# REITs: Look Ahead for an Attractive Entry Point

In the wake of the global financial crisis, central banks around the world have lowered interest rates to historically low levels. These low interest rates have left investors in a search for yield which has affected the price of all income producing assets. With yields on emerging market debt and high yield bonds lower than historical levels, it can be challenging for investors to find assets which provide attractive income relative to their riskiness. Given this backdrop, are real estate investment trusts (REITs) currently an attractive addition to an investor's portfolio?

Real estate investment trusts were created in 1960 and serve as an efficient way for investors to seek exposure to real estate as an asset class. REITs are a type of corporation exempted from corporate income taxation, provided 90 percent of profits are distributed to shareholders, among other requirements. Like other companies, REITs may be privately held or publicly traded on an exchange such as the NYSE. REITs can be separated into mortgage REITs (mREITs) and equity REITs (eREITs). Mortgage REITs own a portfolio of loans backed by real estate such as residential homes or commercial buildings. Equity REITs invest in physical real estate assets and derive their income from rents on real property and capital gains from the sale of properties. Formerly classified as part of the financial sector, real estate became the 8th largest independent GICS sector in August 2016.

REITs offer several advantages over investing in individual properties: a lower initial investment outlay, the benefit of professional management, the liquidity given their exchange traded nature, and diversification both by geography and type of property. Given the requirement to distribute 90 percent or more of their income to shareholders each year, REITs historically have yielded more than large-cap U.S. stocks as measured by the S&P 500. These dividends are attractive to income seeking investors and REIT shares often fluctuate in value to a great degree inverse to interest rates.

After the U.S. presidential election, many investors became concerned about the possibility of higher inflation based on President Trump's policy agenda. Individual REITs and various REIT subsectors differ in their ability to raise prices in the face of inflationary pressures. REITs with interests in hotels and student housing can change pricing almost daily or annually at most. Others, such as healthcare REITs, have rental contracts that last a decade or longer. These long-term contracts are typically linked to a price index such as the CPI. In the very long-term, equity REITs represent ownership of real assets which maintain their value regardless of inflation.

As REITs do not pay corporate income tax their valuations are impacted by market expectations of corporate income tax rates. If the effective U.S. corporate tax rate is lower, REITs become less attractive compared to common stock corporations as the income available to shareholders would increase. Unless held in a tax-advantaged account, REIT dividends are taxed as ordinary income for U.S. individuals. Lower personal income tax rates or changes to allow REITs to pass-through income to shareholders would be positive for REIT valuations.

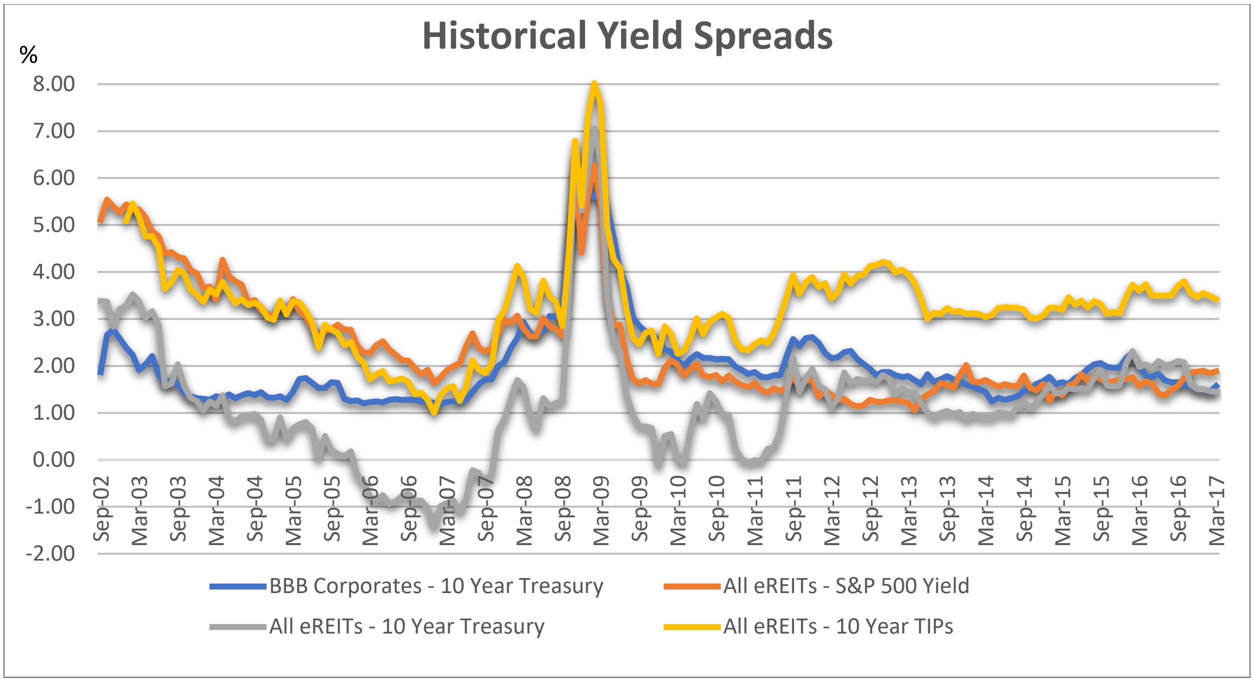


*Figure 1: Historical Yield Spreads*

To examine valuations within a historical context, REIT yields can be compared to a variety of benchmarks. *Figure 1* shows the yield spread between REITs, U.S. treasuries, inflation-indexed treasury bonds (TIPs), the S&P 500, as well as between BBB corporate bonds and treasuries. For a long time prior to the global financial crisis when real estate assets were "red hot", REITs yielded less than a 10 year U.S. treasury note. Looking at current REIT valuations using yields, REITs appear to be relatively fairly valued in a historical context compared to most major benchmarks and attractive relative to large-cap U.S. equities as measured by the S&P 500. This latter difference may be due to the current valuation of the S&P 500, as well as a long-term trend towards corporations returning cash to shareholders with buybacks rather than dividends.

Many of the popular financial media outlets and investment pundits often espouse the narrative that rising interest rates will surely lead to poor returns for REIT investors. Indeed, this relationship typically holds true in the short-term as REIT indexes often sell-off sharply on the day of a Federal Reserve rate increase. However, looking at a long-term perspective, a different state of affairs regarding REIT returns and rising interest rates emerges.

| | 10-Year Treasury Yield | | | Cumulative Total Return During Periods of Rising Rates | | |
|---|---|---|---|---|---|---|
| **Period of Rising Rates** | **Beginning** | **Ending** | **Change (bps)** | **REITs** | **Stocks** | **U.S. Bonds** |
| 12/95–3/97 | 5.6% | 6.9% | 134 | 36.2% | 26.3% | 3.1% |
| 9/98–1/00 | 4.4% | 6.7% | 224 | -7.1% | 39.4% | -0.8% |
| 2/01–3/02 | 4.9% | 5.4% | 50 | 24.0% | -6.1% | 5.9% |
| 5/03–5/04 | 3.4% | 4.7% | 129 | 26.1% | 18.3% | -0.4% |
| 6/05–6/06 | 3.9% | 5.2% | 121 | 19.1% | 8.6% | -0.8% |
| 12/08–12/09 | 2.3% | 3.9% | 160 | 28.0% | 26.5% | 5.9% |
| 7/12–12/13 | 1.5% | 3.0% | 153 | 3.3% | 38.3% | -1.6% |

**At October 31, 2016.** Source: Bloomberg and Cohen & Steers.

*Table 1: Long-term REIT Returns During Periods of Rising Interest Rates*

While evaluating REITs as an investment does depend on interest rates, the market often overreacts in the short-term to the prospect of interest rate increases. Fundamentals such as corporate earnings, unemployment, and changes in personal disposable income fundamentally drive the ability of REITs to raise rents and expand their operations. *Table 1* shows REITs typically provide attractive returns both in absolute terms, as well as relative to U.S. stocks and bonds, during prior periods of rising interest rates. Investors with a long-term investment horizon should look ahead for attractive opportunities to establish positions in REITs caused by short-term volatility over higher interest rates, provided these interest rate increases are accompanied by higher rates of economic growth. Investors can take advantage of opportunities in real estate with vehicles such as the Vanguard REIT ETF (VNQ), the S&P 500 Real Estate Sector ETF (XLRE), and iShares Residential Real Estate ETF (REZ).

Sources: NAREIT, U.S. SEC, Cohen & Steers, U.S. Federal Reserve, Bloomberg