InvestmentNews
The Leading News Source for Financial Advisers

Real estate closed-end funds gain in popularity

Healthy yields driving IPO surge

By **David Hoffman**
June 2, 2003

With interest rates at all-time lows, investing for income has become a serious problem.

Bond funds just aren't yielding very much. Junk-bond funds are generating decent yield, but many advisers say their clients view such funds as too risky.

Luckily, there may be alternatives. Closed-end real estate fund yields look good compared with other investments. According to Mercury Partners LLC of Greenwich, Conn., the average yield generated among the 11 real estate closed-end funds tracked by Mercury was just over 8% at the end of April - about the same as high-yield-bond funds' average yield, as tracked by Morningstar Inc. in Chicago. Emerging-market-bond funds generated an average yield of 7.66%, and multisector bond funds generated an average yield of 5.26%.

The average total return for real estate closed-end funds - 13.9% year-to-date through last Tuesday, according to Mercury Partners - hasn't been bad, either.

Year-to-date through last Tuesday, high-yield-bond funds had returned an average of 9.6%, emerging-market-bond funds re- turned 19.48%, and multisector bonds returned 8.55%, according to Morningstar.

For those investors looking for income, the good relative performance of real estate closed-end funds has caused such funds to become more popular.

Through last Tuesday, six of the 11 real estate closed-end funds tracked by Mercury Partners were trading at a premium to net asset value. That indicates that there is still investor interest in the funds, says Paul Adoranto, director of research.

The fact that so many real estate closed-end funds have been launched within the last year also indicated that they are more popular. Of the 11 such funds currently in existence, seven were launched in 2002, and one was launched in 2003.

Two more will debut this month.

Cohen & Steers Capital Management Inc. in New York plans a public offering of a closed-end fund that will feature a blend of real estate investment trusts and corporate preferred securities.

Neuberger Berman Inc. in New York announced plans for a public offering of a closed-end fund that will feature a blend of REITs and high-yield bonds.

using leverage

But are real estate closed-end funds worth all the attention?

If investors are willing to take on a little more risk, they may be, says Mariana Bush, a Washington-based closed-end-fund analyst for Wachovia Corp. of Charlotte, N.C.

One of the reasons real estate closed-end funds are able to generate such good yields is because they all use leverage to varying degrees, Ms. Bush says.

That means on a total-return basis, the funds should outperform the real estate market during upswings but underperform it during downswings, she says.

Using leverage can also put yield at risk.

Because real estate closed-end funds get leverage by essentially borrowing money, if interest rates move up, the cost of borrowing will go up, and yields will come down, Ms. Bush says.

Many market experts have been saying for a long time that interest rates can't go much lower, but when they will go up is anyone's guess. It appears, however, that real estate closed-end funds will be prepared for it when the time comes.

To varying degrees, all the funds have used fixed-rate financing to lock in the cost of borrowing, thus protecting their shareholders against a potential rise in interest rates, Ms. Bush says.

The Scudder RREEF Real Estate Fund Inc., offered by Scudder Investments in New York, has gone the farthest to protect investors, she says.

Using fixed-income financing, it has covered 100% of its leverage costs. The other 10 such funds have used fixed-income financing to cover about 70% to 75% of their exposure.

Beyond such nuances, however, there is little difference among real estate closed-end funds, says Mr. Adornato. Some will invest in real estate preferred securities, while others may invest in the likes of Canadian real estate securities, he says.

All such funds are too expensive for George Cole Scott, president and portfolio manager of Closed-End Fund Advisors Inc. in Richmond, Va. Declining to be more specific, he says his firm manages less than $25 million.

Mr. Scott says he used to use real estate closed-end funds, but their premiums are now too high.