

The Weekly Take

Built to Last: Investing in Real Estate through REITs

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Spencer Levy

REITs play an important role in providing equity and debt capital to commercial real estate. The range of REIT's available for investors is incredibly diverse, and indeed, the REIT markets in the U.S. are more mature than in most countries, which helps provide considerable liquidity to the industry. On this episode, we delve into all of that and more, a master class in an important class of real estate investing.

Steven Wechsler

Let me put it this way, REITs are about four and a half trillion dollars of real estate assets in the United States.

Spencer Levy

That's Stephen Wechsler, the CEO of Nareit, the leading trade organization of the U.S. REIT industry. Nareit represents publicly traded real estate companies by leading conferences and events, by engaging with policy makers at the federal, state, and even international level, and by reaching out to the wider investor community to provide data and information affecting the industry. Coming up, REITs 101: News you can use along with the state of play in this important class of investment vehicles. I'm Spencer Levy, and that's right now on The Weekly Take.

Spencer Levy

Welcome to Washington D.C. and we're delighted to tape The Weekly Take today with Steve Wechsler, the president and CEO of Nareit, one of the largest and most important real estate organizations that help our industry. And Nareit and Steve, thanks for coming out today.

Steven Wechsler

Good to be here with you, Spencer. I look forward to chatting.

Spencer Levy

We're going to start big picture, because a lot of our listeners hear the term REIT and they say, oh, it's a real estate vehicle, but there's a specific definition of what a REIT is versus just the ownership of real estate. Define what a REIT is, what the different types of REITs are.

Steven Wechsler

A REIT is a real estate investment company that makes a tax election under the federal tax code, which is then honored by the various states in the US, here's reciprocity. And that tax election means that the REIT, the real estate company, has to have at least 75% of

its assets in qualifying real estate, 75% percent of its income, effectively rents or interest from mortgages, and must distribute at least 90% of its taxable income each and every year to its shareholders. That's the core agreement a REIT makes. There's a myriad complicated additional rules not worth getting into, but that's the basic story. It's really about long-term income-producing real estate investment, whether it's equity-focused or debt-focused through the mortgage market, a REIT can come to exist. The way the market has sorted itself out over the years is the bulk of publicly traded REITs are focused on equity, equity REITS, but there are also a number of publicly-traded mortgage REIT's that are focused at holding mortgages and financing real estate as well.

Spencer Levy

How big is the publicly traded REIT business today?

Steven Wechsler

Let me put it this way, REITs are about \$4.5 trillion of real estate assets in the aggregate in the United States. About \$2.5 trillion of that is publicly traded stock exchange listed REITs. About \$1.5 trillion is private REITs which are used in all types of fund settings to hold and own real estate, and the remainder are what we call public non-listed REITS. Some call them non-traded REITs, but many know them today as NAV REITS.

Spencer Levy

One of the interesting things about REITs as a vehicle is how it's expanded the definition over the years. When I got into this business a long, long time ago, that's when the digital REITs started coming in. Is a cell tower a REIT? Is a data center a REIT? Is the income good enough? But now, to have 75% qualifying income, I think the definition may be expanding to include some of these new asset types.

Steven Wechsler

You know, it's an interesting topic. The definition never expanded. If you go back to 1960 when the original REIT law was passed, it really focused on land and effectively permanent or relatively permanent structure put upon the land and the ability to own those assets and bring in rents from those assets, or potentially finance them through a mortgage REIT. And it made no differentiation, the law, between whether that land and structure was used for office buildings and shopping centers versus other types of activities. It's just that the way the economy operated in those years and the way that business came together, it was often in these four, oftentimes we'll call them core groups of retail, residential, industrial and office. The reality is as the economy changes, you're going to find land and structure used for much more. So REITs were always capable of holding, owning, and operating as real estate assets, those properties, not the underlying business necessarily. But that's why today about half the equity market cap of the REIT space is in those four core groups, and the other half is everything else. So think about it this way: If you go back to 1960, when the REIT law was first passed, healthcare was a very small percentage of GDP, under 5%. Today, it's approaching 20%. So doesn't it stand to reason that more and more land and structure in our country is going to be dedicated to healthcare? It is, and that's why we have a healthcare resector today. The same is true, of course, as you mentioned, with data centers. I wave around my phone, no one can see it, but I'll wave it for you. And if you think about it, we're all holding these phones all day and using them for everything. The reality is it takes a lot of land and structure for us to use these phones, and when we think about in terms of the towers, telecommunications towers. There are three large publicly traded tower REITs today. And think about the cloud. The cloud's not in the cloud, it's in a bunch of buildings in those data centers, and we have

significant members that are data center REITs today that hold properties here and around the world.

Spencer Levy

One of the beauties of the REIT structure is twofold from the individual investor standpoint. One is it feels good to own hard assets and you own a share of a big REIT, and you own a piece of a building. But also you get those dividends which are required to be put out every day at, correct me if I'm wrong, is it 90%?

Steven Wechsler

The minimum distribution to comply with the REIT rules is 90% of taxable income. REITs generally are paying out at least 100% of taxable income, it's often misunderstood. If a REIT didn't pay out 100%, that remainder, that 10%, would be subject to the corporate tax. So, REITs at least distribute 100% of taxable income. So the shareholders can get all the taxable income. And the good news is REITs are able to retain some degree of capital because of the way the tax system works with respect to depreciation, deductions, and some other non-cash expenses.

Spencer Levy

And then from the individual investor – and again we're going to REIT 101 here – from the individual investor's standpoint, when you get that dividend, is it called a dividend?

Steven Wechsler

Yes.

Spencer Levy

How are they taxed on that dividend?

Steven Wechsler

The dividend can have different components. The bulk of REIT dividends are ordinary income, but there are also aspects of a REIT dividend that may be capital gain, and therefore tax to the capital gain rate. And there's also the potential for return of capital, which is not taxed currently, but reduces basis in the stock. The vast majority of REIT dividends in the aggregate are ordinary income. The minority is going to be the return of capital or capital gain. It will vary from company to company. Some companies may have far more return of capital, which reduces the basis. Occasionally there could be a large capital gain distribution, depending on the underlying business of the REIT. And what's important to know is the dividend from the REIT ordinary income is taxed at the ordinary rate, but currently qualifies for this Section 199A deduction, currently 20%, which means you're only getting taxed on a \$100 dividend. You're getting tax on \$80.

Spencer Levy

What's the breakdown between institutional and retail?

Steven Wechsler

Today, our best estimate is REITs are owned by approximately 170 million Americans. That's roughly half the households of America have a stake directly or indirectly in REIT-based real estate investment. Now, the bulk of that is indirect, and that comes about through retirement savings and more, 401k plans, IRAs, defined benefit plans that are investing in REITs, and all of that means that the original goal from 1960 which is to make real estate investment more accessible to effectively democratize large-scale professionally managed real estate investment is working. So more and more Americans

have access to real estate in their investment portfolios because of the public real estate market. Publicly traded real estate sits at the intersection, I would say, of the real estate marketplace and the finance marketplace. So it's a way of bringing capital into the real-estate space in conjunction with professional capable management, with ownership with respect to public rates by the public, and to do so in a way that provides liquidity, provides accountability, and provides the potential for a long-term generation of income and capital appreciation over the long term. That's effectively the bargain that's being made between the REIT entity and the management team and the underlying public policy.

Spencer Levy

And they're typically conservative vehicles that are designed for long-term growth. Is that a good way to put it?

Steven Wechsler

Yes, the listed real estate market in the United States is notable because in the aggregate it's roughly 30% leveraged. I think you'll often see on the private side twice as much leverage, plus or minus. And the reason for that is the public capital markets don't want to take on the added risk of more leverage. And so you'll see, you know, I'm talking about the average and the aggregate, some are a little more leveraged, some somewhat less leveraged, but on average, there is a ceiling on that leverage that's imposed not by law, not by regulation, but just the reality of the public capital markets. The other important point to note is, unlike most privately held real estate, the public real estate market through REITs, is largely using investment-grade corporate bonds to finance themselves. Yes, REITs will use mortgages and secured debt on occasion, and some companies use far more of it than others, but if you look at the industry as a whole, the vast, vast majority of debt is unsecured.

Spencer Levy

And I think this is a key point for our listeners who don't understand this about a key distinction between a REIT and a developer that's not a REIT is that developer is gonna have a mortgage on each individual assets. REITs typically do not. Typically it's all at the corporate level. A very different way of financing and quite candidly there's a lot of efficiency to that. Typically you can get a lower cost by doing this in many instances.

Steven Wechsler

Yeah, most of the time it works out that way, so there's ongoing access to capital in relatively liquid debt marketplaces.

Spencer Levy

And speaking of other marketplaces, as you mentioned, Steve, REITs are international all over the world. Tell us about the international scene of REITs and international investors coming in.

Steven Wechsler

REITs first began in the United States in 1960. And today, there are more than 40 countries and regions, we'll say, around the world that have adopted their own REIT laws. All the G7 nations have REITs, roughly two-thirds of the OECD nations have REITs, and if you look at the developed world in terms of the financial marketplaces, the vast, vast majority, say 80 percent, of the listed, stock exchange listed real estate market in the developed world, is populated with REITs. And so in the public capital markets, the way the public around the developed world is engaging with investing in real estate is through REITs. It's been quite remarkable. One of the things Nareit set out to do early in its history,

Nareit was founded in 1960 with the beginning of REITs, in 1972, Nareit created the first REIT index. And, we created that index to better inform and educate the public about REIT-based real estate investment. Today, Nareit works with one stock exchange group, unit, FTSE, and with the FTSE-Nareit US Real Estate Index. And we're also partners with the European Public Real Estate Association, EPRA, and the London Stock Exchange Group's FTSE to put out to the world the FTSE-EPRA-Nareit Global Real Estate Index, which represents listed real estate companies in their constituents around the world, both developed and emerging markets. So it's all a way to ensure that the public is able to benefit from all the good that comes from diversification through real estate exposure to the different sectors of real estate, to the difference geographic regions of real estate. One of the things I often say to people—Steve Wechsler sitting in Washington DC, why shouldn't I be able to get the benefit of the cash flow and potential appreciation the best buildings, best management teams, New York, San Francisco, Dallas, but also London, Paris, Tokyo, Singapore, and beyond? And I can. And that's through REITs and listed real estate companies around the world that are in the public capital markets. It's like a no-brainer. I can, if I want, get a share of that cash flow and appreciation.

Spencer Levy

And you can buy it through a commingled vehicle or buying individual stocks as well.

Steven Wechsler

You can buy the stocks as a direct investor in the stocks, you can buy in mutual funds, exchange traded funds, index funds. There's an endless way to get exposure to REIT based real estate investment in the U.S. and around the world today.

Spencer Levy

Now, one of the things that I remember going back 25 years when I was covering the REIT business was the volatility of the REIT sector was lower than the market overall. I'm not sure where it sits today, but how would you compare REIT performance overall, the indexes, to the overall market? More volatile? Less volatile? About the same?

Steven Wechsler

One way to think about it is over the short term, we're talking about real estate stocks. And there's a degree of volatility in day-to-day, hour-by-hour, minute-by-minute movements in the public capital markets that is inevitable. Markets move on big events, and sometimes even on smaller events day to day. And we see that in the REIT space. They're real estate stocks. Longer term, you start looking over many months, many years, and REITs perform more like we would think real estate directly held performs. And so I'm often surprised the difficulties some people seem to have in understanding that REITs are real estate stocks. In the short term, they're going to perform like stocks. In the longer term, as we know, at least 75% of the assets and income have to be real estate, if you actually look at the industry, it's going to be closer to 90 plus percent. And they're going to reflect in the long term what's happening with the underlying real estate business.

Spencer Levy

Tell us about how the last couple of years have impacted the REIT industry.

Steven Wechsler

Well, I think one of the interesting aspects of the last few years has been you mentioned volatility. We've seen a negative correlation with interest rates in the last few years.

Spencer Levy

Okay, let's stop there. What does that mean?

Steven Wechsler

It means that REITs perform poorly with interest rates rising. Sometimes in the past with interest rates rising, and a lot depends on why rates are rising, right? So if rates are rising because the economy is growing, real estate has tended to perform pretty well because the demand for real estate has gone up and people have made money in real estate, high rates, low rates, mid rates. But in this case, in part because a lot of this was inflation-induced with government spending and everything that's been talked about, particularly in the post-COVID environment, it became a trickier situation in terms of real performance, which reacted very quickly to the Fed raising rates dramatically. So it's been tougher. In the early years of the fight against inflation. More recently, REITs have come back pretty nicely, but we'd like to see more.

Spencer Levy

I know you don't get involved in the day-to-day operations of your constituents, but anything specific that has come out of the significant challenges, particularly in the office real estate sector.

Steven Wechsler

Well, I think the office REIT sector is an interesting one coming out of COVID. And one of the things that has always struck me over the decades I've been representing the real estate community is that there is a degree of obsolescence, not just in office, but in all types of real estate use, and oftentimes people underestimate the obsolescence factor that comes about through technological change in society. And changing demands in the economy. And I think to some extent, parts of the office sector are going through this today in terms of work from home, changing patterns of usage, and what we're beginning to see in the office market is yes, people are coming back, and in the higher quality buildings, there continues to be significant demand. And so then you gotta look at the older building stock people are looking, it can't be converted to residential or other uses. And this is going to play out over a period of years because it takes significant time, you can't change on a dime in the real estate space. So it takes a significant time to rethink land use and match it to the way the economy is changing, the way technology is changing. That is going to get played out in the office sector over a period of years, and we're seeing it. Some of it may well have been inevitable, but what happened with COVID and introduction of Zoom technology and all of this that people have been talking about, it's going to change usage patterns. And we see it in all the different sectors of real estate, frankly, in terms of how our society uses real estate. We talked about it earlier in terms of. Now we need healthcare-related real estate, a way we didn't 50 years ago. Now we need buildings to provide the cloud. We didn't. Same thing is going to happen across all the sectors of real estate.

Spencer Levy

So let's talk about that mortgage REIT space. How'd they do during the downturn and how do they interact with the marketplace?

Steven Wechsler

Well mortgage REITs are, I think, much more related to the movement of interest rates and the spreads associated with them in terms of managing their real estate risk. We have two basic types of mortgage REITs. The larger group is residential focused.

Spencer Levy

When you say residential, single-family or multi?

Steven Wechsler

Generally single family, but they're basically financing in a sense the GSEs, Fannie Mae, Freddie Mac. They're holding their paper and then they're managing the various risks involved with that in terms of the interest rate risk. And they are effectively part of the system of financing. The single-family residential market in the United States because they're taking in that Fannie and Freddy back paper. So those are residential mortgage rates. We have commercial mortgage rates. They're really part of the stream of financing commercial real estate in the country. They are acting very much as an alternative to bank and lending in the marketplace, and they may be providing mezzanine financing, second mortgages, maybe the primary mortgage, it will vary very much. And they are an alternate source of capital for owners of commercial real estate.

Spencer Levy

And how did they do during the downturn?

Steven Wechsler

They were hit pretty hard during the downturn. There was concern about the rising interest rates and what it meant to their loans. But things are firming up.

Spencer Levy

So if you're listening to the show today and you're a real estate owner developer, you're thinking about doing a REIT versus something else, what do you say to that person?

Steven Wechsler

What I would say is that whether public or private, REIT-based real estate investment provides a discipline in terms of real estate investment. And that discipline of having to pay the dividend each and every year puts management in a position to figure out how to successfully do it. And that constraint is, I think, an attribute. So if you look at companies generally in the public sphere, managing the firm to pay that dividend, to grow that dividend, to do so with transparency and accountability, and ensuring the underlying liquidity of the stock through the public capital markets creates a formula for success over the long-term that redounds to the benefit of the investor not too much leverage. The repetitive cash flow hopefully growing. The decision making of the management constantly questions which might aggravate people but it's a reality. People have a lot of good questions, and management needs to be responsive and when you look at all of that, it creates a recipe for real estate investment. In which people can have confidence because of the underlying requirements and guardrails that exist both through law and regulation as well as the unwritten rules of running a public company.

Spencer Levy

There's some nomenclature in our business. I think it's called FFO – Funds From Operations. What's the difference between FFO and NOI?

Steven Wechsler

FFO is based on GAAP accounting, but FFO is determined by taking a gap net income number and adding back certain items, the most significant of which is depreciation, and also excluding gain or loss from sales.

Spencer Levy

I think what you're suggesting, Steve, is that FFO is designed to get as close as you can, realistically speaking, to what is the actual income taking out some of the accounting things like depreciation.

Steven Wechsler

I think that's a first step.

Spencer Levy

So, a couple other questions. Transaction volume is down today. And there are some points in the market cycle where REITs are more competitive, there are some where they are less competitive, depending upon the cost of their capital. Where are they today and how are they competing in today's somewhat transaction-starved market?

Steven Wechsler

I think that REITs are in a good position today in the current market, although transactions are down, REITs have access to capital, they tend to have low leverage in place already, and they I think are ready, willing, and able to make an entrance in the transaction market when the right properties or portfolios are available. Particularly if they can do it in a creative manner, and time will tell.

Spencer Levy

Let me pause on that one point, because I think this is really important for our listeners to understand. When Steve says creative manner, he means that buying the asset in a way that is less expensive than what their current valuation is, their current multiple, has to be at a discount to that. If you could just explain what a creative means

Steven Wechsler

Yeah, it basically ensures that the shareholder is getting the benefit of the acquisition and is not effectively getting diluted in terms of the expenditure of capital for an asset and at a price that varies in a negative sense from the stock.

Spencer Levy

So just to put some like raw numbers on this, let's assume you're a multifamily REIT and your net asset value, your deemed net asset value, values your REIT at five and a half percent cap rate and the asset that you wanna buy is at a four and a cap rate, unless you have extraordinary growth expectations for that asset, hard to buy that if you're a REIT. Fair way to put it?

Steven Wechsler

Yeah, people will be in the penalty box. They know.

Spencer Levy

One of the things I find interesting about REITs is that they're also typically vertically integrated, meaning that instead of farming out leasing or management or some of these other functions, very often they're under one umbrella. Tell us about why that's the case.

Steven Wechsler

First of all, I think in the REIT space you will see a degree of variety in this context. But I do believe that many companies in their management believe that they have the skill set and ability to best manage the asset and operate the asset when it comes to the real estate space. And therefore they will internalize the management, whether it's the property management or the asset management or both as well as the executive functions. You

know, when REITs were first created in 1960, effectively the management had to be externalized. And I mentioned there are over 40 countries around the world, it's an interesting fact that if you look at what's happened in those 40 nations... In Europe, by and large, they followed the current US model where the management is internalized for the REIT. In Asia, they've really sort of decided to look at 1960 as opposed to 2025, and the management is externalized. There are some exceptions, but largely sometimes the law or regulation requires external management.

Spencer Levy

I think they're external in Mexico too, isn't it?

Steven Wechsler

Yeah. What we have in the United States is choice, right? Which is a good thing. So in the United States, management can be internalized or externalized, and what we have in the listed real estate market is the vast, vast majority of the listed REITs are internalized management, although there are some that are external. And on the private side of REITs, you see far more external management in the United States. So there's that, but I think that different companies will have different philosophies, for instance, with respect to property management, asset management, and whether to use outside third-party assistance or not. But, in general you'll see much more internalized in the region.

Spencer Levy

There's also a math reason for this, but when we talk about qualified income for that REIT, if you get a fee for managing that asset, that's qualified income, but if you externally hired somebody, it might be an expense. Is there some of that going on as well?

Steven Wechsler

I think when you're the owner, you're good. So think about it this way, if we're in a partnership, 50-50 partnership with a REIT, and the REITs doing the management, then they're in a good position. But they can't get into the property management business as the REIT itself for that to be qualifying income. What they can do, and maybe this is what you're driving at, is set up what we call a taxable subsidiary. And they can conduct a property management business for others in that taxable subsidiary, which is subject to corporate taxes. Go back to the fact that REIT must hold at least 75% assets real estate, 75% income, qualifying income, rent, mortgage interest, but it must distribute at least 90% of taxable income. What you have in these cases is you get the dividends paid deduction off the corporate, you have to compute a corporate tax bill. You then get a deduction, and if it's not qualifying income, you're not going to be able to deduct that, and you can't in the taxable subsidiary, that's subject to the normal tax system. So if the business is purely managing property for other people, not you, then it's going to be embedded in a taxable subsidiary that's subject to the same corporate tax rules. If you're part owner, it's a different situation.

Spencer Levy

And this is actually quite a common structure in certain segments. Multi-family, I know there's a lot of large multi-family reach that's managed on behalf of third parties. Self-storage is yet another sector where it's quite common, not quite as common in retail and office and industrial, but I would say those sectors, this taxable subsidiary is quite a common structure.

Steven Wechsler

REIT rules were first adopted in 1960. In 1986, there was the Tax Reform Act that was mammoth at the time, and embedded within that was the ability for REIT to be internally managed, to provide all the services normally associated with real estate ownership. That was 1986. In 1999, Congress then modified the REIT law to permit taxable subsidiary, so that, really importantly, a REIT could be competitive in the real estate space by providing these types of services other companies could, but not doing it within the REIT itself, but through a taxable subsidiary.

Spencer Levy

Steve, you've been in the business a long time. You've done so much great work for our industry. How do you see the next couple of years playing out?

Steven Wechsler

I think the next couple of years look positive to me. I think we can see mergers. We'll see acquisitions. If on the private side people get some conviction, there could be some privatizations. We haven't seen the conviction yet. I think people have been wary of the interest rate picture. People often ask about privatizations of public reads. And to me, it's just part of the to and fro of the marketplace. It's a healthy thing. Companies go public, companies go private, public companies buy private portfolios. It's all to the good and, I, one of the interesting things is if you go back decades, decades and decades, there were a couple hundred REITs, and today there's a couple 100 listed REITs and people will say to me 'Aren't there too many listed REITs?' or say 'There are too many listed REITs,' and I say, I don't know if you go back 10 years, 20 years, 30 years, 40 years, there were plus or minus, I'm saying, a couple hundred listed REITs, and today we have a couple hundred now, as we talked about. Some of them weren't in the sectors because the economy has changed.

Spencer Levy

As the economy innovates, so must REITs.

Steven Wechsler

Yes, and the ability to raise large amounts of capital, the public markets can work well.

Spencer Levy

On behalf of The Weekly Take, what a great conversation today here in DC with Steve Wechsler, the president and CEO of Nareit, and I say this on behalf of the industry, thanks for everything you've done for us. You've been in this business a long time, doing a lot of good for us, so really appreciate you taking the time to talk with us on The Weekly Take.

Steven Wechsler

Thank you, Spencer. I've enjoyed the conversation. I've had the privilege over many, many years to represent not just the REIT-based real estate community, but the real estate community at large, public, private, finance, equity investment, you name it, across all sectors. So it's allowed me to see our community, both in its full breath and depth. And I've enjoyed it. Thank you Steve. Thank you.

Spencer Levy

For more about the REIT industry and related content, check out our website, [CBRE.com slash The Weekly Take](https://www.cbre.com/the-weekly-take). We recently covered a variety of angles on real estate investing, and we encourage you to learn more. It's all there in our archives, as well as on your favorite podcast platform, wherever you find the show. We also have more to come, deeper and more diverse insights on investing, developing, and operating across the real

estate spectrum. So stay tuned. For now, we thank you for tuning in and look forward to having you back again soon. I'm Spencer Levy. Be smart. Be safe. Be well.