REAL ESTATE INVESTMENT TRUSTS (REITS): AN ALTERNATIVE INVESTMENT IN VOLATILE FINANCIAL MARKETS

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The standard measures used to examine the investment characteristics of an asset class are returns, standard deviation of returns, and cross correlation of returns. For comparison purposes, we calculate performance for the following indices: (1) the Wilshire REIT Index, (2) the NCREIF (private real estate) Index, (3) Standard and Poor’s 500 (large-cap equity) Index, (4) the Russell 2000 (small-cap equity) Index, (5) the MSCI EAFE (international equity) Index, (6) the Nasdaq Composite (small-cap/technology equity) Index, (7) a 10-year Treasury Bond, and (8) the Dow Jones Utilities Index. Table 1 shows annual results for the 1993 to 2000 “Modern REIT Era” period, as well as the average returns and standard deviation of returns for each index.

Relative to broad stock and bond indices, REITs have generated competitive returns during the 1993-2000 period. As discussed earlier, REITs are not just static pools of assets—they are real estate companies. Therefore, it is not surprising to see REITs behave like other public companies in their attempt to enhance shareholder value through growth in earnings per share. REITs are “real estate...plus”. In addition to a pool of assets designed to deliver real estate return characteristics, REITs have a public company’s incentive to grow earnings from those assets. Thus, the average return for REITs since 1993 exceeds that of private real estate.

The mean return for the REIT market over the modern REIT era has been nearly 10.8%. While this return is lower than that of the S&P 500® Index (14.7%), Nasdaq (17.7%), and the Dow Jones Utilities Index (12.5%) during the same period, it exceeds the returns from private real estate (9.1%), international stocks (7.2%), bonds (7.6%), and small capitalization stocks (9.9%). The recent performance of REITs in Figure 3 shows that REITs have outperformed the S&P 500® Index, the Nasdaq composite, and the 10-year Treasury Bond on a cumulative basis.

As Table 1 shows, the standard deviation of the Wilshire REIT Index since 1993 (17.2%) is somewhat lower than that of the S&P 500® Index (18.0%), modestly higher than the Russell 2000 Index (13.4%), higher than the 10-year Treasury Bond (11.2%), and significantly lower than the Dow Jones Utilities Index (20.6%).

While the standard deviation of REIT returns has been high over the past seven years, we attribute these levels to abnormal circumstances. First, as we have pointed out, the market has transitioned in number and size of companies as well as sheer volume of properties. Second, this transition climaxed in 1997 just as the dot.com bubble began to expand and attract record amounts of capital. The return to a more normal stable investment climate should lead to a reduction in the standard deviation of returns in the range of 12% to 14%, without sacrificing total return.

Therefore, on both the risk and return spectrums, REITs fall somewhere between stocks and bonds. The fact that REITs only slightly underperformed the S&P 500® Index during the extended bull market for equities and outperformed bonds during the same period of time shows that REITs have the potential to deliver competitive absolute returns to complement a variety of portfolio types.
Correlation of REITs to Other Investments

We believe one of the most compelling aspects of REIT investments is their low correlation relative to other investments and, consequently, their potential value as a risk-reduction tool. Table 2 shows the correlation of quarterly returns for the 1993 to 2001 period.

The correlation of the Wilshire REIT Index to major stock indices, including the S&P 500® Index (0.20) and the Nasdaq (0.06), is extremely low. The correlation to bonds (0.15) and international stocks (0.13) is equally low. While still comparatively low, REITs are correlated more closely to the Russell 2000 (0.39) and the Dow Jones Utilities Index (0.41). This low correlation is in marked contrast to the high correlation of the S&P 500® Index to the Nasdaq, the Russell 2000, and the one international stock index (all in the 0.75 to 0.85 range). Clearly, REITs have the potential to provide diversification in a portfolio of stocks significantly better than international equities and to a similar or better degree than utilities and bonds.

REITs in a Mixed Asset Portfolio

The information presented on return, risk and correlation show that REITs have the potential to be a valuable performance enhancement and diversification tool in a mixed asset portfolio. To back this claim, we have constructed an efficient frontier for a portfolio of stocks, bonds, and REITs using standard deviation and return data. Figure 4 demonstrates the ability of REITs to potentially reduce portfolio risk and/or increase return in a mixed asset portfolio.

Are REITs a Good Relative and Absolute Value Now?

While our research clearly shows that REITs are a valuable diversification tool, we have not yet addressed the question of investment timing. In this section, we review several statistics that demonstrate the attractive current (as of April 2001) valuation of REITs, both on a historical basis and relative to alternative investments.

As Figure 5 shows, REITs have a high current dividend yield of 7.4% and a high cash flow yield of 10.7% as of March 31, 2001. This implies a dividend payout ratio of 69%, low by historical standards and providing comfort as to the safety of this important source of income.

As Figure 6 shows, this high cash flow yield represents a more than 500-basis-point spread relative to the 10-year Treasury bond as of March 31, 2001. Over the past three years, this spread has increased dramatically. This reflects both the underlying strength of the real estate markets during that period and the valuation gap created when REITs were overshadowed by competing growth-oriented investments, hurting REIT returns but at the same time lowering asset-class correlation.

Figure 7 presents the price-to-earnings multiple of the S&P 500® Index relative to the AFFO (cash flow) multiple of the REIT market over time. While these multiples cannot be
compared directly, their relationship over time is helpful in assessing relative valuation. Over the past four years, the average multiple on the S&P 500® Index has continued to expand, while the average REIT market multiple has contracted. During this time, REIT company earnings have grown at a healthy and consistent rate, such that earnings growth has, on average, translated to total return. Only recently has the relationship between these multiples begun to change as the earnings of the S&P 500® Index companies weaken. By historical standards, however, the differential remains large.

Finally, an important metric that we use in judging the value of REITs is the comparison of REIT stock prices to the underlying private market value of the real estate they hold, as measured by net asset value, or NAV. As Figure 8 shows, by this metric, REITs are trading at roughly a 20% discount to the current private market value of real estate assets they hold as of March 31, 2001.

In summary, on all relative and absolute measurements, REITs appear attractively valued as of March 31, 2001. Only in November and December of 1999, right before the 2000 REIT rally, were REITs more attractive.

How Will Real Estate and REITs Perform in a Slower Economy or a Recession?

REITs and real estate are not immune to the negative impact of a sharp economic slowdown or recession. Weak economic conditions lower real estate demand, in turn reducing occupancies and rents. However, as we enter this economic slowdown, in most markets, real estate is well positioned relative to previous downturns. As Figure 9 shows, vacancy rates at the close of 2000 were low relative to the recent past and are much lower than the period leading into the last recession. Also, as Figure 10 shows, cap rates (conceptually, the inverse of a P/E ratio) are high relative to Treasury yields by historical standards, signifying that real estate valuations are conservative and underlying operating performance of the assets is healthy heading into the second quarter of 2001. As a result of these initial conditions, while real estate will suffer during a recession, we believe earnings erosion should be relatively modest compared to other equities and past real estate cycles, and any impairment to real estate asset values should be relatively mild.

Summary

While real estate, unlike conventional stocks and bonds, has not been widely embraced as a stand-alone asset class, we believe investors should consider the performance enhancement and risk reduction potential of REITs in their portfolio construction process. A REIT allocation serves to diversify a stock and bond portfolio while providing competitive rates of return. The income component of REIT returns and the relative consistency of earnings based on a highly visible revenue stream make REITs an alternative worth considering in the face of broad equity market volatility. Finally, incorporating or increasing a portfolio’s exposure to REITs when they move to meaningful discounts to underlying net asset value may provide downside protection and the opportunity to capture excess return relative to other forms of real estate investment.