The Time is Right for Real Estate Investment Trusts (REITs)

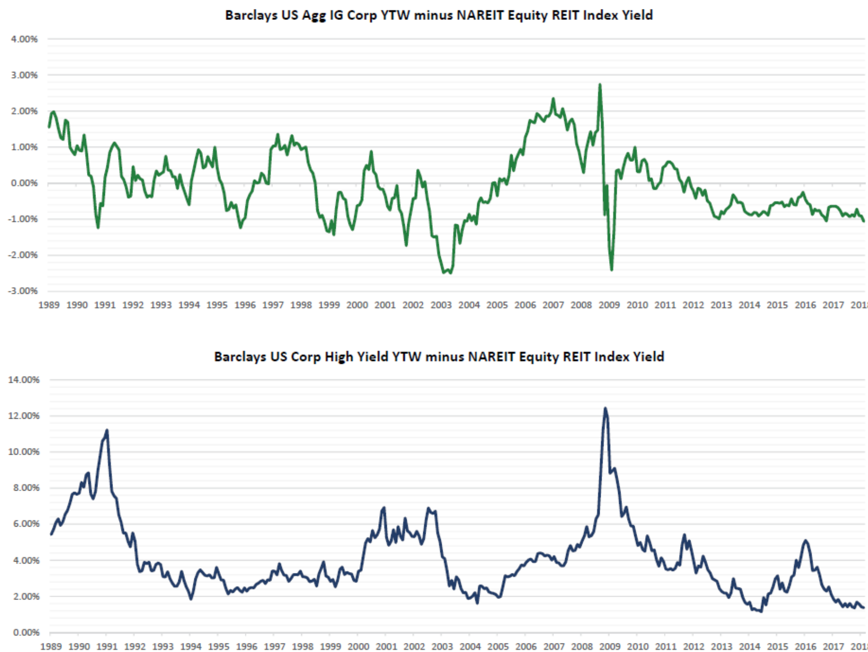
The current bull run in the capital markets has left few assets untouched. Most financial assets are fully valued, if not over-valued, making the job harder for value investors. But one outlier that remains attractive from a valuation standpoint is the real estate investment trust (REIT). REITs are corporations that own and operate a portfolio of real estate properties and mortgages. REITs were established in 1960 when Congress created a pass-through structure designed to help small investors invest in commercial property by avoiding double taxation. A company must distribute at least 90 percent of its taxable income to its shareholders each year to qualify as a REIT. In return, a REIT does not pay corporate, federal or state income taxes, instead passing the tax burden on to its shareholders.

It is expected that the price of yield-driven assets decline with a rise in interest rates as the present value of future cash flows goes down. In other words, prices of existing investments will generally decline to make their yields competitive with newer securities that are issued with higher interest rates. While the above condition holds true for bonds because the future cash flows are fixed, interest rates are not the only driving force for assets like REITs where future cash flows can increase. Cash flows from REITs tend to rise with a growing economy, making them hybrid investments which exhibit characteristics of both bonds and equites. Furthermore, certain REITs hold shorter term properties such as apartments and hotels, affording them flexibility to raise rents more quickly when interest rates go up. Not only are REITS attractive based on valuation, but their balance sheets are also better prepared to handle a rising rate environment.

Investors use several indicators to determine whether REITs are over or under valued. We compared REIT equity yields to yields on both investment grade and high yield bonds. REITs are currently yielding slightly below 5% and as is apparent from the bottom graph in Chart 1, their relative attractiveness versus high yield bonds, ignoring the 2008 aberration, has not looked as attractive since the 2004 time period when high yield was again in an overbought scenario. Similarly, REITs look attractive in comparison to investment grade bonds (top graph of Chart 1). One should note that since REITs are equities, they should yield *less* than various bond investments, regardless of credit quality.

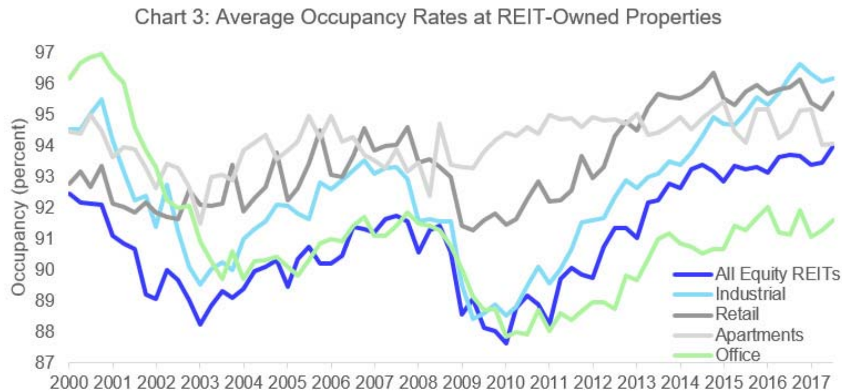
Therefore, we would argue that today's yield advantage exhibited in the attached charts makes the argument for REITs even more compelling. We also believe that given the strength of the economy, REITs have better pricing power to grow their net operating income (NOI), especially those that are not focused on class B retail properties but are more closely aligned with growth in the economy such as industrial REITs. Chart 2 provides occupancy rates, which continue to get stronger for industrial and office REITs. According to the NAREIT database, the same-property NOI growth has averaged 3.5% year-over-year, tracking closely with GDP growth.

Chart 1



Source: Bloomberg Data

Chart 2



As we mentioned above, we also believe that REITs are well positioned to handle a rising rate environment, and depending on the duration of their underlying assets, they are not all created equal in that regard. The balance sheet for the overall industry is less leveraged today than at any point before; looking at Chart 3, the ratio of debt/book assets and the ratio of debt/market assets has never been lower. Not only is the balance sheet less levered but the interest expense to service that debt, a function of lower debt and lower rates, is at an all-time low, as seen in Chart 4. Interest expense is unlikely to rise because nearly all the debt has been financed by fixed long-term rates with average maturities of 75 months.

Lynx
Investment Advisory

Chart 3

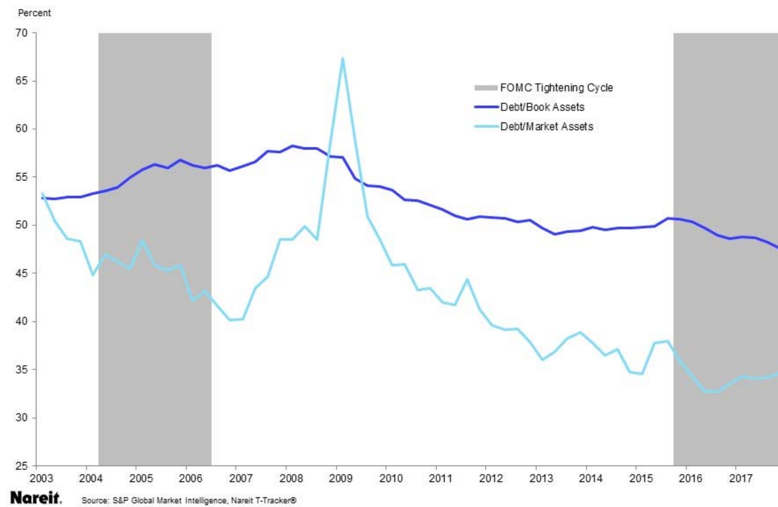
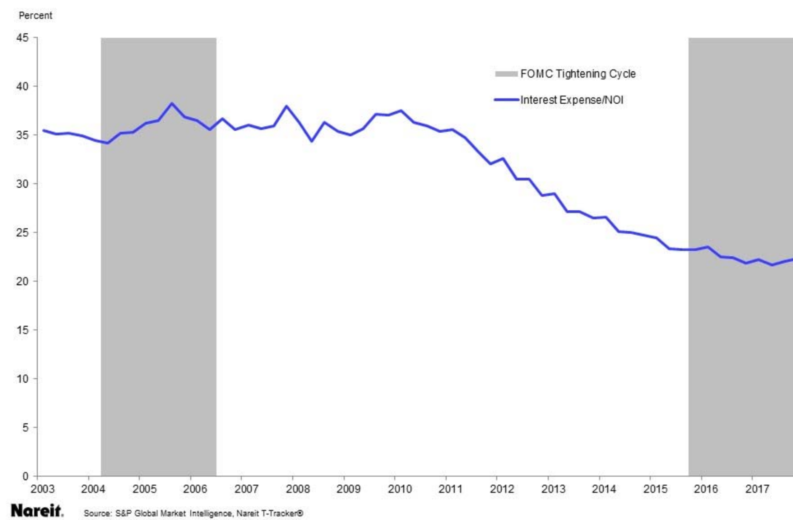


Chart 4



Rather than recommending individual REITs we suggest funds that invest in REITs. While we believe this is the right time to invest in an active fund in the space, an investor can always invest in a passive ETF such as Vanguard's VNQ (Vanguard Real Estate) that carries an expense ratio of 12bps and currently yields 4.8%.