IFB223: Investing Close to Retirement and REITs 101

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Dave 00:00

Alright, folks, welcome to Investing for Beginners podcast. Tonight is episode 223. Tonight we're going to answer great listener questions that we got recently. And so, without any further ado, I'm going to go ahead and turn it over to my friend Andrew, and he's going to explain a great email he wrote, actually today, that covers a question that we're going to cover here in just a moment. So Andrew, could you kind of explain, like, I'm five, what the email was that you sent out today?

Andrew 00:26

Sure, we've had a lot of volatility. So we're recording this beginning of March; there's been a ton of volatility, a lot of geopolitical events happening. And so the markets pretty freaked out. I mean, that's been very volatile. It seems like we've been saying that for like a month straight. Now, the market has been vulnerable; it's been moving up and down. So I basically wrote an email; I said, If I could give one piece of advice, it would be, look, you got to buy and hold for the long term. And that's really what it comes down to. At the end of the day, if you look at the economy and you zoom out, do you think the economy is going to get bigger over the long term? Or do you think it's going to get smaller?

And so if you think the economy will grow, because we are human beings, we are hardworking, we like to push forward and innovate? If that's the reality, and that's what you believe, then you should invest in the stock market? And if it's not, then you shouldn't because that's the only way the stock market grows is if the economy grows. And so that kind of the idea of the email was the stock market represents ownership of businesses are what make up the economy. So as those businesses grow, the stock market grows. And so we should not worry about, is there going to be a recession tomorrow? Is the stock market going to crash tomorrow? Should I wait to buy the dip? Those are all things that are out of our control? And nobody knows the answer to those things. So that's why you need to, instead focus on what's the big concept, it's, I think the economy is going to grow.

So I'm going to continue buying stocks and continue to hold them for the long term because, over the history of the market, the stock market has grown as the economy has grown. And we should continue to see that over the long term as well.

Dave 02:10

So here's the question, though, what if you're 63 years old?

Andrew 02:14

Yeah. So this is somebody who wrote a response to me today; that was a very good response. And in my mind, it really comes down to two questions. Well, the first question is, How soon do you need the money? And then, if that question is anything less than five to 10 years, then I would say you probably should not be in the stock market. Because you can look over the history of it, and the stock market is very up and down.

And to be successful in the stock market, you got to be able to ride those ups and downs. So if you're 63, and you need the money, when you're 68, I probably would really think about reducing your exposure to the stock market, if you maybe are thinking of doing you know, there's a lot of I think, nuances to that question, because the idea of retirement is even something we could debate.

Because the way people work now, you know, back when 65 was the kind of the rule, there was a lot more manual labor and things of that nature that required, you know, maybe being in front of inside the factory or something. But nowadays, people can work on their computers; we see how much people work from home now. So it doesn't need to be this all-or-nothing thing. We could have people with semi-retirements and other options that kind of make that question a harder one to answer.

Dave 03:32

Yeah, for sure. And I agree with you; I think the nuance to the question Is it can be, it can be difficult to determine because a lot of it depends on what Andrew was pointing out, your time horizon, and what your plans are beyond retirement air quotes, because at 55 like I am, you know, I don't plan to stop working when I'm 65, I will keep doing something going beyond that. And the other part of this, too, is that our parents, my parent's generation, their parent's generation, today are living longer than my parents were, and then their parents were kind of down the line.

And so it's not unusual now for people to retire at 65 67 68 and live to be 85 90 95. Whereas before, that maybe wasn't as common. Maybe people would only have to plan for retirement to last them ten years and not be on the morbid side of things. But the planning stage was much shorter than it is now. And so now, you have to kind of think, okay, you know, what is my expected lifespan from the time that I retire? And some of that, of course, is going to depend on genetics and your health now, and maybe what your health will be farther down the road. Of course, none of us know the future and none of us know what's going to happen tomorrow.

But those are all things that you kind of have to, I guess, play with and account for, and So just a yes or no answer to a question like this is maybe not quite as black and white as it may appear on the surface. And standard operating procedure. In most cases, when you think about retirement planning for your portfolio is, the closer you get to retirement, the more you reduce your exposure to the stock market by moving money out of stocks into safer assets, like bonds or money market accounts, or things of that nature, you know, gold, just a savings account, all those things all kind of come into play, depending on how conservative you want it to be. And some of them, I guess, the rationale behind that is like Andrew was saying, as you get

closer to retirement, and you need that money, the volatility could rear its ugly head. And it would really suck the day before you retire. And you want to cash out all of your Microsoft or whoever. And all of a sudden, the market crashes, and you lose 50% of what you own, just in a day, and it can happen.

And it is happening. Right now, depending on what kinds of companies you've been invested in over the last couple of months, even there have been companies that have lost 5060 80% of their value in a very short amount of time. And as we have pointed out in the past, recovering from those kinds of losses can happen. But the amount of return or gain that you have to get just to get back to even from those high points is astronomically high; when you start getting to the 80 90%, I think it's what 120 150% return that that company has to generate, just get to get back to

Andrew 06:37

even be more like 809%.

Dave 06:39

Okay, all right, see? So it's even more of a dire. So I was wrong. So anyway, the point I'm making is that the standard operating procedure is to think about that. But I think the key question is, when do you need that money. So if you're in great health and you plan on working until you're 75, maybe you have to think about whether you want to start adjusting your portfolio as you get closer to retirement.

But I think that the bigger question is, is what is your time horizon. And again, none of us know the future. And none of us can predict where we're going to be five years from now and what our health is going to be. Hopefully, we can take care of ourselves. But those are all

Andrew 07:20

let's play a game then. Okay, let's create an example scenario; some of these may be 63 years old; let's say they have 200,000 saved from 401k is over the years. And let's say maybe they're kind of like you, or maybe they'll work part-time or, you know, get some social security along the way. So it's not like they're gonna need all this 200k Right at 65.

Give us an example of not to say this is your prescription. But here's an idea of maybe if I was in your shoes, how I would think about it, and how people can start to apply that to themselves.

Dave 07:56

I think, you know, if I was in that situation, if this was me, I think what I would do is I would start rotating part of my portfolio into safer assets if I needed the money, and I was planning on using that income to help me along with my social security, to help me live. And so I would probably start rotating, you know, maybe, as an example, maybe taking 10% of that, and rotating it into something like bonds.

And then, you know, the next year, maybe rotating another five or 10% into more bonds and just kind of gradually scaling it down as I get closer to when I'm going to retire. And so that maybe my target would be, let's say, by the time I retire, and I'm planning on still working a little bit, then maybe I would reduce my allocation from 100% stocks, or maybe 9010 to something like 5050. And then, even as I get into retirement, I could also continue to look at how much do I want to reduce some of that exposure. And some of that's going to depend on the makeup of what is in the portfolio.

So, for example, if I have all companies that are not paying dividends, then I might want to reduce those sooner than the ones that are paying dividends because I want that dividend income to continue farther down the path than giving up a stock gain of something like I'll just pick a company Amazon that doesn't pay a dividend currently. And so, just thinking about something like that, maybe I reduce exposure in Amazon but continue my exposure in Microsoft, for example, because it does pay a dividend. So I guess that's what I would think about if I was in Scenario A, so to speak.

Andrew 09:35

So you're saying because they pay a dividend, you could kind of life of that dividend and not have to sell anything, right taxes. Yes. And I guess when you think about the fact that there are tax implications, I think it's worth if you're close to retirement, even talking to a professional, you know, financial planner, a financial advisor, who can help you with not only what should I do with my stock portfolio, but how does this effect, you know, if I were to sell this company because how much you sell depends on how you know, that will factor how much taxes you'll pay. And so maybe you don't want to sell it all at once because you're gonna have a huge tax bill. But then it goes back to how much money do you make, too,

Dave 10:16

right.

Andrew 10:16

And so I think the advice if you're starting like kind of from Square zero, which I think investing for beginners tends to a lot of our questions tend to be that way, we also get a lot of, you know, we get some questions like this one, the ideas, and important information probably a little bit different if you're closer to retirement,

Dave 10:35

absolutely, and other things to consider, along with the tax implications, which is a great idea to consider. And it's something you need to keep in mind. And maybe that would also if you do it more on a gradual basis, then that could help potentially reduce some of the tax burdens you may have. As you get closer. The other thing to consider, too, is depending on what kind of tax vehicle you have the investments in; if you have a majority of your money tied up in a traditional IRA, then you're going to have a bigger tax burden than you will if you have them in a Roth IRA, for example.

And so those are things that you need to consider. And Andrew and I are by no means tax experts. And as you consider any of these choices, absolutely talk to your tax professional about whatever kinds of advice or guidance you need to help alleviate any sort of tax burden that you have. I mean, we all have to pay taxes. And that's what we have to do as citizens. But anyway, you can help reduce that impact on your livelihood. Going forward is something you definitely want to consider.

Andrew 11:35

I'll just, I guess, finish off my last thought; it could be an interesting exercise to say what would you do if you're 63, and you're starting from square zero, but that would just say, to kind of wrap it up in a bow and tie it up nicely. The reason why I say do not put money in the market unless you don't need it for the next five to 10 years or more is, again, if you put all your money into the market today, your chances of making money

are about 5050, maybe a little bit more on the 51% that you'll make money, you tend to see more green days. But if you're talking about the daytime period, it's close to 5050.

The longer you extend that out, the bigger your probabilities, your percentages of making money on that investment are. And so once you get to like the five-year mark, your probability of making money goes up to like 90% ten-year mark, it goes again, you're like 90 95%, and then 20. year mark, we've never seen a 20 year period where the market has lost money. So you're making money after 20 years. So that's kind of like the idea of why having that longer time frame. And especially not putting money in the market that you need in the next one to three, four, or five years.

Because the market moves up and down just like the economy does, and you just can't know what's going to happen with your investment over a short time period. So you bet instead on the economy growing rather than betting on Well, I'm gonna outsmart the entire world and time in and out when I'm going to get in and out of the market. That's just not a reliable way to think about your money.

Dave 13:12

Well said, well, so that wraps it up nicely. Alright. Let's move on to the next question. We have Hey, guys, great work on the show. I have been an avid listener for almost a year and about six months ago purchased a few stocks on my own. I am happy to share that my portfolio is up 10%. I have a question about REITs. On the show, you have often said to be cautious of REITs and make sure you know exactly what you're getting into before you buy. I own it to read stocks in my portfolio, l y, and dx, both of which seem to be solid companies, and they pay around a 10% dividend.

To me, this seems like a very high dividend that can do quite a bit in the long term. Right now, my read stocks are about are down due to the raised interest rates, but I still feel like they may be a good investment long term. What are the downsides to REIT? So what am I missing? Do they belong in every balanced portfolio? Are they too good to be true? Thanks, Scott. So Andrew, what are your thoughts on Scott's Great question about REITs

Andrew 14:09

So maybe let's start with defining rates stand for real estate investment trusts, and would you care to give us a real 101 for somebody who's never heard of a REIT?

Dave 14:20

Sure, alright. So REIT a one-on-one. So REITs are a company that tends to invest in real estate, depending on the type of REIT, and there are all different kinds of flavors of REITs that you could possibly ever want, whether the retail REITs, whether they're small REITs, mortgage REITs, whether they're apartment REITs. There are all kinds of flavors. And REITs are companies that will generate revenue by collecting rents or by collecting interest or dividends from the investments that they make. And they pay out dividends, very big dividends, and the structure of the companies the way that they're taxed are they have to pay out upwards of 90% of their earnings has to be a dividend.

And so because of that, they are very well valued and very highly regarded by dividend investors; they also do appreciate in the market like a stock, it is a great way to invest in real estate if you don't want to go out and buy land or company, or a building or something along with those kinds. So you get a slice of

investment in real estate without having that huge capital outlay. So those are, I guess, that's kind of the overview of REITs that I can think of; I miss anything.

Andrew 15:35

No, I think that's a good kind of overview.

Dave 15:37

Okay. Alright. So as far as I guess, let's kind of take a quick look at each of these companies and kind of talk through a little bit, kind of what Scott is getting at, and maybe why REITs could be great investments, and maybe why they couldn't be great investments.

Andrew 15:53

I mean, I would kind of think about it, as he asks, Is this too good to be true? One of the downsides? What am I missing? Now? I almost look at it like, would you say that about a business, like a pick any stock, some of them have really great business models, some not so great. So when you look at REITs, they are just like a company, they are a company, I mean, essentially, and they're gonna buy different things. So every REIT is going to be different; you have to think of it differently and don't try to group them all together; I think that is one key takeaway. And I even like looking at the pandemic as an example; ask yourself, I mean, I don't know what it's like in your area.

But here in Raleigh, there have been several shopping centers, kind of like a building where it used to be a gym, or place used to be a shopping center. Now it's just begun. It's been vacant for like two years, right? So you have that as like one part of real estate, commercial real estate, which really got hurt from the pandemic. And then you have the other side where nobody can buy a home around here. Right? So it's both real estate. But there are two very different pictures; they're two different markets. And so if you have a REIT that has exposure to residential, that's gonna be different than a REIT that is in commercial real estate, that's gonna be different from a REIT that's in, you know, the cell phone towers and healthcare REITs, they're all very different. So you do have to be careful about aggregate; I don't think they have necessarily any sort of upside or downside to any other business.

And I think that's maybe something; I can see the excitement of it. But if you think that's too good to be true, there's always a cost. And I don't know if we want to go down deep into like, dilution and all of that. But to say that, like, there is a reason why they're able to pay such high dividends. And it's because they're paying as a shareholder; you're paying for it in a different way than you might with a regular company.

Dave 17:40

Right, I guess let's explore the dividend part of it for a little bit. So let's talk about the yield that they pay and maybe why people invest in REITs, as opposed to buying a bank stock; for example, what are the advantages dividend wise that you would get from a REIT versus those other ideas?

Andrew 17:58

Yeah, kinda as you said, they have to pay more of their earnings in dividends. And so investors like that because you're getting a higher yield. I mean, I know one of the REITs in my portfolio; I see the dividend in there. And I'm like, Well, I get a bonus, what's going on here, right, like it's much higher than other companies would payout, right? It doesn't come for free. Because if I'm a regular company, and I want to

grow, I gotta take those profits instead paid as a dividend; I got to reinvest in the business, right. So with a REIT, it's the same way they have to generate money to grow.

So instead of doing that from their profits, they will do it from the shares; they will dilute the shares. So we remember, I don't know if people remember, we talked about the pizza; if you have one share of stock, it's like a slice of a pizza. And if a company buys back shares, your slice gets bigger and bigger because you own more and more of the company, with a REIT they do the opposite. So your slice actually becomes smaller. And that's how they generate the cash that they need to buy the real estate; they'll also take out debt.

So you'll see a lot more debt with REITs, too, but that's what they'll do. And so it's different, you know, a lot of times they will grow faster than they make your slice smaller. So you'll still see growth. But that's one of the things that it's not too good to be true. You're just paying for it in a different way. That might be harder to conceptualize because it's not as simple as we make a profit. And then we invest in, and we grow. It's taken out, and you're paying for it in a different way.

Dave 19:26

Right, Yeah, I agree. And so a couple of things about the dividends to also consider about with REITs is number one, the yield is going to be based on the fixed dividend. They're paying compared to the price of the stock. And so, as the stock market moves, that price is going to fluctuate. And so both of these companies, the stock price has dropped recently. And so that is driving up the yield of these companies. I think this is just a generality.

So this is not, you know, all-encompassing, but generally when you're looking at yields on REITs and that for those, If you aren't familiar with this term, that basically is the comparison of what the dollar amount that they're paying for the REIT, compared to the price in the stock market. And so what you're seeing is, if that goes up, it means the stock price is probably dropped because they don't change the amount of money they give you on a dividend that quickly, so there will be fluctuation, but generally, for good quality REITs, you want to see probably as spitball, three and a half to five and a half percent range for a dividend yield. And if it starts going up or down, based on that, then you want to do some investigation. And so, if you see a 10% yield on a read, that may be great, but it also could just be because the stock price has dropped a little bit.

And that in and of itself may not be anything to be concerned about. Again, it goes back to the underlying fundamentals of the company. And so, like any other company, a REIT is something that you have to look at the financials and analyze and try to determine what the economic outcome will be based on how the company is performing. And so, just like Microsoft or VISA, you have to look at Annaly Capital and decide whether their financials are going in the direction you want to see them go in. So going along with that, then thinking about the return that you get from investing in a REIT is a little different than you would get from investing in a company like Wells Fargo, for example. And a lot of the return that you may get from a company like Wells Fargo or even Microsoft is from the share appreciation. Whereas with a REIT, sometimes more of your return is going to be based on the dividend that they pay you because the stock price may not move as much.

And so you may not, you're not going to see a 50% return on a stock. Or you could see a 50 a REIT where it's not unusual to see a company like Google go up 50% in a year. But to see a REIT go up 50% in a year is probably more unlikely. And so the return that you're going to get from investing in a company like a REIT is going to be more from the dividend over the long term than it will be the share appreciation. Again, that's just a generality. And that's not something that you're going to see individual companies obviously do very well in different cycles. And so those are things that you have to consider; data REITs, for example, right now are the hot thing because data centers are huge. And you know, companies like Microsoft and Amazon,

and Google are in a race to see who can be the biggest cloud provider. And so they're building massive amounts of data storage and reached there are companies that manage those for Microsoft, Amazon, and Google. And so there's a huge race for that.

So those are hot stocks right now. But whereas something like healthcare, maybe not so much, so it'll go in cycles. But to get back to my previous point for my long-winded answer here is that the basic idea is you need to understand the business like Andrew was saying, and that's key to just investing in general, and REITs are like banks in that they are a different kind of language to understand. And we have written a lot about REITs on our website. And so if you're unfamiliar with a lot of this language, if you're like, Yeah, I really want to get into this, but I don't really know where to start, go to investing for beginners calm, and type in REITs, we have a search bar, type in REITs.

And you're going to find lots of great articles about the structure of REITs, how they work, how to analyze them, how to value them, lots of great stuff, how the dividends work, there's lots of great stuff out there. And there are lots of great people on the internet as well, that is very, very well versed. Brad Thomas is probably, I guess, the acknowledged master of REITs, if you will, and he's written some great books about REITs as well. And so there are lots of great resources if this is something you really, really want to kind of dive into.

Andrew 23:49

Yeah, I agree with that. Nothing to add

Dave 23:51

okay. All right, Charlie, I have nothing to add,

Andrew 23:55

I would just say, you know, for this new investor, I would gently suggest maybe putting a little b limit sign on your new kind of journey. I think it's awesome, you know, having listened to our show, having some success with your stocks, being a new investor, these companies are pretty complex, I mean, annually capital and this other one, they are mortgage REITs. So it's almost like you take the complexity of a bank and when you combine it with the complexity of a REIT. I don't even know how anybody would analyze that, just to start. So it's not a simple business model. And I would caution, maybe trying to learn a little bit more about the company you're invested in.

Because I mean, interest rates do play a role in these companies, but it's not all of it. And I will admit, even for myself, markets, back securities, and all that nonsense from the financial crisis; there's a lot of complexity involved with those. And again, it's not good or bad. It's just different. So I would really, really caution jumping into companies like this. If you read the annual report and, you know, understand Some of the stuff in there, I would say, maybe slow down, maybe take a U-turn, maybe go somewhere else where it's easier and simpler to understand.

Dave 25:08

Yeah, that's good advice. Investing in REITs is definitely a different beast than looking at a company like VSA, or looking at a company like Walmart, for example. And so you have to kind of understand the language that those companies are speaking. And beyond just the fundamental analysis of the company, you also have to kind of have a pulse on real estate in general, and the different kinds of real estate like Andrew

was talking about earlier, the differences between commercial and residential. And there are a lot of differences between investing in retail versus investing in mall REITs.

And so those are some complexities that definitely need to be considered. And I don't want to discourage you from investing in these kinds of investments, but definitely doing some due diligence and learning a little bit about the real estate market in general. And then thinking about how the companies operate is definitely something that would behoove you, as you kind of go down that path for sure. But yeah, a speed bump is probably not, you know, I'm going to tell you this from experience. After studying banks for all these years, you read a bank 10k.

And then you read a 10k, like Walmart, and you're like, Oh, my God, this is easy. So the complexity of REITs, and financials just in general, can be a little more complicated. But if that's something you like, then you know, dive in and as you can, before you pull the trigger,

Andrew 26:26

Well said,

Dave 26:27

thanks, I have nothing to add.

Andrew 26:29

Alright. Okay.

Dave 26:33

All right, folks. Well, with that, we are going to go ahead and wrap up our conversation for today. I want to thank everybody for taking the time to send us those fantastic questions. Please keep them coming. You guys definitely stretch our knowledge base. And really stretch what Andrew and I know to answer some of these questions. And it's a lot of fun for us to do this.

And hopefully, you guys get some good information from that. If you guys want to learn more about things beyond what we talked about in the podcast, we have this great email list that you can join, and we send you daily nuggets that will teach you more about the stock market in little bite-sized pieces that you can consume at your leisure. And it's great and easy for you to sign up; you can go to stock market pdf.com And you can sign up there and keep abreast of everything that Andrew and I think about the stock market. So without any further ado, I'll go ahead and sign us off; you guys go out there and invest with a margin of safety. Emphasis on the safety. Have a great week. We'll talk to you all next week.

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