REITs & Rates

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THE MYTHS OF REITS AND RATES

As my co-author Stephanie Krewson-Kelly and I explain in *The Intelligent REIT Investor*, “one of the greatest misunderstandings about REITs is how rising interest rates will affect their future profitability.”

By extension, some of the most attractive buying opportunities in REITs have resulted when investors erroneously drove down REIT share prices because they expected interest rates to increase. ...

Most REIT investors tend to focus too much on the perceived relationship between interest rates and REIT performance. Rising bond yields may unsettle markets in the short term, but what matters most in the long run is the direction of the economy and job growth.

In 2015 many investors shifted away from REITs leading up to the Federal Reserve’s first interest rate increase in years. And yet, despite a volatile backdrop for financial markets, REITs still managed to deliver a 3.2% gain for the year, edging out both stocks and bonds at 1.4% and 0.6%, respectively.

It’s true that the uncertainty of the first interest rate hike is behind us, but now the market is anxious for another nudge. As the economic recovery progresses, I believe that investors may benefit from understanding how REITs have responded in past rising rate environments.

As you recall, the Fed was expected to raise the Fed funds rate ¼ point at the September 12 FOMC meeting, but most members didn’t think conditions were robust enough to warrant a rate increase. Many economists believe we’ll see a second rate increase this year, but as Brad Case, vice president of research at NAREIT explains, “It’s not that they (REITs) won’t be affected: it’s that usually an increase in interest rates happens because macro conditions are improving—that’s certainly the case this time—and what REIT returns respond to is the improvement in macro conditions, rather than the change in interest rates per se. And because of that, usually REITs do well when interest rates are increasing—not because higher interest rates are good for REITs, but because both developments—higher interest rates and higher REIT returns—are caused by the improvement in macro conditions.” ... There’s a second-order effect, too. If the REIT borrows at a (low) fixed interest rate, and market interest rates go up, then the market value of the REIT’s debt declines, just the same way that the principal of a bond declines (because its interest rate is fixed but market rates have gone up). But the debt counts as a liability on the REIT’s balance sheet, which means that its liabilities have declined, which means that the REIT is worth more.

THE LAST FED TIGHTENING CYCLE

The last monetary tightening cycle occurred between June 2004 and June 2006, a period of economic expansion (Exhibit 1). Just before the Fed’s first rate hike, a strong jobs report in March 2004 led to a spike in Treasury yields, causing REITs to sell off and underperform the broad stock market over the next month. But after the market digested the jobs report, both the federal funds rate and REIT returns proceeded to move higher at a measured pace as the economy continued to improve.

Beginning in mid-2004, the Fed raised the federal funds rate 17 times, from 1.25% to 5.25%, during which time U.S. annual gross domestic product increased from $11.5 trillion to $13.4 trillion. Over this period, REITs had a cumulative return of 57.9%, compared with just 15.5% for stocks and 5.9% for bonds. While the current environment is not identical, there are key similarities, including strong job growth, an expanding economy and a general expectation of higher interest rates.

BEFORE AND AFTER FEDERAL FUNDS RATE HIKES

Prior to the most recent interest rate hike in December 2015, the Fed had increased the target federal funds rate 24 times in the past 20 years. As Exhibit 2 illustrates, REIT performance prior to the change in the federal funds rate has historically been positive on average and generally in line with the broad stock market.

Afterward, however, REITs have dramatically outperformed stocks in the ensuing 3-, 6- and 12-month periods. This pattern shows that long-term performance is not about incremental increases in interest rates, but whether cash flows are growing. Typically, the Fed decides to increase its target interest rate in response to improving employment data and rising inflation, which are generally reflective of a more robust economy.

Exhibit 1: U.S. REITs During the 2004–2006 Interest-Rate Hike

U.S. REIT Total Return (lhs)
10-Year U.S. Treasury Yield (rhs)

At December 31, 2015. Source: Bureau of Labor Statistics and Morningstar.

Performance data quoted represents past performance. Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above.

U.S. REITs represented by the FTSE NAREIT Equity REIT Index; stocks represented by the S&P 500 Index; bonds represented by the Barclays Capital U.S. Aggregate Bond Index. See page 4 for index definitions and additional disclosures.

Exhibit 2: Cumulative Total Returns Before and After Increases in the Federal Funds Rate Over the Past 20 Years

U.S. REITs
U.S. Stocks

At December 31, 2015. Source: Cohen & Steers and FactSet.

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The federal funds rate is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. Performance data above based on averages of the rolling 3-month, 6-month and 12-month returns at each federal funds rate change, which occurred on 3/24/1997, 6/29/1999, 8/23/1999, 11/15/1999, 2/1/2000, 3/20/2000, 5/15/2000, 6/29/2004, 8/9/2004, 9/20/2004, 11/9/2004, 12/13/2004, 2/1/2005, 3/21/2005, 5/2/2005, 6/29/2005, 8/8/2005, 9/19/2005, 10/31/2005, 12/12/2005, 1/30/2006, 3/27/2006, 5/9/2006 and 6/28/2006; excludes 12/16/2015 due to the lack of forward 12-month returns. U.S. REITs represented by the FTSE NAREIT Equity REIT Index; U.S. stocks represented by the S&P 500 Index. See page 4 for index definitions and additional disclosures.

PERIODS OF RISING TREASURY BOND YIELDS

Over the past 20 years, there have been seven times when the ten-year Treasury yield increased by at least 50 basis points over a period of one year or more (based on month end data). We use these parameters to distinguish between the sustained, meaningful increases in bond yields that typically occur as a result of improving economic growth and short-term yield spikes resulting from sudden shifts in market conditions.

REITs produced positive returns in six of the seven periods of rising bond yields and outperformed the broad stock market in five of these periods. The two times REITs did not outperform stocks were during the dotcom bubble in 1998–2000 and during the so-called Taper Tantrum in 2013, when Treasury yields surged in anticipation of the end to the Fed's aggressive monetary stimulus. In 2014, once the Fed actually began to scale back its easing measures, REITs performed exceptionally well, returning 30% for the year amid signs of continued strengthening in property fundamentals.

When the economy is improving and fundamentals are strong, yield-driven corrections have historically presented attractive buying opportunities for long-term investors. These downturns are generally driven by a Real Estate contraction in valuations rather than by company balance sheet strength or fundamentals. As the benefits of stronger economic growth become more apparent, valuations tend to return to normal. We believe investors who are aligned to take advantage of these opportunities will be rewarded over the long term.

Our thoughts

Whether your objective is Capital Appreciation or Income, Real Estate is an Asset Class we recommend, and publically traded REITs are the best way to gain exposure. However, valuations matter. In our October 3rd posting titled **The New Real Estate Sector** we wrote:

"Most of our clients, including those focused on Capital Appreciation, are significantly overweight REITs, fortunately bought at a time when they were out of favor. For clients looking for Income, we normally recommend a 10% allocation to this asset class, using a Closed End Fund (CEF) like the Global IGR as a Transitional Fund when it is trading at a significant discount to NAV. However, as shown below, it is currently trading at a below average discount, -12.5%: (a Morningstar Chart followed) Our valuation concerns, as previously shared, are also evidenced by our Buy/Watch list of stocks with heavy Insider Buying that meet our other criteria. That list doesn't currently contain any REITs. As a result we currently recommend that investors seeking Income be patient. The Fed is likely to raise interest rates at their December meeting, and the inherent volatility of REITs should provide future opportunities."

The subsequent Correction has been painful, as shown in this tablet from today's Forbes Real Estate Investor Hotline:

REITCap Weekly Update									
	% off High	% off Low	P/eFFO	AFFP P/O	Div Yield	1wk TRR	YTD TR	1yr TRR	3yr TRR
S&P500					1.98%	0.96%	8.84%	6.95%	8.96%
VNQ	**-15.06%**	**11.33%**			**3.03%**	**0.48%**	**1.71%**	**5.41%**	**9.87%**
Triple Net	-17.87%	29.72%	13.20	71%	6.27%	1.32%	16.81%	19.95%	8.51%
Industrial	-10.24%	39.21%	18.77	71%	3.66%	3.58%	25.37%	26.87%	14.33%
Apartment/Multifamily	-13.37%	18.21%	19.38	82%	4.28%	-1.58%	3.14%	7.20%	15.63%
Office	-12.99%	30.34%	13.99	57%	4.39%	1.53%	9.98%	9.78%	7.54%
Healthcare	-20.06%	27.92%	12.10	76%	6.26%	1.99%	11.29%	21.43%	5.74%
Datacenter	-23.51%	27.56%	14.62	51%	5.07%	0.84%	21.38%	24.07%	25.61%
Shopping center/Mall	-18.29%	12.51%	15.50	67%	4.18%	-0.16%	2.99%	4.00%	8.63%
Storage	-24.96%	12.60%	16.55	67%	4.73%	-2.73%	-5.83%	0.98%	14.85%
Own2Rent	-8.38%	54.33%	18.74	54%	2.26%	2.73%	26.89%	28.19%	7.65%
Campus Housing	-17.97%	16.95%	20.24	75%	3.77%	-2.40%	10.90%	16.58%	17.50%
Hospitality/Hotel	-12.33%	32.29%	9.53	60%	5.34%	1.65%	5.66%	-0.09%	4.28%
Manufactured Housing	-13.54%	23.36%	17.66	84%	3.92%	-1.77%	15.25%	25.29%	23.43%
Dirt	-4.48%	48.46%	36.11	102%	4.05%	8.18%	19.63%	10.61%	10.52%
Trees	-3.62%	56.48%			3.74%	5.05%	26.39%	19.10%	3.57%
Towers	-14.23%	19.39%	18.11	57%	3.28%	1.38%	5.62%	5.27%	9.54%

VNQ, which is often used as a benchmark, is the Vanguard REIT ETF. With over $60 billion in Net Assets it tracks the MSCI US REIT Index.

IGR's discount to NAV has improved to 14.4%, which isn't sufficient yet for us to use for clients. This weekend we added a second REIT to our buy list. So, given the improved valuations resulting from the current Correction (or Bear Market depending on which Sector) we are now recommending the Quantitative GFMRX for new clients. Both GFMRX, whose Risk ratio relative to the S&P 500 is 1.1, and IGR, with a Risk ratio of 1.5, are Global Real Estate Funds. However, GFMRX is an unleveraged OEF, hence its lower yield, while IGR is a CEF, which usually trade at a discount to NAV. IGR (green line) has been added to the Morningstar chart below: