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REITS VS. RATES

WHY HIGHER YIELDS DON'T SPELL DISASTER

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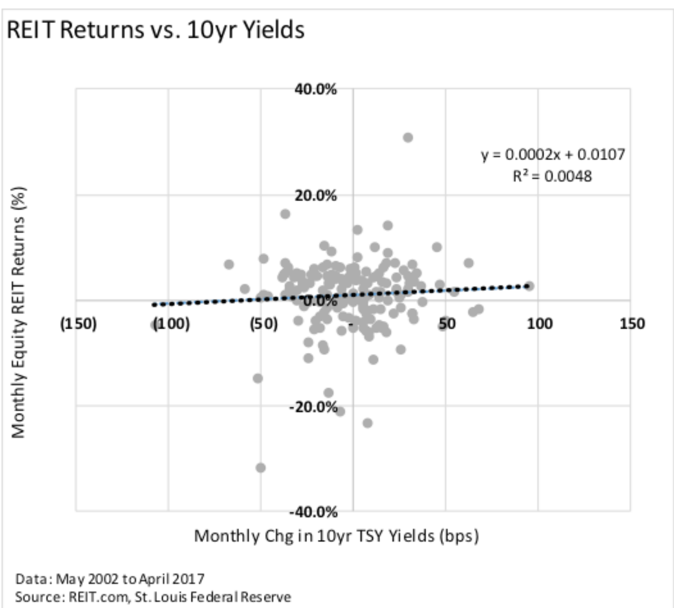
I. INTRODUCTION

A popular investment mantra is that rising rates are bad for real estate investment trusts (REITs). The premise has several variations but often centers on the assumption that REITs are passive yield investments. Since REIT laws mandate a 90% earnings payout, the regular cash distributions lead many investors to assume these investments will track performance in the fixed income markets. However, this view ignores the many positive aspects of modern REIT investing, namely the ability to grow earnings and distributions over time. A closer look at the historical evidence suggests investors should revisit the REITs versus rates debate and take a more nuanced view of the REIT industry.

II. WHAT HISTORY TELLS US

Over the past 15 years, the monthly returns of equity REITs have demonstrated a near zero correlation with rising rates. In fact, in months when the 10-year Treasury yield increased, REITs returned an average of +1.1%.



The data for periods of sustained rising rates shows similar results. In the years from 2000 through 2015, REITs achieved positive returns in 8 out of 13 instances when long-term yields rose more than 50 basis points. Importantly, these results were achieved during previous Fed tightening cycles and across multiple economic environments.

	Chg in 10y TSY (bps)	REIT ETF Returns
March '01 - June '01	66	8.2%
November '01 - April '02	122	11.6%
June '03 - September '03	128	8.7%
March '04 - June '04	106	(4.6%)
September '04 - March '05	60	2.4%
June '05- May '06	117	9.0%
December '06 - June '07	73	(7.8%)
March '08 - June '08	89	6.2%
December '08 - June '09	180	(4.9%)
November '09 - April '10	70	17.4%
October '10 - February '11	118	8.4%
May '13 - September '13	126	(12.3%)
January '15 - June '15	81	(10.8%)

Source: St. Louis Fed, Bloomberg

With the data suggesting that REITs can (and often do) generate positive total returns during rising rates, investors should revisit the long-held assumption that these investments are simple bond proxies.

III. INCOME WITH GROWTH

Unlike bonds, effective REITs have grown their cash distributions over time. This can produce significantly higher returns over longer hold periods. Consider two investments, one with a flat 6% annual distribution and another starting with a 6% dividend that grows 5% annually. After ten years, the second investor will have generated approximately 25% more in cumulative cash distributions.

Similar growth in REIT dividends has allowed REITs to outperform bonds by more than 50% over the ten years ending in 2016 (source: REIT.com/NYU Stern). This performance has been shaped by both same property income growth and portfolio expansion through acquisitions.

Since 2006, REITs have grown same property net operating income by an average of 3.2% per year. With REITs' aforementioned 90% payout requirement, much of this growth in cash flows has passed directly to shareholders in the form of higher dividends. Unlike bonds where the annual distributions are fixed in advance, REITs' internal growth has allowed them to serve as a partial inflation hedge, raising investor payouts to keep pace with an increasing cost of living. For net-lease REITs, this same property performance often comes in the form of contractual rent escalators, providing a more predictable source of growth over a long-term lease.

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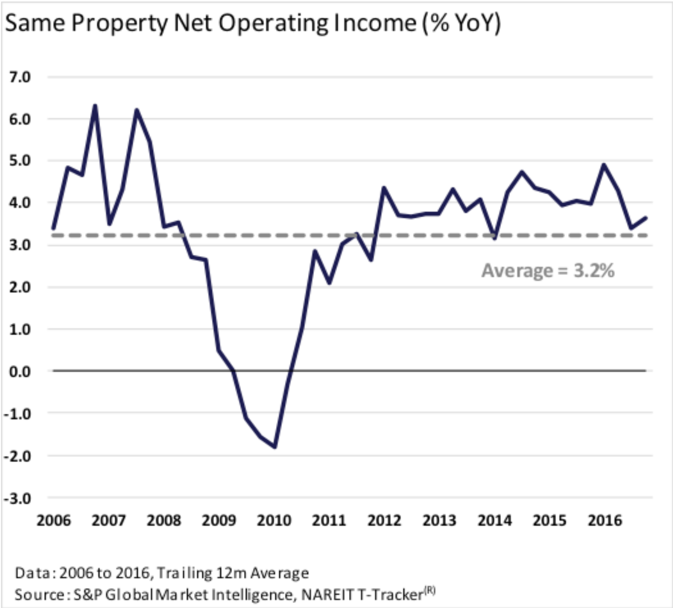
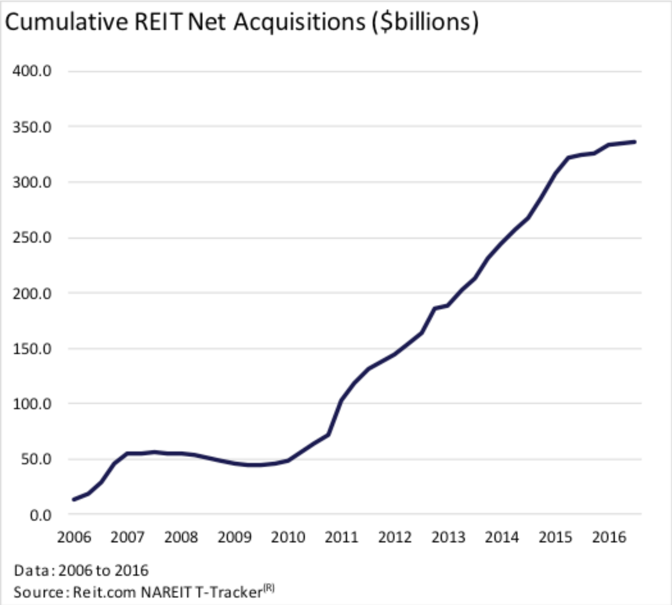


Dividend growth has also been supported by acquisitions with the publicly listed REITs acquiring some $350 billion in net real estate assets over the past decade. In addition to higher cash payouts, this portfolio expansion has produced a more diversified investment base. With real estate assets spread across multiple industries and geographies, REITs have been able to minimize the impact of adverse market conditions in any one location or with any one tenant.



IV. FINAL THOUGHTS

REITs are dynamic investments. Unlike bonds with fixed distributions and finite durations, Real Estate Investment Trusts are perpetual life entities with active managers seeking to grow investor cash flows over time. While interest rates undoubtedly impact REIT performance, the correlation is not as straight-forward as many financial commentators suggest. Rather than concluding that higher rates spell disaster for REITs, investors should consider the broad multitude of factors influencing returns, particularly the ability to compound dividend growth over time.

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