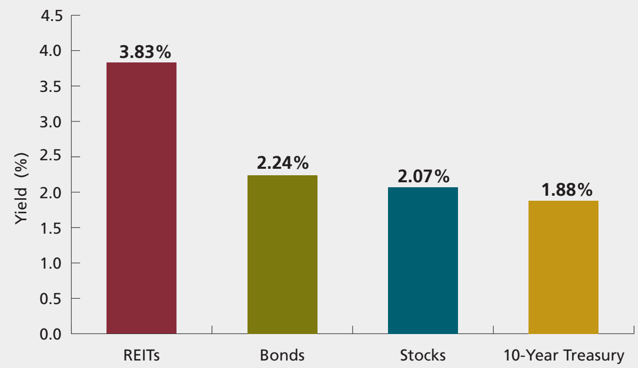
10 years, 10.9% over 20 years, and 12.0% over 30 years. The dividend stream has been a critical driver of this performance, accounting for two-thirds of the total return for REITs since 1972.[6] This is why we call REITs the "Rodney Dangerfield" of asset classes—they just don't get the respect we believe they deserve based on the strength of their short-, medium- and long-term performance.

Tax advantage leads to higher yields

Because of their tax-advantaged structure, REITs have been a higher yielding asset class that many investors find appealing in a yield-starved world (see Chart 2). At year-end 2011, the FTSE NAREIT Equity REITs Index had a dividend yield of 3.8%, meaningfully above the Barclays Capital U.S. Aggregate Bond Index at 2.2%, the S&P 500 Index at 2.1%, and the 10-Year Treasury Note at 1.9%.[2] The Fed's recent announcement that it plans to keep short-term interest rates anchored near zero for another three years is a strong positive for the asset class on two counts: Borrowing rates for REITs should stay lower for longer and their yields should look more attractive relative to a variety of fixed income securities. Historically, a portion of the dividends paid by REITs has included a partial return of principal.

CHART 2

REITs Currently Offer an Attractive Dividend Yield
Asset Class Yields (as of December 31, 2011)



Source of chart data: FactSet, 12/31/11. REITs are measured by the FTSE National Association of Real Estate Investment Trusts (NAREIT) Equity REITs Index, which consists of certain companies that own and operate income-producing real estate that have 75% or more of their respective gross invested assets in the equity or mortgage debt of commercial properties. Stocks are measured by the S&P 500 Composite Stock Index, a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Bonds are measured by the Barclays Capital U.S. Aggregate Bond Index, an index of U.S dollar-denominated, investment-grade U.S. corporate government and mortgage-backed securities. Each index includes reinvestment of dividends but does not include fees, expenses or taxes. Each index is unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. **Past performance does not guarantee future results.**

Robust distribution stream

Significantly, the REIT distribution stream has held up well in recent years, despite the sharp drop in real estate prices during the financial crisis in 2008. Part of the reason for this relates to the structure of REITs, and part relates to the nature of the income stream. REITs are designed to generate income and then distribute that income to shareholders. As underlying economic conditions improve, or even with stable conditions but a positive rate of inflation, rental rates tend to rise. This can lead to a virtuous cycle of higher revenue, cash flow and earnings for the REITs, and higher dividends and net asset values for shareholders. In addition, REITs own hard assets which can generate cash flow under long-term leases, often for five years or more, which has provided both visibility and stability to the distribution stream. Unlike other kinds of companies that have to manufacture a product and then sell it, or offer a service and then sell it, REITs only need to collect rent from tenants who are contractually obligated to pay it, in exchange for the use of long-lived assets that they already occupy. Moreover, REITs often take steps to reduce the volatility of their distribution streams, such as diversifying by property type or geography, or by staggering lease expirations.[7]

Yields that have outpaced inflation

Finally, REIT yields have grown faster than the rate of inflation over the past decade, which has helped to protect investors against the loss of purchasing power (see Chart 3). There are several reasons for this. In the hotel/hospitality sector, for example, leases tend to be shorter term (sometimes just one night), which means rental rates can adjust quickly to changes in inflation. In the retail sector, leases often include a rent component based on sales, so rising inflation that translates into rising prices for the products sold can also translate into rising rents. Many commercial leases also require tenants to pay for operating costs, thereby insulating the REITs from increases in these expenses. Lastly, the longer term leases generally used in the office and industrial sectors often contain rent escalation clauses tied to the rate of inflation.

Fundamentals are improving

We believe the recent strong performance by the REIT asset class should continue for the foreseeable future. The reason is that underlying fundamentals are improving. Apartments, storage facilities, malls, shopping centers, office buildings, healthcare facilities and other commercial properties in desirable locations are all in a strong position despite the slow pace of U.S. economic growth. Construction lending, which froze during the credit crisis, has yet to thaw. In the absence of lending, building new commercial properties has become exceptionally difficult, in part because developers must now put up much more of their own capital to finance a project. As a result, new supply has been slow to come online, and whatever supply is out there is being soaked up by demand, particularly for Class A properties in Tier 1 cities such as New York, Chicago, Boston, Los Angeles, San Francisco and Washington, D.C.[8] In such areas, demand for space is growing, albeit modestly, but supply cannot keep pace. This is driving occupancy and rental rates higher, making properties more valuable while increasing revenue, cash flow, earnings and distributions for REITs with such exposure. Since a key macro driver for many REIT sectors is employment, any continuation of the current downward trend in unemployment would be a significant positive for the asset class.

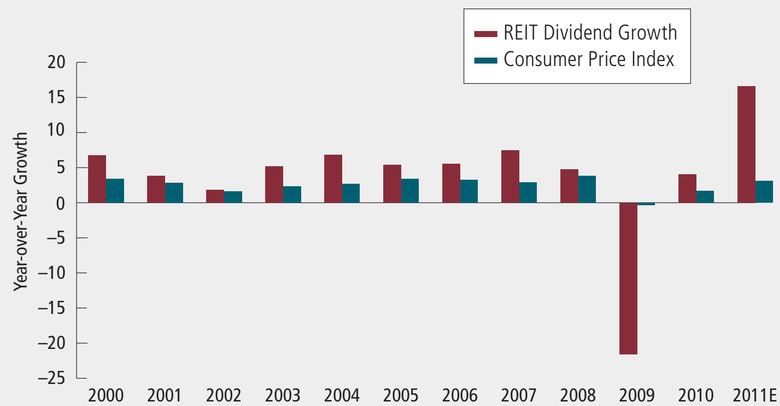
Historical benefits of Oppenheimer Real Estate Fund (OREAX)

Investors interested in the potential for attractive total returns, solid income and diversification available through REITs may want to consider Oppenheimer Real Estate Fund (Ticker: OREAX). The Fund focuses on Class A properties in Tier 1 cities where supply/demand is tight, incumbents enjoy barriers to entry, and both occupancy and rental rates are rising. This strategy has delivered strong performance over the past decade, with the Fund (Class A shares without sales charge) beating the S&P 500 Index in eight of the 10 years since inception and the FTSE NAREIT Equity REITs Index in seven of the last 10 years. **Past performance does not guarantee future results.**

CHART 3

REIT Dividend Growth Has Historically Outpaced Inflation

Annual REIT Dividend Growth vs. Inflation



Source of chart data: Cornerstone Research, NAREIT, Bloomberg, 12/11. REITs are measured by the FTSE National Association of Real Estate Investment Trusts (NAREIT) Equity REITs Index, which consists of certain companies that own and operate income-producing real estate that have 75% or more of their respective gross invested assets in the equity or mortgage debt of commercial properties. The Consumer Price Index (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services. **Past performance does not guarantee future results.**

1. Source of data: NAREIT Market Report for 2011, 1/4/12.
2. Source of data: FactSet, 12/31/11. **Past performance does not guarantee future results.**
3. Congress created the legislative framework for REITs in the U.S. in 1960, effectively democratizing the ownership of large, income-producing properties. Prior to that, typically only institutional investors or wealthy individuals could afford to own commercial income properties. More than 30 countries currently allow the use of REITs.
4. REITs are represented by the FTSE NAREIT Equity REITs Index, which consists of more than 100 companies that own and operate income-producing real estate and have 75% of more of their respective gross invested assets in the equity or mortgage debt of commercial properties.
5. Source of data: NAREIT and FactSet, 12/31/11.
6. Source of data: NAREIT, 12/31/11.
7. For example, a typical shopping mall may have just 12% of its leases expire in a single year, which reduces renewal risk.
8. Source of data: Cornerstone, Dodge, CBRE-EA Winter 2011 Outlook.

The S&P 500 Index is a broad-based measure of domestic stock market performance that includes the reinvestment of dividends. The index is unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any particular investment.

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The portfolio manager of Oppenheimer Real Estate Fund is employed by the Fund's Sub-Adviser, Cornerstone Real Estate Advisers LLC.

For Fund performance data, please visit **oppenheimerfunds.com.**

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