Below is a Q&A session sponsored by SNL Financial with the financial writer, Ralph Block. It originally appeared as a blog on 7/9/13:

Ralph Block, author of "Investing in REITs," has been a REIT investor since 1972 and was a REIT portfolio manager from 1995 until his retirement in 2007. Opinions expressed in this blog are solely those of the author and do not represent the views of LDR Capital and SNL Financial.

Q. When we ended our discussion last week we were about to consider one other income opportunity for investors — REIT preffereds. But they've taken a pounding since the bond market began to [back up].

A. REIT preferreds are, of course, fixed-income investments that provide very substantial dividend yields, with only modest default risk. They have been solid investments over time but, being quasi-bonds, they are exposed to price declines when interest rates and bond yields rise — and when risk aversion spikes. They should appeal to conservative yield-hogs, particularly during stable bond market conditions.

Q. So isn't it dumb to invest in them in a rising interest rate and higher bond yield environment?

A. First, all we know is that bond yields have escalated in recent months; anyone who tells you he knows where bond yields are going next week, next month or next year is dumb. All those growth retardants that we read about every day remain with us, and a further rise in bond yields is hardly a sure thing. Also, remember that the high dividends on these preferreds can fairly quickly offset any capital depreciation, especially if one has an investment time horizon longer than one year.

From June 2000 to December 2012, data from LDR Capital Management LLC shows, the spreads between REIT preferred yields and 10-year Treasury yields tended to tighten when the latter rose; this makes sense when we understand that business and recession risks are priced into REIT preferreds — thus lower default risk in the stronger economic conditions usually associated with higher Treasury yields can offset much of the effects of rising bond yields. And, finally, data from LDR, Bloomberg and Wells Fargo Securities LLC, comprising seven periods of rising 10-year Treasury yields beginning in September 1998, show that REIT preferreds provided a negative return in only one such period (September 1998 to January 2000), when the 10-year's yield rose from 4.42% to 6.67%.

Q. Is there any evidence of this resiliency in the current time period?

A. I looked at two representative REIT preferreds the other day, Taubman Centers Inc.'s TCOpJ and Public Storage's PSApS, which can be considered good- and excellent-quality, respectively. During the past six weeks (May 31 through July 15), a period of rising bond yields, the yield on the 10-year Treasury jumped from 2.16% to 2.56%, an increase of 40 basis points. During that same period, the current yields on the TCOpJ and PSApS rose just 25 and 30 basis points, respectively. And the losses to shareholders of these two preferreds during that time period, with one quarterly dividend taken into account, were just 2.1% and 3.4%, respectively. That hurts, but it's hardly disastrous.

Q. What do I think of REIT preferred values today?

A. I think they are very reasonable, certainly relative to yields on 10-year Treasurys, Baa rated bonds, and perhaps most equities. REIT balance sheets are, for the most part, quite strong. We can get current yields (and yields to first call) on good-quality REIT preferreds

of somewhere between 6% and 7%. We may not do *a lot* better than that with equities, especially when adjusted for risk. Also, they continue to offer significant portfolio diversification benefits. Correlations with other asset classes have been modest during most time periods; according to LDR, using its own data and that of Bloomberg, REIT preferred stock correlation versus the MSCI US REIT Index (RMZ) is just 0.60x, and versus the S&P 500 is only 0.38x. REIT preferreds are also less volatile; LDR's data suggests that REIT preferreds are only one-quarter as volatile as the S&P 500 Total Return index.

Q. So, how does one decide how to invest in these strange birds?

A. I like solid stuff when buying REIT preferreds. Debt leverage and EBITDA ratios are, of course, very important. I look for good value among quality merchandise, but will sometimes buy the preferreds of a medium or even lower-quality REIT if its properties are in a very stable sector, the business strategy is conservative and management is committed to reducing debt leverage. And some preferreds are mispriced, as when a good REIT doesn't try to appease the Rating Gods, and thus lacks an investment-grade rating. I also look at the extent to which preferred dividends are covered by AFFO.