REITs: An Opportunity?

The goal of diversification is to increase risk-adjusted returns. However, how risk is measured matters, as does the recognition that clients often face different types of risk. Diversification among Asset Classes is where most Investment Advisors start, and far too many end. While Stocks, Bonds, and Cash are the three primary Asset Classes, some Advisors, including HCM, add Real Estate (REITs), and Commodities. Our website details our view on each of these Asset Classes. Of these five, only Stocks and Real Estate have provided the historical returns that justify their inclusion in most portfolios.

RATE REACTION OPENS A REIT OPPORTUNITY

By Thomas Bohjalian, CFA, executive vice president and head of U.S. real estate at Cohen & Steers

Despite a generally healthy real estate market, REITs have been held back amid heightened short-term sensitivity to interest rates. While rates could remain a factor, we see the recent pullback as an opportunity to build allocations to REITs: they're looking attractive next to stocks, bonds and private real estate, equity correlations are at a 16-year low, and better fundamentals may be on the horizon.

Rising rates don't happen in a vacuum. One of the things we find that some investors and the financial press consistently get wrong about REITs is the relationship with interest rates—that if rates are rising, you shouldn't own REITs. This belief, however disconnected from historical evidence, often seems too ingrained to suggest otherwise.

Interest rates are part of the equation, and sudden moves in bond yields can create volatility. But REITs are not bonds. In an improving economy, landlords can raise rents as tenants fight for more space, potentially increasing cash flows to offset the effects of higher rates. In other words, it should matter why rates are rising, not simply that rates are rising.

Rising Treasury yields have been historically positive for REITs when accompanied by a stronger economy. That hasn't been the case recently.

What's driving recent underperformance? Since the start of 2015, REITs have been among the most out-of-favor segments of the market, delivering flat returns even while growing cash flows at 7%–8% per year. REITs have pulled back sharply in early 2018, trailing the broad market by 12% through February 15, bringing their one-year underperformance to 24%. REITs have also fallen behind private real estate, compared with a 3% annual return premium to the private market over the past three decades.

We believe a perfect storm of factors have contributed to the negative sentiment:

- Interest-rate sensitivity has been unusually high, with rates coming off historically low levels amid the unprecedented unwinding of quantitative easing (QE).
- Markets are anticipating the need for faster rate hikes in response to tax cuts, tight labor markets and rising inflation.
- REIT fundamentals have slowed as the cycle has matured, while corporate tax cuts will not directly benefit REIT earnings (the benefit is likely to be more gradual as a result of stronger demand, and many investors may benefit from lower taxes on REIT distributions).

An opportunity is emerging. Considering these unusual circumstances, we believe interest rates could continue to be an outsized factor in the current environment, and volatility could persist. However, waiting for the ideal environment in any asset class is not practical— and in the meantime, we are seeing credible indications of value on multiple fronts.

While there is no way of knowing exactly when a bottom will occur, we believe an opportunity is shaping up for increasing REIT allocations, taking advantage of their attractive valuations and diversification potential.

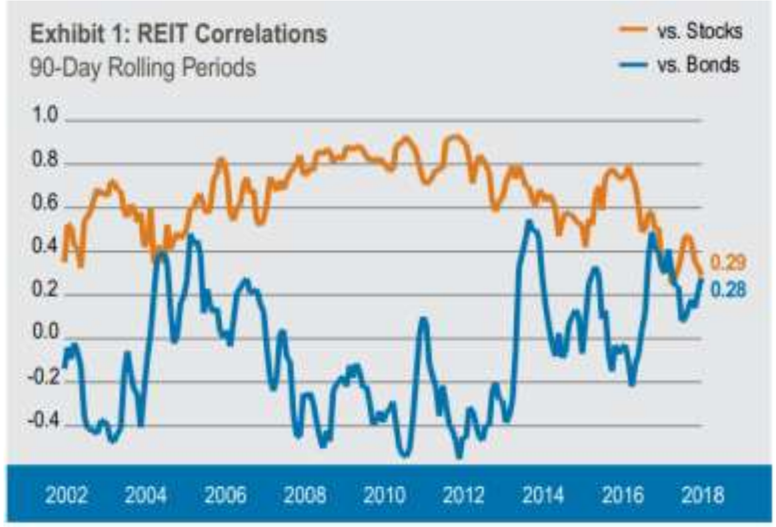
1) REIT correlations with stocks are at a 16-year low.

REITs have the potential to be strong diversifiers with financial assets, illustrated by their low correlations to stocks and bonds (Exhibit 1). We believe the need for diversification is especially important at a time when bonds face challenging return prospects in the face of QE unwinding, which could suppress their effectiveness in countering the volatility of stocks. (It is important to note that low correlation does not equal lower risk. **"The only thing that goes up in a market crash is correlation."** - Rob Arnott)

2) REITs are trading at attractive historical values relative to stocks, bonds and private real estate.

Versus stocks (Exhibit 2) Over the past five years, REIT earnings multiples have contracted, while those of the S&P 500 have expanded, accounting for most of the broad market's outperformance compared with dividends and earnings growth. Paradoxically, the market seems less concerned about the risk that higher interest rates and the QE unwind poses to stocks even though their multiples are more inflated by comparison.

Versus bonds (Exhibit 3) REITs are often valued in terms of the income they provide in relation to bonds. REITs currently offer a yield premium of



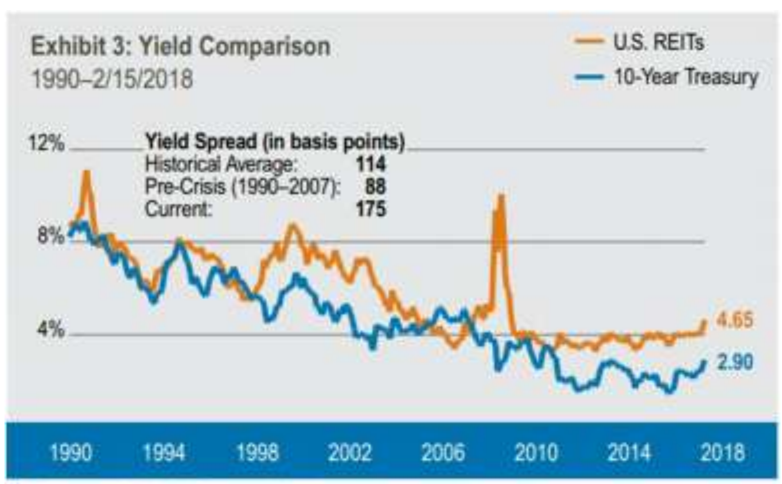
At January 31, 2018. Source: Morningstar, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. Correlation is a statistical measure of how two data series move in relation to each other, with 1 representing perfect synchronization and -1 representing perfect opposition. See page 4 for index definitions and additional disclosures.

At January 31, 2018. Source: Morningstar, Cohen & Steers estimates based on proprietary metrics.

Data quoted represents past performance, which is no guarantee of future results.

Exhibit 2: P/E: price to earnings per share; P/FFO: price to funds from operations per share, the key earnings metric for REITs, calculated as GAAP net income, plus depreciation and amortization, minus any gains (or losses) from asset sales.



At February 15, 2018. Source: Morningstar.

Data quoted represents past performance, which is no guarantee of future results.

Exhibit 3: Treasury yield represents yield to maturity. REIT dividend yield represents the current share price divided by total dividends per share over the trailing 12 months.

175 basis points over 10-year Treasurys, wider than their historical average of 114 bps, indicating relative value compared with fixed income.

Versus private real estate (Exhibit 4) Since 1994, REITs have traded at a 2.7% average premium relative to their property holdings, measured by net asset value (NAV). This premium partly reflects the expected value that REIT managements may add over and above the underlying real estate. As of February 15, REITs were trading at a 4.3% overall discount based on our estimates—meaning investors gain access to properties for less than what private investors are likely to pay, while getting the management operations for free.

At February 15, 2018. Source: Cohen & Steers (current estimates), UBS (historical average, 1/1994—1/2018).

Data quoted represents past performance, which is no guarantee of future results.

Exhibit 4: Price to NAV is similar to price to book value, representing the net market value of a company's assets minus liabilities. Sectors and market average represented by the FTSE NAREIT Equity REIT Index.

Since the early 1990s, there have been 11 times when REITs ended the month at an NAV discount after spending at least six months at a premium (Exhibit 5). Most of these discounts occurred in periods of economic expansion and strong fundamentals, just like now. In the 12 months following these occurrences, REITs generated an average total return of 16.1% and, in the majority of cases, returned to trading at a premium to NAV.

Exhibit 5: U.S. REIT Premium/Discount to NAV and Total Returns

Months When REITs Began Trading at Discounts to NAV After 6+ Months at Premium to NAV	Discount to NAV at Month End	12 Months Later	
		Total Return	Premium or Discount to NAV
October 1994	-0.7%	12.2%	-1.7%
November 1995	-0.1%	29.2%	19.0%
August 1998	-7.7%	2.7%	-9.2%
September 2002	-0.7%	25.2%	11.8%
December 2005	-10.8%	35.1%	3.8%
May 2007	-3.7%	-11.9%	-3.3%
September 2011	-6.0%	32.6%	5.5%
August 2013	-5.1%	24.1%	5.0%
September 2014	-1.1%	9.9%	-7.1%
April 2015	-1.6%	10.5%	6.2%
October 2016	-3.2%	7.3%	-4.5%
Average	**-3.7%**	**16.1%**	**2.2%**

At February 15, 2018. Source: UBS and Cohen & Steers.

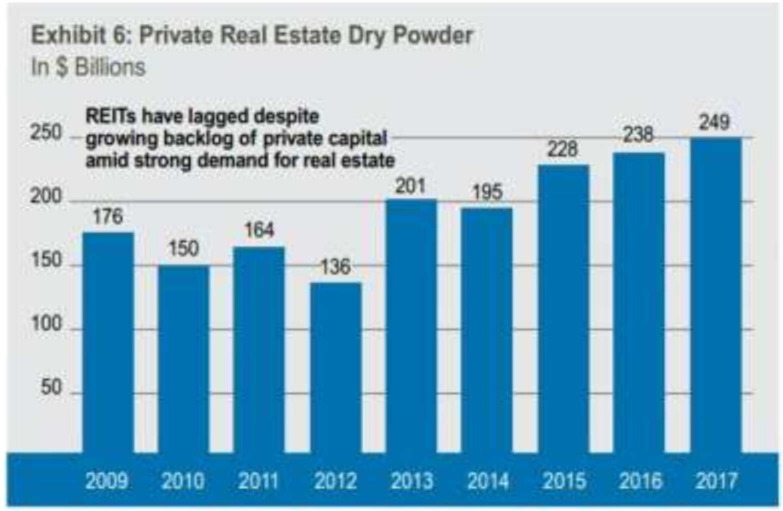
Data quoted represents past performance, which is no guarantee of future results. Periods selected based on month-end data using UBS price-to-NAV. See page 4 for index definitions and additional disclosures.

In our view, NAV discounts alone should not be viewed as a buy signal, but rather as context for understanding the relationship between REITs and the health of the underlying property market. When the economy is improving and real estate fundamentals are strong, yield-driven corrections have historically been a time to consider adding an allocation to REITs.

We are confident in the prospects for economic growth over the next year, supported by a continued upturn in the business cycle, regulatory relief and continued job growth amid one of the broadest global expansions on record—with added fuel from $200 billion in tax cuts for 2018. Furthermore, we believe property supply in the U.S. appears to be peaking, which could lead to some acceleration in fundamentals later in the year. In this context, we believe a reasonable framework for return expectations is roughly 9%, composed of mid-single-digit cash flow growth plus 4.7% dividend yields, assuming no multiple expansion.

3) Demand for private real estate is substantial and growing.

Managers of private equity funds are holding onto a record $250 billion of uninvested capital ("dry powder") earmarked for real estate (Exhibit 6). Fundraising efforts have increased for 2018, suggesting that this amount is only likely to grow. With the recent underperformance of REITs, private fund managers are warming up to acquisitions through the listed market, particularly for companies trading at deep and sustained discounts.



At June 30, 2017. Source: Preqin, Cohen & Steers.

Dry powder measures total capital commitments to private equity funds minus capital that has been called by the general partner for investment. See page 4 for additional disclosures.

While we cannot say when REITs will reverse their recent underperformance, we see this as an attractive opportunity to begin legging into higher REIT allocations, taking advantage of low relative valuations, strong diversification potential and robust demand in the private market.