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Gimme shelter

Where do you turn in such an unstable investing environment?

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RBC Dominion Securities vice-president Leigh Cunningham advises holding proportionately fewer equities

The warnings have been out there for months -- Canadian investors are too heavily invested in home-grown energy and commodities stocks.

Numerous prognosticators have advised people riding the impressive three-year run on the Toronto Stock Exchange to sell some of their holdings, lock in the profits and reinvest the money elsewhere, preferably in safer vehicles.

After all, we've seen this picture before. Remember the all-powerful Nortel Networks, the stock that was worth one-third of the entire TSX, the one that would lead us all to the promised retirement land earlier than we ever dreamed?

Nortel peaked at about $120 in 2000 and next to nobody was selling.

"To the moon, Alice!" they would shout.

The great Nortel then fell down the proverbial elevator shaft to trough at just 79 cents -- a penny stock! -- two years later. Since then, it's been mainly flatlining in the $2 to $4 range.

This time around, very few have heeded the advice to diversify, preferring instead to hold out hope the wave will continue. That means very many received a serious jolt over the past two weeks as the TSX wave crashed, wiping out all of the gains of 2006 in a few short days.

So, where do you turn if you're looking for shelter in such an unstable environment?

A recent report by CIBC World Markets says recent price declines have made real estate investment trusts, or REITs, more attractive investments in its view.

"Their fundamental outlook has not changed," the report says. "Leasing markets for commercial space continue to strengthen and investment markets remain robust. Rates of new space construction are constrained and well-disciplined, providing a high degree of predictability for commercial property income in 2006 and 2007."

CIBC says it expects one-year returns in the REIT sector to be about 12 per cent, which is pretty good when you consider the long-term returns on stocks is around four per cent lower than that.

REITs are less risky than many other investments primarily due to the predictable flow of revenue they receive from their long-term lease agreements with tenants.

But they are by no means risk-free. Rising interest rates can hurt them for a number of reasons, including hiking the cost of capital. (Essentially, their behaviour is not unlike that of a bond, where the price falls as interest rates rise.)

Kate Warne, Canadian market strategist for Edward Jones, says REITs do typically have low correlation to the stock market -- that is, they don't tend to move in the same direction and at the same time. But she cautions they've also benefited from generational low interest rates over the past five years.

"Will they continue to have low correlation if we move into an environment of rising long-term interest rates?" she asks.

"REITs tend to have lower correlation but I wouldn't always count on that. A lot of industries seem to be correlated when we don't want them to be."

Even though interest rates have been rising steadily for the past year, just a few days ago, BMO Nesbitt Burns economist Douglas Porter predicted the Bank of Canada would soon raise them again to choke off expected inflation.

Of all the REITs in Canada, Edward Jones is most bullish on RioCan, the largest and most-established player in the shopping centre sector.

"It has the strongest credit rating and it's the best diversified in its business but we think you're buying fully-priced shares," she says.

Kevin Hooke, vice-president of corporate finance at Wellington West Capital in Winnipeg, says investors interested in the REIT sector need look no further than their own back yard. They might even find a few deals in the tall grass.

Lanesborough, Huntingdon, Lakeview and Westfield REITs are all based in Winnipeg. The biggest factor impacting their success, he says, is the supply and demand for real estate in their respective market.

"I think REITs are a good place to be if you're in strong markets where the fundamentals are good and you're a believer that interest rates aren't going to increase appreciably. Then you have a solid investment," he says.

He says Huntingdon and Lanesborough in particular are trading at attractive yields.

Arni Thorsteinson, CEO of both REITs, is inclined to agree. He says he considers REITs defensive investments because their value is supported by the distributions they pay out.

Carving out a market niche is also key for REITs, he adds. Lanesborough, for example, is one of four apartment REITs in Canada and it's got considerable exposure in Fort McMurray, Alberta, focal point of the province's lucrative oil sands.

"There isn't an apartment to be had. Rents for two-bedroom apartments are $2,600 per month," he says.

Leigh Cunningham, vice-president and investment adviser at RBC Dominion Securities in Winnipeg, is advising her clients to rebalance their portfolios and reduce the amount of equities they own.

She says Canadian equities outperformed their bond counterparts from 2003 to 2005, a streak last seen from 1987 to 1989.

"What are the chances of a fourth year of equity outperformance relative to bonds? It's happened once in the last 49 years," she says.

She says many investors can tolerate the volatility of equity markets when they're on their way up, but the bumpy ride seriously loses its appeal when they're on their way down.

"People's memories are short," she says. "They forget where we came from several years ago. We had three outstanding years in the stock market. It makes sense it's going to pull back at some point."

Rather than stuffing money in your mattress, Cunningham recommends increasing foreign content and fixed-income positions for equity-heavy investors. She says she's using exchange traded funds to get exposure to Europe, the U.K., Australia, Japan and the Far East.

"We're just trying to protect some of the gains we've had by redeploying money into other asset classes," she says.

Warne recommends investors move into less risky investments, as well. She suggests consumer staple stocks, such Shoppers Drug Mart, Proctor & Gamble and PepsiCo., because they're slow-growing, dividend-paying stocks that are attractively priced right now.

She also recommends bank and insurance company stocks, because of their dividends, current price and positive outlook for growth, as well as health care companies, such as Johnson & Johnson and Abbott Labs, which are benefiting from global growth.

"You want to look for companies where you continue to see earnings growth and the stocks haven't moved up as much as a result. We think the stocks are less risky today because they're more attractively valued. They won't react as much to commodity volatility," she says.

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