

Mortgage REITs - High Yield but High Risk

FINANCIAL SERVICES SECTOR REPORT

For more information:

If you have any questions, please contact a local Edward Jones financial advisor, or write to: Edward Jones, 12555 Manchester Road, St. Louis, MO 63131.

We do not recommend mortgage REITs for individual investors. Mortgage REITs carry unique risks, and we do not believe that they are appropriate for many individual investors. After reviewing the mortgage REIT sector, we note several risks in investing in mortgage REITs versus traditional equity REITs:

- **Mortgage REITs borrow more to fund their operations than equity REITs** - Mortgage REITs borrow up to 85% of the fair market value of assets, while equity REIT levels are usually in the 25%-50% range.
- **Mortgage REITs can be vulnerable to rising interest rates** - Mortgage REIT profits and dividends are typically reduced as interest rates rise.
- **Mortgage REIT dividends have been unpredictable over the past five years** – Over the last five years, six of the largest and most well-known residential-mortgage REITs (by market capitalization) both raised and lowered their common dividends. In 2020, due to significant financing challenges, all six of these mortgage REITs cut their dividends, and two of them even suspended payments for a period of time.
- **Most mortgage REITs have consistently issued significant amounts of new common shares to fund their business activities** - New common stock issuance typically results in ownership dilution for stockholders.

As a result of the items noted above, we do not believe mortgage REITs are appropriate for many individual investors.

We do acknowledge that the high dividend yields offered by mortgage REITs can appear attractive, and that mortgage REITs can offer reasonable total returns in certain economic environments. However, high yield comes with high risk.

We recommend investors focus on select equity REITs that offer stronger financial positions with low levels of outstanding debt, rising cash flow and earnings, and a track record of consistently increasing their common dividend.

There are many differences between equity REITs and mortgage REITs

Equity REITs own and operate different types of commercial real estate, such as shopping centers, office buildings, apartment complexes, and industrial buildings. The majority of the income received by equity REITs is rental income generated by the lease agreements. Most equity REITs utilize relatively modest amounts of debt, typically in the range of 25%-50% of their enterprise value. Given the steady rental income and modest leverage, the income streams and common dividends from equity REITs have historically been relatively stable.

Mortgage REITs, on the other hand, tend to lend money on different types of real estate, including both residential and commercial properties. Mortgage REITs also invest in mortgage loans and other types of debt-related securities, including residential mortgage-backed securities (RMBS) and collateralized mortgage obligations. In contrast to the equity REIT sector, the majority of the income generated by mortgage REITs is considered interest income. Many mortgage REITs use high levels of debt to run their businesses, often in the range of 55%-85% of the fair market value of their assets.

Many mortgage REITs invest in loans and pools of loans backed by residential real estate. As a general rule, residential mortgage loans can be repaid in full at any time without penalty. This differs from commercial real estate mortgage loans which often cannot be paid off early or require the payment of a large fee or penalty if the loan is paid off prior to maturity. When residential mortgage loans are paid off faster than the mortgage REIT expects, this can create a capital reinvestment issue for the mortgage REIT. Generally speaking, many residential mortgage loans are paid off early due to the borrower seeking a lower interest rate loan. As the higher interest rate residential mortgage loans are paid off and replaced with loans with lower interest rates, this can negatively impact mortgage REITs that invest in these securities.

Historically, equity REITs have outperformed mortgage REITs on a total-return basis

The chart that follows details the average annual total return and price performance for equity REITs compared with mortgage REITs over six different time periods.* The chart illustrates the more pronounced fluctuations in share prices for mortgage REITs. For the 15-year measurement period, which

captures two full economic cycles, the annualized total return for mortgage REITs is only 5.7% per year, below that of the equity REIT index, which delivered an average annual total return of 8.3% per year. Over 15 years, \$10,000 invested in equity REITs at 8.3% per year would increase to more than \$33,000, 43% more than \$10,000 in mortgage REITs over the same timeframe at 5.7% per year.

	Equity REITs Returns		Mortgage REITs Returns	
	Annualized Total Return	Annualized Price Return	Annualized Total Return	Annualized Price Return
1-Year	(6.1%)	(10.0%)	(5.7%)	(17.0%)
3-Year	5.1%	1.5%	0.1%	(10.0%)
5-Year	2.5%	(1.3%)	(5.6%)	(15.1%)
10-Year	5.0%	1.1%	1.8%	(8.4%)
15-Year	8.3%	4.1%	5.7%	(5.7%)
20-Year	7.4%	3.0%	(0.0%)	(10.7%)

Source: National Association of Real Estate Investment Trusts (NAREIT)

Performance data as of 10/31/2023.

Past performance is no guarantee of future results. Indexes are unmanaged and cannot be invested in directly.

Risks in investing in mortgage REITs:

- Extensive reliance on borrowing** - As noted earlier, mortgage REITs tend to utilize a higher percentage of leverage (borrowing to fund operations) than most equity REITs; we believe this higher leverage can represent a higher level of risk, especially if interest rates rise quickly and/or access to debt becomes restricted. Additionally, most mortgage REITs do not have investment-grade credit ratings from the major credit-rating agencies, making it difficult for mortgage REITs to access the unsecured debt market. We note all of the equity REITs followed closely by Edward Jones currently have investment-grade credit ratings.
- Potential sensitivity to movements in interest rates** - Many mortgage REITs generate most of their profits from the difference, or "spread," between their cost to borrow and the rates at which they loan money. In our opinion, the mortgage REIT business model will generally work best when market interest rates are declining. Conversely, we believe an increase in interest rates will likely negatively impact mortgage REITs by increasing their cost of borrowing. We note that the average maturity of many of the loans and securities held by mortgage REITs tends to be in the range of two to five years, while the maturity of the debt used to fund the loans is often much shorter (often less

than six months); in simple terms, most mortgage REITs borrow short and lend long. As a result, we believe increases in interest rates may cause the cost of funds to increase faster than the rates received on funds lent out, thus causing the lending spread to compress and negatively impact profits.

- **Large issuances of new common shares -** Companies in the mortgage REIT sector must pay out a significant portion of their earnings as dividends. As a result, mortgage REITs cannot retain a great deal of cash to fund their growth, and a number of these companies have instead issued new common stock in order to grow. While the issuance of common stock is a widely used method for REITs to fund their growth initiatives, we note such large issuances of new common shares typically causes significant ownership dilution for shareholders.

Why doesn't Edward Jones recommend mortgage REITs?

Due to a number of factors cited above, including the higher use of debt, fluctuating common dividends and large common stock issuances, Edward Jones has chosen not to follow mortgage REITs. We believe long-term investors are better served by investing in select equity REITs that have strong financial positions with low levels of outstanding debt, rising cash flow and earnings, and a track record of consistently increasing their common dividend.

*NAREIT®, the National Association of Real Estate Investment Trusts®, is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. The equity REIT group is an index composed of 170 equity REITs tracked by NAREIT. The mortgage REIT group is an index composed of 45 mortgage REITs tracked by NAREIT. Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

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James Shanahan, CFA

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