REITs

From High Dividend Opportunities on Nov. 11th, with most of our edits in red:

Sell Property REITs?

We have been getting many emails and private messages by members who are concerned about the state of Property REITs and some who are worried and considering selling their REIT investments. Following these messages, we have decided to dedicate this article to them.

Summary:

- *Fears over REITs are increasing. Investors are worried of potential interest rate hikes, the state of the retail industry, the current market valuation, and the potential impact of Trump's tax plan.*
- *Yet, studies show that REITs perform well in times of interest rate hikes. Retail REITs keep posting strong results for the most part. REITs don't appear overvalued. And Trump's tax plan should be beneficial to REITs in our opinion.*
- *The bears seem to misunderstand the real drivers of REITs. REITs, unlike bonds, can grow internally by increasing their Net Operating Income or NOI and externally by buying new properties at a positive spread. The positive impact of growth is most often superior to other factors such as interest rate increases.*
- *Don't jump in and out of REITs. Real estate deserves a permanent allocation in one's portfolio* (at least 10% for most of our clients) *and REITs should be considered a long-term investment. Historically holding REITs for the long run has resulted in strong outperformance.*

REITs attract lots of negative press these days. This is especially true since Trump won the presidential election and treasury yields increased to newly high levels.

It led REITs to temporarily sell off as investors became more and more pessimistic on the prospects of REITs in times of increasing interest rates. Moreover, with the growth of companies like Amazon (AMZN), concerns over the state of the retail industry have emerged. Many also point out that REITs are dangerously valued after a long period of outperformance. Finally, the potential impact of tax reforms is worrying REIT investors and causing many to become increasingly bearish.

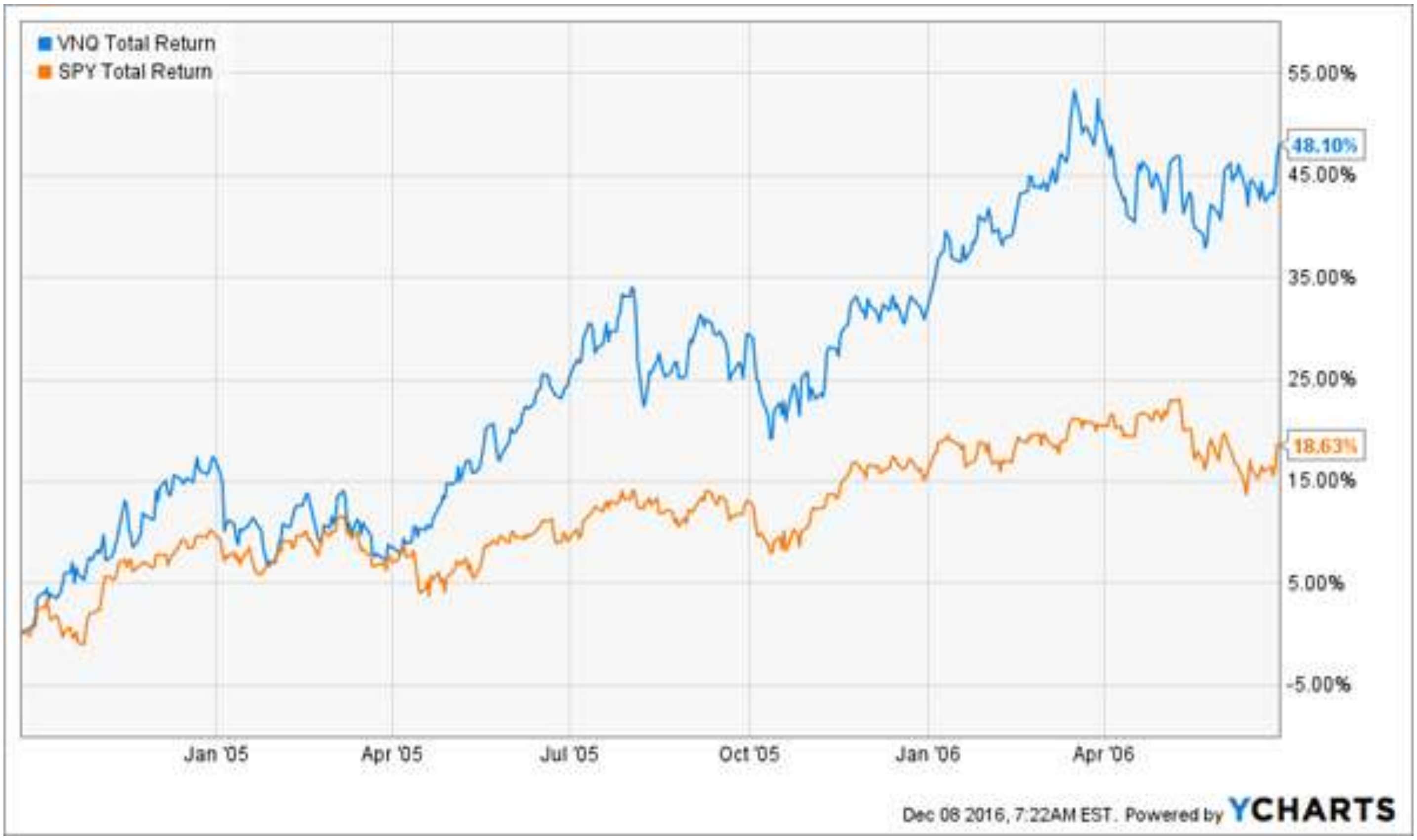
Yet, we believe that a large part of the above-mentioned fears to be misplaced or even fully irrational:

#1 Misconception: REITs will Underperform as Interest Rates Increase

A common misunderstanding is that REITs will significantly underperform in periods of rising interest rates. REITs do suffer from interest rate increases, but this is not a REIT-specific risk. All income-producing assets, including stocks, are affected by higher interest rates as they push discount rates higher in DCF valuation models.

We are not here to say that REITs are unaffected; rather we want to point out evidence showing that the fears are overblown. Studies from NAREIT have shown that share prices of listed (we warned about Non-traded REITs in our last Worth Sharing, First Financial's Turn (Non-Traded REITs are a Red Flag) – 11/11/17, which has been posted to our website) equity REITs have more often increased than decreased during periods of rising interest rates. In the 16 periods since 1995, when interest rates rose significantly, equity REITs generated positive returns in 12 of them.

A good example here is when the Federal Reserve hiked interest rates from 1.25% to 5.25% in less than two years from July 2004 to June 2006. Most would agree that this was a very material increase that we are unlikely to see today. According to the consensus belief, this should have been a horrible time for REIT investors, yet REITs significantly outperformed the broad equity market:



The reason is that changes in the level of interest rates often reflect changes in the level of economic activity. A better economy then results in higher occupancies, rental growth and overall superior business fundamentals for REITs. So, on the one hand, increased interest rates may result in less demand for real estate investments and increased cap rates which then lead to lower real estate values and lower NAVs for REITs. But on the other hand, REITs may be able to increase cash flow as a result of the stronger economy, so the effect tends to often balance itself out. Therefore, a conservatively financed REIT with low levels of variable interest rates is likely to do just fine over time, regardless of small changes in interest rates.

We are currently still in a very low interest rate environment, and it is not 25 basis point bumps that will cause material pain to some of the high quality REITs ....

Over the long term, Property REITs have outperformed the general markets, including the S&P 500 index. During the past 20 years, Property REITs have delivered an average annual total return of 14.2% compared to the S&P 500 index only delivering 10.0%.

Source: NAREIT

That is despite all the rate hikes, and the Fed tightening cycles that occurred during the period.

#2 Misconception: Amazon Will Kill Retail REITs

Wall Street has recently decided to massively discount retail REITs with abnormally high risk premium based on its belief that e-commerce will kill these properties. We do not believe in this theory. On the contrary, I believe that malls, shopping centers and freestanding retail properties are all attractive assets to our society and that their utility is not in danger. It is clear that e-commerce will keep on growing and certain tenants will suffer. Names including Sears (NASDAQ:SHLD), Macy's (NYSE:M) and J.C Penney (NYSE:JCP) may even disappear. That said, retail REITs are not retailers, they are landlords. If tenants vacate, REITs can replace them with other ones that may be more resilient to e-commerce. Some of the large tenants that we know today will go bankrupt, but others will come replace them. It is just part of retailing.

Physical retail is still doing lots of business, and consumers still prefer shopping in stores than shopping online by a large margin. As of 2016, online sales were about 10% of total retail sales. This number will grow over time, but the significance of this is not as substantial as the market is predicting. ...

While most fundamental metrics show resilience at the REIT level, the share prices have been collapsing due to fears over the growth of e-commerce. Some market adjustments are perhaps warranted given that companies like Amazon (AMZN) keep growing at a fast pace, but we find it hard to understand how REITs such as WPG (WPG), CBL (CBL) and others (Our purchase of PEI, a Mall REIT, for 4 of our clients on Nov. 6th will be detailed in November's Newsletter. We wouldn't buy WPG or CBL.) would become 40% or even 50% less valuable within such a short time frame while fundamentals remain relatively favorable. Occupancies are high, sales per square feet have not collapsed, and releasing spreads remain attractive, suggesting strong demand for retail space. We have noted for months that there was a vast disconnect between perception and reality in the retail REIT space.

Even Amazon understands that **physical retailing is here to stay**. After having opened many Amazon stores in malls in recent years, the company recently decided to take this a step further and buy out Whole Foods for $40 billion. Retail real estate is here to stay and so are Retail REITs.

#3 Misconception: REITs are Overvalued

Another argument that I often hear on Seeking Alpha is that REITs are very expensive, some even talk of a bubble. After running up in price in the last years, some investors cannot foresee much upside anymore, especially in a rising interest rate environment. We do not agree with this and do not believe that REITs are overvalued. If you look at valuations on an absolute basis, then everything would appear expensive today compared to historical standards: bonds are trading at significantly lower yields than average, the S&P500 trades for close to 25 times its earnings, and commercial real estate is being sold at relatively low cap rates.

However, if you look at valuations on a relative basis, by comparing valuations between asset classes, you will notice that REITs are still quite attractive. REITs on average sell for about 19 times FFO, pay higher dividend yields than the broad market, and the spreads over 10-year treasuries are still substantial or even higher than historical averages. Moreover, REITs trade today at reasonable valuations relative to underlying NAVs and Price/FFO ratio (as shown above).

Finally, we are able to find many opportunities in the REIT market today. We find the range of valuations to be excessively high within the REIT space and this is especially true in the small and mid-cap segments of the REIT market which often remain overlooked by large institutions due to the lack of liquidity. ...

#4 Misconception: REITs will Suffer from Trump's Tax Plan

Some analysts have speculated that REITs may be the victims of Trump's tax plan. The argument is that if the corporate tax rates are reduced to 15% (both the House and Senate versions are currently aiming for 20%), the relative taxation advantage of REITs compared to corporation will diminish, and consequently, the valuation multiples of REITs may come down.

This is too simplistic in our opinion and ignores that tax cuts could also lead to faster FFO and NAV growth.

If corporations suddenly become significantly more profitable due to lower taxes, they can afford to grow, lease more space and pay higher rents. So, in this sense, REITs will indirectly benefit from tax cuts as they will lead to superior NOI growth.

Moreover, if NOI is anticipated to increase at faster rates, investors will be willing to pay higher prices for properties. It will lead to further cap rate compression and higher NAVs for REITs. Higher NAVs have historically also resulted in higher share prices.

Lastly, tax breaks will incentivize Sale-Leaseback transactions and REITs will be the great beneficiary of this. The benefits of depreciation will become lower in a low-tax environment and leasing will become relatively more attractive. The main problem of today's real estate market is that LOTS of capital is chasing very FEW deals. It is increasingly difficult for REITs to find good quality properties and tax breaks may help here.

The potential impact on FFO and NAV will be POSITIVE: faster rent growth, higher occupancies, more external growth opportunities, and potential cap rate compression. We think that these positive effects would more than outweigh any potential "loss" in relative taxation benefits.

Final Thoughts

Real estate deserves a permanent allocation in each portfolio. Research has proven that by allocating some capital to REITs or real estate, investors can reduce the overall risk of portfolios without negatively affecting its expected return.

Diversification is the only free lunch as they say…

... REITs have historically generated very attractive risk-adjusted returns and provided great diversification benefits to investors.

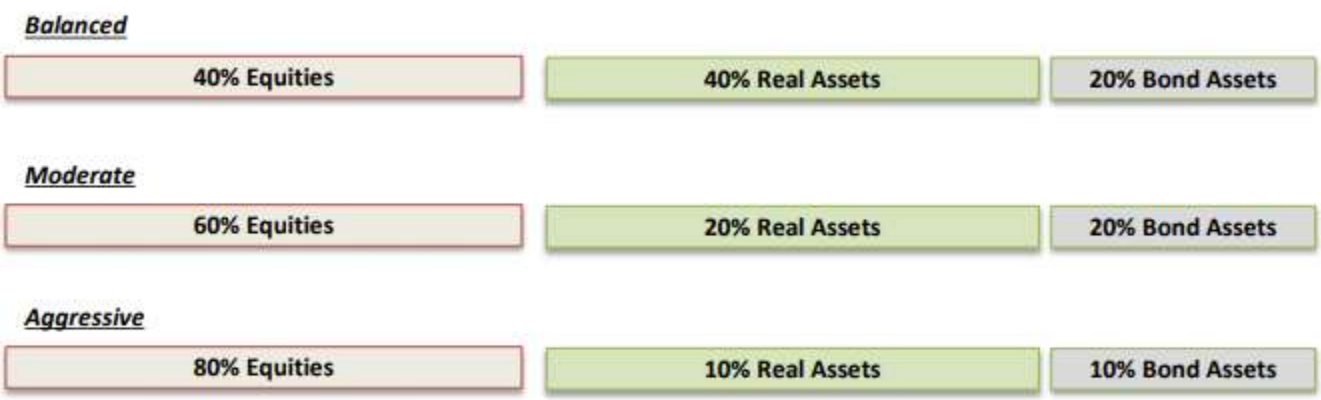
REITs have indeed been strong outperformers despite all the naysayers... Bears are nothing new to Property REITs. They have been around for decades and this has not prevented REITs from achieving very satisfying performances. The simplest way to outperform the market would have been to simply overweight REITs while others ignored them. With Property REITs currently trading at relatively low valuations, we are advising our members to overweight this sector which is likely to outperform other asset classes over the next 12 to 24 months. Long-term investors are set to be very well rewarded!

Our thoughts:

While the percentage of a portfolio allocated to commercial real estate needs to be dependent on a client's Risk Profile and Objective(s), one approach is the "Ivy 5":

As detailed in Alpha Architect's white paper, https://alphaarchitect.com/2014/12/02/the-robust-asset-allocation-raa-index/: "Meb Faber and Eric Richardson in their book, *The Ivy Portfolio,*" recommend "a simple portfolio that allocates across ... 5 asset classes ... since they form the basic building blocks for the endowments of the ivy league schools and others. ... We'll discuss this framework and why it is an interesting starting point for those trying to achieve an objective that may differ from those blindly allocating to a generic 60/40 portfolio."

To Faber's equal weight allocation, which places 20% of a portfolio in Commercial Real Estate, Alpha Architect adds Moderate and Aggressive allocations, which decrease Real Estate to 10% and 5% respectively:



Both Faber and Alpha Architect recommend using Trend to limit Risk, an approach we have previously analyzed and shared.

Under Asset Allocation on our website, http://www.hughescapitalmanagement.com/asset-allocation/, we detail why investors should avoid Commodities and Government Bonds. As for Real Estate:

"Real Estate exposure can be a critical component of a well-diversified portfolio. As the Forbes Real Estate Investor has stated: "Commercial real estate is the third largest asset class in the U.S., representing some $6.5 trillion of market value, or roughly 12.4% of the $52.8 trillion investable universe in the U.S." The best way to obtain exposure to this market is through publicly traded REITs, which over the past two decades have outperformed the broader equity market.

While the short-term volatility of REITs can be jarring (as the Great Recession in 2008 demonstrated), with a long time horizon their risk profile dramatically improves. The Morningstar graph below illustrates the realized gains and losses in REITs for one-, five-, and 15-year periods. Of the 42 one-year periods from 1972 to 2013, only eight resulted in a loss. By increasing the holding period to five years, only one of the 38 overlapping five-

year periods resulted in a loss, while none of the 28 overlapping 15-year periods from 1972 to 2013 resulted in losses."

For most clients we are currently recommending a 10% allocation to GFMRX, a Global Real Estate OEF. For those clients focused on Capital Appreciation or Income, we are also selectively adding 2% positions in REITs that meet our Insider Buying criteria and are recommended by at least one of our preferred analysts, being careful to diversify across Sectors.