Investing in REITs
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Investing in REITs

REAL ESTATE INVESTMENT TRUSTS

FOURTH EDITION

Ralph L. Block

BLOOMBERG PRESS
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To my father, Jack,
who led me into REITville,
and without whom this book,
in more ways than one,
would never have been possible.
My only regret is that he was not
able to witness its birth and popularity.
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Introduction

“Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly and one by one.”

—Charles MacKay, Extraordinary Popular Delusions and the Madness of Crowds, 1852

All of us think we know real estate, and we have all been involved with it in one way or another since our arrival in the hospital delivery room. That building, our earliest impression of the world, is real estate; the residence we were taken home to, whether a single-family house or an apartment, is real estate; the malls and neighborhood centers where we shop, the factories and office buildings where we work, the hotels and resorts where we vacation, even the acres of undeveloped land we have walked across or played baseball on—all are real estate. Real estate surrounds us. But do we really understand it?

For many years we’ve had a strange relationship with real estate. Despite the housing market problems of recent years, we still love our homes and fully expect that they will, over time, appreciate in value. We admire real estate tycoons, past and present, such as Joseph Kennedy, Conrad Hilton, and the Rockefellers; we even find Donald Trump fascinating. Yet we believe real estate to be a risky investment and marvel at how supposedly sophisticated institutional investors have spent hundreds of millions of dollars on hotels, major office buildings, and other “trophy” properties, only to see their values plummet in real estate recessions, most recently from
2007 through 2009. During the past 10 years, as in prior cycles, we’ve experienced gut-wrenching changes in property valuations.

Is real estate a good investment? Real estate investment trusts, or “REITs,” own, and sometimes develop, commercial real estate and have delivered excellent returns to their investors—but will this continue? Can we still make money in REITs, regardless of the inevitable ups and downs of real estate cycles?

This book seeks to answer those questions and many others. I believe it makes a convincing case for investing in REITs, but also provides the details, background, and guidance investors should have before delving into these often misunderstood but highly rewarding investments. Here’s what’s in store:

**Part I: Meet the REIT** serves as an introduction to REITs. The first order of business is to explain why REITs have been, and will continue to be, excellent long-term investments that belong in every well-diversified portfolio. From there, we’ll explore the “nature of the beast,” and obtain a good working familiarity with REITs and their characteristics. We will follow with a description of the types of properties REITs own and the investment characteristics of each. And, finally, this section compares REITs with some other traditional investments and also describes the structure and evolution of REITs.

Upon reaching **Part II: History and Mythology**, readers should find REITs such an intriguing investment that they’ll wonder why these solid and profitable companies have been neglected for much of their history. This section answers this question and dispels some common myths and misperceptions about REITs. We’ll take a step back and study the 50-year history of the REIT world since its inception in 1960, and trace REITs’ progress up to today.

**Part III: Investing in REITs Intelligently** provides the basic tools investors need to understand the dynamics of REITs’ revenue and earnings growth, identify those REITs that have the capacity to create the most value for their shareholders, and consider ways of valuing the shares of a particular REIT. It will also get into the nitty-gritty of building REIT portfolios with adequate diversification. A new chapter for this edition of *Investing in REITs*, written by well-respected REIT industry veterans Kenneth Campbell and Steve Burton, discusses investing in non-U.S. REITs and real estate companies.
Near the end of the book, **Part Four: Risks and Future Prospects** contains a discussion of the risks that investors should be aware of as they wend their way through the streets of REITville. In addition, we’ll speculate a bit and consider how current and future trends may change the landscape of the REIT world and how new opportunities may evolve.

By the time you finish this book, you will have a firm understanding and appreciation of one of the most rewarding investments on Wall Street. Even more important, you will be able to build your own portfolio of outstanding real estate companies that should provide you with attractive current dividend yields and the prospects of significant capital appreciation in the years ahead. REIT investors, of all shapes and sizes, have been able to earn total returns averaging close to 12 percent annually over the past 30 years, along with, during most market periods, steady income, low market price volatility, and investment safety.

REIT investors today have a much wider choice of investment properties than ever before and can choose from some of the most experienced and capable management teams that have ever invested in and operated real estate in the United States. As you read on, you’ll see why REITs should be an essential part of every investor’s portfolio.

Finally, I hope you will permit me a few personal thoughts. Just like the REIT industry itself, *Investing in REITs* has evolved significantly since the first edition was published approximately 15 years ago. That first edition was written primarily for “mom and pop” investors, who might be looking to diversify their investments and to obtain stable performance and above-average dividend yields. But as one edition followed another, I realized that an increasing portion of the book’s readers consisted of real estate people, including many in REITland, as well as professional investors. Thus, the tone of the book has generally become less folksy and has assumed more investment knowledge on the part of the reader. And, there has been another change from prior editions: recent events have taught us how increasingly complex today’s world has become—now almost everything comes in shades of gray. The REIT world is no different, and I have tried to remind readers of that in this edition.

Some readers will note that I have not included in this book a large number of graphs and charts. They tend to absorb lots of...
page space and, although they can illustrate where we’ve been and where we are now, they don’t necessarily tell us much about where we’re headed. I have thus concluded that a full textual discussion of the most important aspects of REITs and REIT investing, rather than a plethora of graphs and charts, will be most helpful to most readers, and hope that you will agree.

An old Chinese proverb claims, “Give a man a fish and he will eat for a day. Teach him how to fish and he will eat for a lifetime.” My objective in writing this book was not to provide the names of particular REITs in which investors should put their hard-earned investment dollars—indeed, there are no specific REITs that are recommended for investment anywhere within its covers. Rather, Investing in REITs is intended to provide investors and others with a basic understanding of these interesting critters, who have treated me and my fellow REIT shareholders very well over many decades. It offers some historical perspective, some characteristics—both good and bad—to watch for, and some basic tools for investing intelligently in this quite remarkable asset class. I have done the best I could, but only you, dear reader, can judge whether I’ve succeeded.
Acknowledgments

“Writing is easy. All you have to do is sit down at a typewriter and open a vein.”

—Red Smith

Much to my surprise and delight, Investing in REITs has been popular enough to justify a fourth edition, this one under the aegis of John Wiley & Sons, Inc. I cannot, of course, claim more than a modicum of credit for the book’s prior success. REITs’ transition from the sleepy backwaters of the world of equities to a mainstream investment choice has been the principal contributor to the interest in Investing in REITs. Even more important, many kind, perceptive, and dedicated professionals have midwifed the birth of the original edition of the book and its subsequent revisions. I would be remiss if I didn’t mention a few of these outstanding individuals.

Bill Schaff and Gary Pollock provided the essential encouragement and support for the book’s predecessor, The Essential REIT, and Alan Fass, Jared Kieling, John Crutcher, and many other outstanding professionals at Bloomberg Press helped to transform that first book into Investing in REITs, and exposed it to the marketplace—to sink or swim. More recently, it has been my great pleasure to have worked with Laura Walsh, Judy Horwarth, Donna Martone, and Adrianna Johnson at John Wiley & Sons; they have given me the opportunity to bring the book up to date through a fourth edition, for which I am very appreciative.

I’d also like to express my thanks, again, to Mike Kirby and the all-star analysts at that quintessential research firm, Green Street
Advisors, for their outstanding research and analysis on REITs over the years. Thanks, also, to Kenneth D. Campbell, who introduced me to the world of institutional REIT investors many years ago and who, along with his colleague, Steve Burton, wrote Chapter 11 on investing in real estate overseas. Malcolm Bayless, who—like me—continues to search for the Holy Grail of investing, was very helpful as I labored through the creation of this fourth edition. I have learned much from many REIT experts and fellow investors over the years, and wish I could name all of them here.

I'll never be able to repay my debt to Milton Cooper. He is truly a giant of the REIT world and a gentleman in every respect. Milton provided me with the necessary moral support and encouragement to undertake my first book on REIT investing, which led ultimately to *Investing in REITs*. I owe much to the folks at the National Association of Real Estate Investment Trusts (NAREIT), including Mark Decker (now managing director at Robert W. Baird), Steve Wechsler, Michael Grupe, Kurt Walten, and many of their associates who have been supportive in every way and generous in providing me with useful REIT statistics and information. Limited space prevents me from noting specifically the many other individuals whose support and assistance has made this book possible.

Finally, allow me to express my gratitude to my lovely wife, Paula, who has put up with a great deal of “benign neglect” during the time it’s taken me to complete this book and its revised editions.

R. L. B.
PART I

MEET THE REIT
What’s your idea of a perfect investment? That’s a trick question—there is no perfect investment! Greater returns come with greater risk. But those looking for above-average current returns, along with reasonably good price appreciation prospects over time—and with only modest risk—will certainly want to consider apartment communities, office and industrial buildings, shopping centers, and similar investments. In other words, commercial real estate that can be leased to tenants to generate reliable streams of rental income.

Sure, you might say, but only if there were an easy way to buy and own real estate, where an experienced professional could handle the business of owning and managing it well and efficiently, and give you the profits. And only if you could sell your real estate—if you wanted to—as easily as you can sell a common stock like General Electric or Intel. Well, read on. This is all possible with real estate investment trusts, or REITs (pronounced “reets”).
REITs have provided investors everywhere with an easy way to buy major office buildings, shopping malls, hotels, and apartment buildings—in fact, just about any kind of commercial real property you can think of. REITs give you the steady and predictable cash flow that comes from owning and leasing real estate, but with the benefit of a common stock’s liquidity. Equally important, REITs usually have ready access to capital and can therefore acquire and build additional properties as part of their ongoing real estate business.

Besides that, REITs can add stability to your investment portfolio. Real estate as an asset class has long been perceived as an inflation hedge and has, during most market periods, enjoyed fairly low correlation with the performance of other asset classes.

REITs have been around for nearly 50 years, but it’s only been in the past 20 that these appealing investments have become widely known. From the end of 1992 through the end of 2010, the size of the REIT industry has increased by more than 20 times, from just under $16 billion to $389 billion. But the REIT industry, having so far captured only about 10 to 15 percent of all institutionally owned commercial real estate, still has plenty of room left for growth.

Stan Ross, former managing partner of Ernst & Young’s Real Estate Group, defined REITs by saying, “They are real operating companies that lease, renovate, manage, tear down, rebuild, and develop from scratch.” That helps define a REIT, but investors need to know what they can expect from it in terms of investment behavior. That’s really what this book is about.

REITs provide substantial dividend yields, which have historically exceeded the yields of most publicly traded stocks, making them an

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**REITs Are a Liquid Asset**

A *liquid asset* or investment is one that has a generally accepted value and a market where it can be sold easily and quickly at little or no discount to that value. Direct investment in real estate, whether it be a shopping mall in California or a major office building in Manhattan, is not liquid. A qualified buyer must be found, and even then, the value is not clearly established. Most publicly traded stocks are liquid. REITs are real estate–related investments that enjoy the benefit of a common stock’s liquidity.
ideal investment for an individual retirement account (IRA) or other tax-deferred portfolio. Their actual dividend yields tend to be somewhat correlated with—and generally higher than—yields on 10-year U.S. Treasury bonds. But, unlike most high-yielding investments, REIT shares have a strong likelihood of increasing in value over time as the REIT’s properties generate higher cash flows, the values of their properties increase, and additional properties are added to the portfolio.

When you buy stock in Exxon, for example, you’re buying more than oil reserves. And with REITs, you own more than its real estate. The vast majority of REITs are public real estate companies overseen by financially sophisticated, skilled management teams who have the ability to grow the REIT’s cash flows (and dividends) at rates in excess of inflation. Adding a 4 percent dividend yield to capital appreciation of 4 percent, resulting from 4 percent annual increases in operating cash flow and property values, provides for total return prospects of 8 percent annually.

A successful REIT’s management team will accept risk only where the odds of success are high. REITs must pay out most of their earnings in dividends to shareholders, and thus must be very careful when they invest retained earnings. REITs operate their properties in such a way that they generate steady income; but they also have an eye to the future and are interested in growth of the property portfolio, its values and its cash flows, and in taking advantage of new opportunities.

Types of REITs
There are two basic categories of REITs: equity REITs and mortgage REITs.

An equity REIT is a publicly traded company that, as its principal business, buys, manages, renovates, maintains, and occasionally sells real estate properties. Many are also able to develop new properties
when the economics are favorable. It is tax advantaged in that it is not
taxed on its income and, by law, must pay out at least 90 percent of
its net income as dividends to its investors.

A mortgage REIT is a REIT that makes and holds loans and
other debt instruments that are secured by real estate collateral.

The focus of this book is equity REITs rather than mortgage
REITs. Although mortgage REITs have higher dividend yields and
can, at times, deliver spectacular investment returns, equity REITs
are less vulnerable to changes in interest rates and have historically
provided better long-term total returns, more stable market price
performance, lower risk, and greater liquidity. In addition to that,
equity REITs allow the investor to determine not only the type of
property he or she invests in, but also, quite often, the geographic
location of the properties.

General Investment Characteristics

Performance and Returns

Although the long-term performance of equity REITs varies with the
measurement period used, they have, during most time horizons,
compared quite well with that of broader stock indices such as the S&P
500 index. For example, according to data provided by the National
Association of Real Estate Investment Trusts (NAREIT), shown in
Figure 1.1, during the 35-year period ending December 31, 2010,
equity REITs delivered an average annual total return of 14.0 percent. This compares quite well with the returns from various other indices during the same time period.

However, if REITs’ performance was merely comparable to the Standard & Poor’s (S&P) 500, you wouldn’t be reading a book about them. And the performance of many high-risk stocks has substantially exceeded the returns provided by the broad market. Here’s the difference: REITs have provided total returns comparable to the S&P 500 index despite having benefits not usually enjoyed by stocks that keep pace with the market, including only modest correlation with other asset classes, less market price volatility, more limited investment risk, and higher current returns. Let’s look at each of these.

**Lower Correlations**

Correlations measure how much predictive power the price behavior of one asset class has on another to which it’s compared. In other words, if we want to predict what effect a 1 percent rise (or fall) in the S&P 500 will have on REIT stocks, small caps, or bonds for any particular time period, we look at their relative correlations. For example, if the correlation of an S&P 500 index mutual fund with the S&P 500 index is perfect, that is, 1.0, then a 2 percent move in the S&P 500 would predict that the move in the index fund for the same period would also be 2 percent. Correlations range from a perfect +1.0, in which case the movements of two investments will be perfectly matched, to a –1.0, in which case their movements will be completely opposite. A correlation of 0.0 suggests no correlation at all. Correlations in the investment world are important, as they allow financial planners, investment advisers, and individual or institutional investors to structure broadly diversified investment portfolios with the objective of having the ups and downs of each asset class offset one another as much as possible. This, ideally, results in a smooth increase in portfolio values over time, with much less volatility from year to year or even quarter to quarter.

According to NAREIT, as summarized in the graph in Figure 1.2, REIT stocks’ correlation with the S&P 500 during the period from December 1980 through December 2010 was just 0.55. Thus, price movements in REIT stocks have had only a 55 percent correlation
Meet the REIT

with the broad market, as represented by the S&P 500, during that period. Accordingly, in markets where stocks are rising sharply, REITs’ relatively low correlation suggests that they may lag relative to the broad stock market indices. This happened in 1995, when REIT stocks underperformed the popular indices—but still provided investors with total returns of 15.3 percent—and in 1998 and 1999, when REITs’ returns were actually negative despite strength in the technology-led S&P 500. Conversely, during many bear markets in equities, such as in 2000 and most of 2001, lower correlating stocks such as REITs tend to be more stable and may suffer less. And yet there are some markets, as in 2008 and 2009, when virtually every investment, including REITs, will drop by similar amounts. When investors decide to unload everything, there is no place to hide!

A study of correlations by Ibbotson Associates completed in 2001 and updated in 2003 concluded that the correlation of REITs’ stock returns with those of other equity investments has declined significantly when measured over various time periods since 1972, when NAREIT first began to compile REIT industry performance data. Nevertheless, correlations will vary over time—particularly during short time frames—and REIT stocks have been more closely correlated with other stocks during the market turmoil of the past decade.
few years. However, because commercial real estate is a distinct asset class, and due to the unique attributes of REIT investing as discussed in this chapter and elsewhere in this book, it is reasonable to expect that REIT stocks will maintain fairly low correlations with other asset classes over reasonably long time periods.

**Lower Volatility**

A stock’s “volatility” refers to the extent to which its price tends to bounce around from day to day, or even hour to hour. My observations of the REIT market over the past 35 years have led me to the conclusion that REIT stocks are, most of the time, simply less volatile, on a daily basis, than other equities. Although REITs’ increased size and popularity, particularly over the past 5 years, has brought in new investors with different agendas and shorter time horizons, and thus created more volatility, REIT stocks should remain less volatile than their non-REIT brethren.

There is a predictability and steadiness to most REITs’ operating and financial performance from quarter to quarter and from year to year, and there is simply less risk of major negative surprises that can stoke volatility.

Another factor that should help to dampen the volatility of REIT stocks is their higher dividend yields. When a stock yields next to nothing, its entire value is comprised of all future earnings, discounted to the present date. If the perceived prospects for those earnings decline just slightly, the stock can plummet quickly. Much of the value of a REIT stock, however, is in the REIT’s current dividend yield, so a modest decline in future growth expectations will have a more muted effect on its trading price. The volatility of REIT stocks spiked from 2007 through 2009, due to concerns about REITs’ balance sheets and our nation’s space markets, but
those issues were pretty much resolved by 2010, and a reasonable assumption for REIT investors is that REIT stock volatility will, in the future, as in most of the past, be lower than that of other equities.

This is important because our biggest investment mistakes tend to be the result of fear. When our stocks are going up, it’s human nature to ignore risk in our pursuit of ever greater profits. But, when our stocks are dropping, we often tend to panic and dump otherwise sound investments because we’re afraid of ever greater losses. When is the “right” time to sell or buy? There is no easy answer to this question, but prudent investors have learned through experience to control their emotions; low volatility in a stock can make patient and disciplined investors of us all.

Sometimes our financial decisions are not based on long-term investment strategy but on some unexpected personal event that requires that we liquidate some of our holdings. That can be very unpleasant if it occurs during a sizeable market downturn. But if we own ample amounts of REIT shares, chances are we can sell some of them at prices that are reasonably close to where they were trading a week or a month ago, even in soft markets.

**Less Risk**

There’s just no way to avoid risk completely. Even simple preservation of capital carries its own risk— inflation can impact the real value of even seemingly low-risk investments such as investment grade bonds. Real estate ownership and management, like any other business or commercial endeavor, is subject to all sorts of risks. Mall REITs are subject to the changing spending habits of consumers; apartment REITs are subject to changes in the popularity of single-family dwellings and declining job growth in the areas where their properties are located; and health care REITs are subject to the politics of government cuts in health care reimbursement, to cite just a few examples. In general, all REITs are subject to an increased supply of rental properties and demand-weakening recessions.

Yet, despite this, owners of commercial real estate can limit risk, including the risk of tenant bankruptcies—if they are diversified by sector, geographic location, and tenant roster. For example, if some tenants are doing badly, there are usually other tenants who are doing fine. This has happened repeatedly in the history of the retail industry,
and the retail REITs have remained resilient; they continually find new tenants to replace those that must close their doors.

Holders of most common stocks must contend with yet another type of risk, related not to the fundamentals of a company’s business but to the fickle nature of the financial markets. Let’s say you own shares in a company whose business is doing well. The earnings report comes out and the news is that earnings are up 15 percent over last year. But because analysts expected a 20 percent increase, the price of the stock drops precipitously. This has been a common phenomenon in the stock market in recent years, but REIT investors have rarely suffered from this syndrome.

This is because of the stability and predictability of REITs’ rental revenues, occupancy rates, and real estate operating costs. Long-term leases enjoyed by most commercial real estate owners provide earnings stability and make this asset class more “bondlike.” The risks, therefore, are reduced.

Few REITs have gotten themselves into serious financial difficulties over the years. Those few instances of severe financial stress have generally been caused by risky balance sheets, for example, General Growth Properties, or poor allocation of their investment capital. Remember, there is no such thing as zero risk. If you’re investing primarily in the higher-quality REITs (we’ll review the nature of “blue-chip” REITs in a later chapter), the long-term risk of REIT investments is far lower than that of most other common stocks.

**Higher Current Returns**

As we’ll see in Chapter 3, REITs must, by law, pay out at least 90 percent of their pretax income to shareholders in the form of dividends. As a result, REITs’ dividends tend to be higher than those of other companies as a percentage of their free cash flows, and REIT shares normally trade at higher dividend yields (see Figure 1.3).
Although many academics claim that it shouldn’t matter to shareholders how much of its net income a corporation pays out in dividends, many argue that dividends really do matter with respect to shareholders’ total returns. According to Ed Clissold, an equity strategist at Ned Davis Research (as referred to in a *Barron’s* article of September 20, 2010), the S&P 500 index has delivered average annual price appreciation since the end of 1929 of 4.92 percent, but its average annual total return has been 9.16 percent. Thus, dividends have provided approximately 46 percent of those total returns. Dividends *do* count.

Perhaps another benefit of owning REIT stocks, relating to REITs’ dividend payment requirement, is that its shareholders are legally entitled to 90 percent of the REIT’s income each year. This allows the shareholder to participate in income reinvestment decisions. He or she can plow the dividend income back into the REIT by buying additional shares (albeit on an after-tax basis if owned in taxable accounts), investing elsewhere, or spending it on a vacation in Hawaii. Shareholders in non-REIT companies don’t have this...