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What Are REITs?

Real Estate Investment Trusts (REITs) are companies that own and typically operates income-producing real estate or real estate related assets.

Why Buy REITs vs. Individual Properties

- *Be the Landlord Without the Hassle*—REITs buy, sell, manage, and collect the rents for you.
- *Easy Way to Invest in Real Estate*—REITs trade like stocks on stock exchanges; this liquidity enables you to add or subtract real estate from your investment portfolio when you want.
- *Efficient Way to Invest in Real Estate*—Buying and selling individual properties takes lots of time, expertise, and significant resources.
- *Real Estate Diversification* — Individual REITs hold many properties, often in different parts of the country.

Why REITs?

Investors typically look to REITs for their combination of consistent income, inflation protection, plus growth.

How Do Real Estate Investment Trusts Work?

Key Takeaways

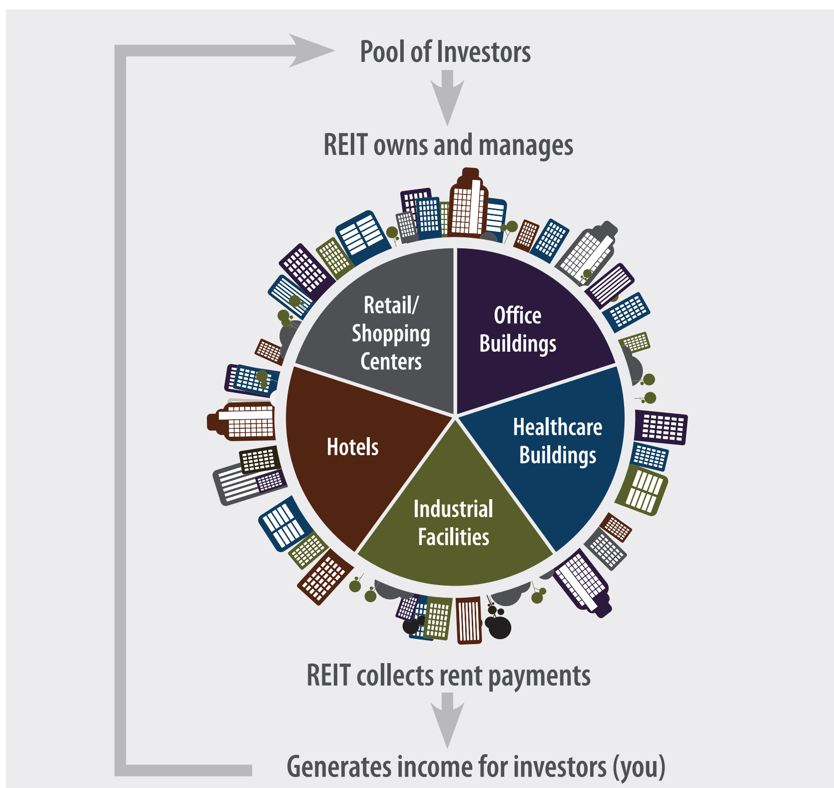
- REITs offer easy access to real estate inside your portfolio.
- REITs give investors rental income and proceeds from real estate sales plus price and rent appreciation potential.
- We classify REITs as real assets because they generate their value and income from their underlying physical real estate holdings.
- REITs can share characteristics of both stocks and bonds.
  - REITs offer growth potential like stocks.
  - REITs offer potential for consistent income, like bonds.
- REITs can be more volatile than other investments, especially during quickly rising interest rate environments and economic downturns.

This report covers only publically-traded equity REITs. REITs are registered with the Securities and Exchange Commission (SEC) and are publicly traded on a stock exchange (publicly traded REITs). There are also REITs that are registered with the SEC that are not publicly traded. These are known as non-exchange traded REITs.

How REITs Work

When you purchase REITs, you are pooling your money with other investors to buy a portfolio of real estate holdings. The REIT manages the holdings, paying out most of the income (e.g., rents) to you in the form of dividends.

Some REITs can be quite diversified; others may specialize in specific real estate categories. A few of the categories are shown below.



Where REIT Returns Come From

REITs' performance is generally measured by total return. This means that there are two main components to your REIT return:

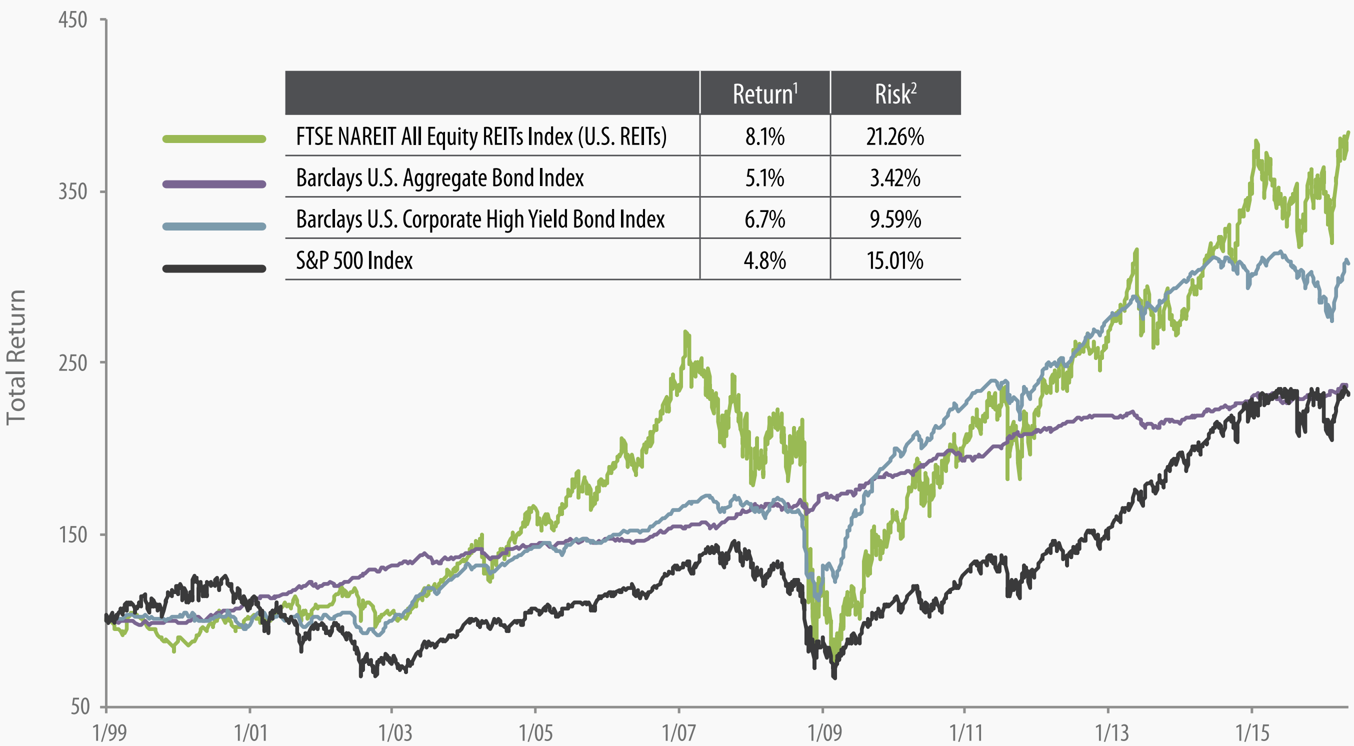
- Dividends (rents collected and proceeds from real estate sales)
- Price appreciation (increased real estate values)

Rents and proceeds from real estate sales typically provide a steady stream of dividends to REIT investors (income) while capital appreciation (share-price growth) comes from the potential for increasing real estate values and rents.

REITs as Portfolio Diversifiers

While REITs share characteristics of both stocks and bonds, they do not always follow the price direction of stocks and bonds. In other words, REITs can add diversification to your portfolio. Portfolio returns can be enhanced by adding REITs, but keep in mind that the extra returns can come with added risk. This trade-off between risk and return can be seen in the chart below. Since 1999, REITs delivered a better total return than U.S. bonds, U.S. corporate high-yield bonds, and even large-cap stocks. But they did so with substantially more risk.

Return and Risk—REITs, Bonds, and Stocks



	Return[1]	Risk[2]
FTSE NAREIT All Equity REITs Index (U.S. REITs)	8.1%	21.26%
Barclays U.S. Aggregate Bond Index	5.1%	3.42%
Barclays U.S. Corporate High Yield Bond Index	6.7%	9.59%
S&P 500 Index	4.8%	15.01%

Source: Bloomberg, Morningstar, Wells Fargo Investment Institute. 5/5/16

[1]Data Sample: Daily, 12/31/1998-5/4/2016. All Indexes indexed to 100 as of 12/31/1998

[2]Data Sample: Monthly, Jan. 1999-April 2016. Annualized risk is the annualized standard deviation.

Past performance is no guarantee of future results. Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. **Bonds** are subject to interest rate, price, credit, and other risks. Prices tend to be inversely affected by changes in interest rates. **REITs** have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Standard Deviation is a measure of volatility. The higher the standard deviation, the greater volatility has been.

Where Do REITs Fit In?

Some have wondered how to classify REITs inside an investment portfolio. REITs can have both stock and bond characteristics, but they generate their value and income from real estate. Real estate, in the investment industry, is considered a real asset, which means an asset with tangible/physical value. At Wells Fargo Investment Institute, we believe REITs are real assets because they generate their value and income from their underlying physical real estate holdings. In fact, to be classified as a REIT by law, at least 75 percent of a REITs gross income must come from real estate related sources, including rents from real property and interest on mortgages financial real property.

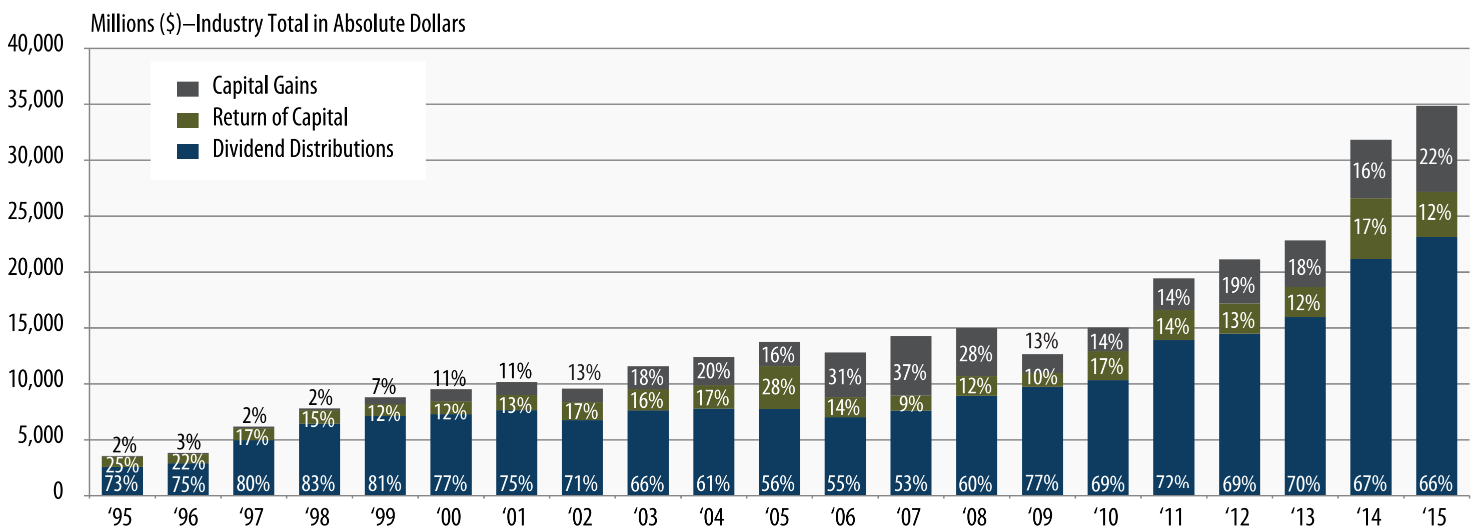
Potential Benefits	Potential Risks
Income: Rents and proceeds from real estate sales typically provide a steady stream of dividends to REIT investors (income).	**Interest rates:** REITs share some characteristics with bonds. Should interest rates rise quickly and significantly, REIT performance can suffer.
Growth: Increasing real estate values and rents provide potential for increasing REIT share prices (growth).	**Economic cycles:** REIT values revolve around their underlying real estate holdings. Economic downturns can hurt REIT valuations, as they do other major asset classes.
Inflation protection: Rental incomes have historically risen with inflation.	**Volatility:** REITs can be volatile at times. During the 2008 financial crisis, when real estate values dropped, REIT prices dropped 72 percent from peak to trough, while the S&P 500 fell 55 percent. (You can see the size of the drop in the chart on page 2.)
Liquidity: Since REITs trade like stocks on stock exchanges, buying and selling can be relatively easy.	**Management:** REITs are typically managed by professional management teams. Management acumen can have an impact on individual REIT performance.

How REITs Are Taxed

Taxation on REITs can be complicated, and every investor's tax situation is different. Before investing in REITs, it may make sense to get advice from a tax professional. In general terms, here are the types of income distributions REITs make, all of which are subject to taxes:

- **Dividend distributions:** When REIT shareholders receive dividends, these are generally taxed as ordinary income. Unlike stocks, REIT common dividends do not qualify for the lower common dividend tax rates; in other words, REIT dividends are "nonqualified" dividends.
- **Capital gains:** When REITs distribute capital gains to shareholders, they may be taxed at different rates. Keep in mind that capital gains for REITs are not subject to the 15 percent maximum capital gains rate. REITs often work to reinvest sales proceeds into other real-estate assets to avoid taxes on capital gains.
- **Return of capital:** When a REIT's common dividend exceeds its net income, it may make a "return of capital" distribution. This is not taxed as ordinary income. The investor's cost basis in the stock is reduced by the amount of the distribution.

Taxation of REIT Common Share Dividends 1995-2015



Source: National Association of Real Estate Investment Trusts (NAREIT) – "Historical tax treatment of REIT common share dividends"

Dividends paid by REITs are subject to change or elimination.

Wells Fargo and its affiliates are not legal or tax advisors.

Are REITs Right for You?

- **Do you need the income?** Investors looking for a potentially dependable income stream that can provide a hedge against inflation are most drawn to consider REITs.
- **Can you handle volatility?** REITs have had years when they have performed significantly better than the broad stock market, as measured by the S&P 500, and years when they have performed significantly worse. Investors with longer time horizons and who are looking for a potential hedge against rising inflation may be better positioned to handle short-term volatility.
- **Do you understand the tax implications?** The tax implications of REITs will vary based on your tax bracket. Be sure you understand how dividends, capital gains, and returns of capital are taxed.

An index is unmanaged and not available for direct investment.

Barclays U.S. Aggregate Bond Index covers the U.S. dollar-denominated, investment-grade (rated Baa3 or above by Moody's), fixed-rate, and taxable areas of the bond market. This is the broadest measure of the taxable U.S. bond market, including most Treasury, agency, corporate, mortgage-backed, asset-backed, and international dollar-denominated issues, all with maturities of one year or more.

Barclays U.S. Corporate High-Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB= or below. Included issues must have at least one year until final maturity.

FTSE NAREIT All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. Equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

S&P 500® Index consists of 500 industrial, financial, utility and transportation companies with market capitalizations of $4 billion or more.

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