

CHAPTER 7

REIT Performance

Historical Total Returns

This chapter examines the market forces that influence demand for REIT shares and, ultimately, REIT performance relative to other investments. Understanding the various factors that influence REIT stock price performance will enable investors to make better buy, hold, or sell decisions among the various REITs that are publicly traded. With an aggregate equity market capitalization of \$939 billion, REITs are an established asset class, but still represent a relatively small piece of the investment world. For comparison, the market capitalization of Apple, Inc. (NASDAQ: AAPL) was approximately \$530 billion at the end of 2015. As the industry has grown, particularly in the last 10 years, REITs have gained traction in the minds and portfolios of an increasing number of investors, though some still view them as alternative investments. In any given year, the total returns of REITs have to be all the more compelling to attract and retain investors. The industry's smaller relative size magnifies the effects of investor rotations into or out of REITs. A \$100 million swing of funds into or out of the \$939 billion REIT market has a more material impact on REIT returns than it would on the Dow Jones Industrial Average, whose 30 constituent companies had a combined market capitalization of \$5.1 trillion at the end of 2015.

As the shaded areas in Table 7.1 show, REITs delivered strong total returns in 1995–1997, from 2000 to 2006, and again from 2009 to 2012. The disappointing total returns in 1998–1999 illustrate what happened to REIT returns when fund flows rotated to the higher growth NASDAQ. During the 2007–2008 global financial crisis,

Table 7.1 Total Returns of REITs vs. Major Indices

	REITs ^a	S&P 500	NASDAQ	DJIA	Russell 2000	10-Year Ty Yield ^b	10-Year CMBS ^c
1990	-17.3%	-3.1%	-17.8%	-4.3%	-21.5%	8.1%	NA
1991	35.7%	30.5%	56.8%	20.3%	46.0%	6.7%	NA
1992	12.2%	7.6%	15.5%	4.2%	16.4%	6.7%	NA
1993	18.5%	10.1%	14.8%	17.0%	17.0%	5.8%	NA
1994	0.8%	1.3%	-3.2%	5.0%	-3.2%	7.8%	NA
1995	18.3%	37.6%	39.9%	36.9%	26.2%	5.6%	NA
1996	35.8%	23.0%	22.7%	28.9%	16.6%	6.4%	115
1997	18.9%	33.4%	22.2%	24.9%	22.2%	5.7%	140
1998	-18.8%	28.6%	40.2%	18.1%	-2.2%	4.6%	270
1999	-6.5%	21.0%	86.1%	27.2%	21.4%	6.4%	210
2000	25.9%	-9.1%	-39.2%	-4.7%	-3.0%	5.1%	235
2001	15.5%	-11.9%	-20.8%	-5.4%	2.5%	5.0%	220
2002	5.2%	-22.1%	-31.2%	-15.0%	-20.5%	3.8%	181
2003	38.5%	28.7%	50.8%	28.3%	47.3%	4.3%	129
2004	30.4%	10.9%	9.2%	5.3%	18.3%	4.2%	127
2005	8.3%	4.9%	2.1%	1.7%	4.6%	4.4%	180
2006	34.4%	15.8%	10.4%	19.0%	18.4%	4.7%	123
2007	-17.8%	5.5%	10.7%	8.9%	-1.6%	4.0%	790
2008	-37.3%	-37.0%	-40.0%	-31.9%	-33.8%	2.2%	5,362
2009	27.4%	26.5%	45.4%	22.7%	27.2%	3.8%	7,315
2010	27.6%	15.1%	16.9%	14.1%	26.9%	3.3%	5,932
2011	7.3%	2.1%	-1.8%	5.5%	-4.2%	1.9%	725
2012	20.1%	16.0%	15.9%	7.3%	16.4%	1.8%	400
2013	3.2%	32.4%	38.3%	26.5%	38.8%	3.0%	370
2014	27.2%	13.7%	13.4%	7.5%	4.9%	2.2%	355
2015	2.3%	1.4%	5.7%	-2.2%	-4.4%	2.3%	545
1991–2015, 25-year CAGR	12.1%	9.8%	10.9%	7.9%	10.5%	–	–

Shaded areas represent years in which REITs outperformed most major indexes.

Source: NAREIT; S&P Global Market Intelligence; Yahoo! Finance; Bloomberg & Wells Fargo Securities, LLC

^aAnnual total returns on the FTSE NAREIT All REITs Index.

^bRepresents the yield on 10-year U.S. treasury notes at the end of each year.

^c10-year CMBS yield for BBB notes in excess of 10-year U.S. Treasuries (CMBS “spreads”), in basis points.

REITs significantly underperformed other indexes in 2007, strongly rebounded (like other indexes) in 2009, and then significantly outperformed other indexes in 2010. Real estate fundamentals, changes in interest rates, and many other market forces all play a role in determining REIT performance. Understanding the evolution of the marketplace for REIT shares is instructive for predicting how the companies may perform in future circumstances. The following sections highlight the major milestones in the evolution of the modern REIT market—which in 25 years, has emerged from obscurity

and grown into an industry that, effective September 1, 2016, will largely compose S&P's eleventh Global Industry Classification Standards (GICS) sector: Real Estate.

Factors Influencing Demand for REIT Shares

A basic economic principle is that the price of something equals where supply of that item intersects with demand for it. Although current stock prices reflect investor expectations about future company earnings, the fundamental laws of supply and demand also matter. Because the REIT industry is small relative to other industries, REIT returns can be negatively affected when too many REITs issue too many new shares, creating a temporary market situation of oversupply. As Figure 7.1 shows, the FTSE NAREIT Equity REITs (FNER) index returns declined after 1997 and 2006. Although other market forces also played a role in declining REIT values, both years were preceded by multiple years of heavy new equity issuance. When other forces caused demand for REIT shares to soften, the greater supply of REIT equity likely compounded those declines. What is encouraging is that, after five years of record equity issuance from 2009 through 2013, the FNER continued to rise in 2014 and in 2015. Demand for REITs appears to have kept up with new supply of REIT shares.

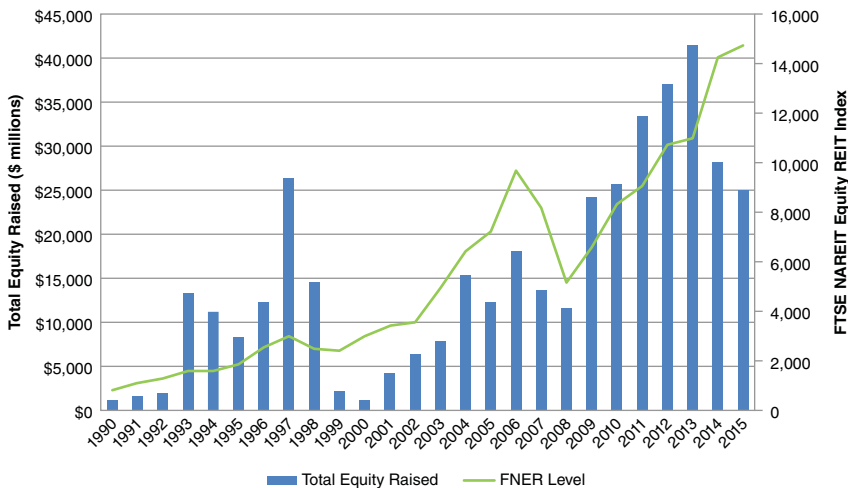


Figure 7.1 Supply of New Equity versus REIT Performance, 1990–2015

Source: NAREIT.

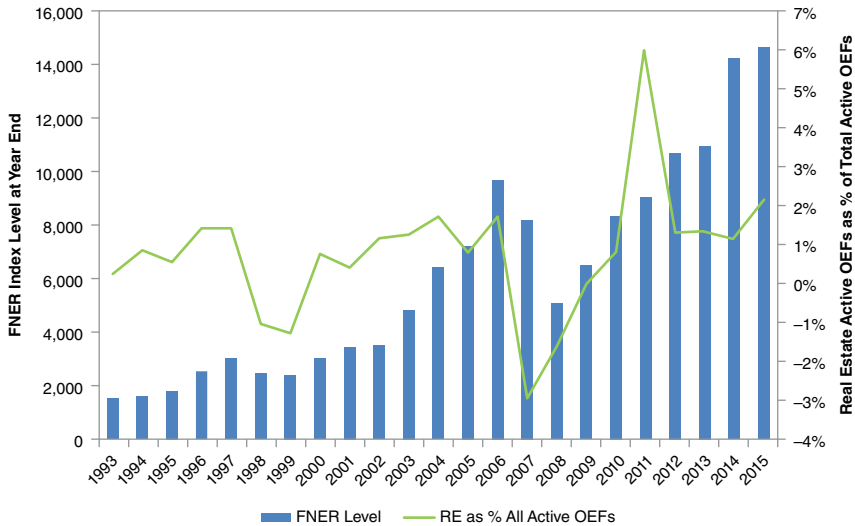


Figure 7.2 Real estate-dedicated mutual fund flows through, 1993–2015. (Note: Total Fund Flows based on all actively managed open-end funds (OEFs) for all U.S. OE Morningstar Categories excluding Money Market & Funds of Funds. Total Fund Flows for U.S. Real Estate based on actively managed funds in the Morningstar U.S. OE Real Estate Category. The percent of real estate active OEFs as a percent of all active OEFs is calculated using annual fund-flow data.)

Source: Morningstar Direct; Cohen & Steers; NAREIT.

Demand for REIT shares plays a larger and multifaceted role in REIT performance. It can be measured by observing the weekly flow of funds into (or out of) real estate–dedicated mutual funds. As Figure 7.2 shows, the strong performance of REITs from 2000 through 2006 corresponded to a sustained flow of funds into real estate mutual funds. Similarly, REIT returns were negative in 2007 and 2008, years in which funds flowed out of REITs. Fund-flow data is expensive to access, and, therefore, not available to all investors. Some REIT research teams at investment banks produce weekly or monthly fund flow reports but, again, these are not accessible to all investors. The data shown in Figure 7.2 was provided by Cohen & Steers, Inc. (NYSE: CNS).

Events That Increased Demand for REIT Shares

What Figure 7.2 also shows is that fund flows into REITs—though volatile from year to year—have increased from around 25 basis

points of total fund flows in the early 1990s to over 2 percent in 2015. From 1993 through 2015, real estate fund flows as a percent of total fund flows averaged 80 basis points. What Figure 7.2 does not show is that REITs existed for three-and-a-half decades, from 1960 through 1995, before the industry gained meaningful traction with investors.

Until the mid-1990s, the percent of real estate assets as a percent of total mutual fund assets was less than 25 basis points. Prior to 1990, the supply of REIT shares was too small and the marketplace for REITs was too illiquid to attract meaningful institutional investor interest. Though REITs offered attractive yields and strong portfolio diversification benefits discussed in Chapter 2, their thin average daily trading volumes (see Figure 7.3) relegated them to a subset of income-seeking individual investors. In 1990, for example, there were 58 equity REITs with a combined average trading volume of \$114 million, implying an average trading dollar volume per REIT of less than \$2 million. By contrast, in 1990, The Walt Disney Company (NYSE: DIS) average daily dollar trading volume was \$58 million (source: NYSE).

In the past 25 years, however, the REIT industry has grown dramatically. Since 2005 alone, the industry's average daily dollar trading volume has increased at a compounded average rate of 12.5 percent, from \$1.7 billion in 2005 to \$6.2 billion in 2015

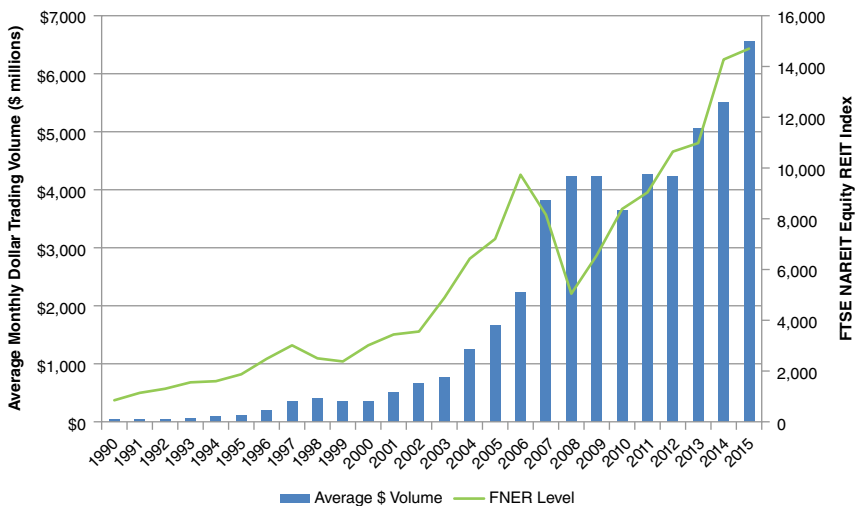


Figure 7.3 Annual Dollar Trading Volume of the FNER, 1990–2015

Source: NAREIT.

(source: NAREIT). In the 1990s, the REIT industry went through a period of tremendous growth, both in terms of the number of REITs that came public and in terms of the market capitalization of the REIT industry itself. Recall Table 1.1 in Chapter 1, which summarizes the industry's growth since the early 1970s. In 1990, there were 58 equity REITs, 43 mortgage REITs, and 18 hybrid REITs, for a total of 119 companies with a combined equity market capitalization of \$8.7 billion. At the end of 2015, there were 182 equity REITs and 41 mortgage REITs, for a total of 223 companies with a combined equity market capitalization of \$939 billion. Several distinct events supported the REIT industry's rapid growth since 1990. The following pages address the major milestones that punctuated the REIT industry's growth.

S&L Crisis of 1980s Was a Unique Buying Opportunity

During the savings and loan crisis (the S&L crisis), approximately one-third of the 3,234 savings and loan associations in the United States failed between 1986 and 1995. Two government organizations were created to close or otherwise resolve the failed associations: the Federal Savings and Loan Insurance Corporation (FSLIC) and the Resolution Trust Corporation (RTC). A major tactic used by these organizations was to sell the commercial real estate holdings of S&Ls, often for pennies on the dollar. Real estate companies and REITs purchased high-quality assets from the RTC for deeply discounted prices, a rare buying opportunity that positioned the REIT industry for tremendous growth in the 1990s. As the U.S. economy and commercial real estate markets recovered, REITs began leasing up vacancy and capturing higher market rents in their RTC properties. As a result, REITs were able to generate average annual total returns of 17 percent from 1992 through 1996, which significantly outperformed the returns of other investments (see Table 7.1).

REIT Returns Attract Tsunami of New Capital, 1992–1996

The REIT industry's strong performance from 1992–1996 attracted significant amounts of new capital. Taking advantage of the strong demand for REIT shares, dozens of private companies and portfolios were able to complete the initial public offering (IPO) process, swelling the ranks of publicly traded REITs from 138 at the end of 1991 to 199 companies at the end of 1996. By the same token,

the size of the REIT industry also expanded rapidly. According to NAREIT, REITs issued \$49.7 billion in equity (both through IPOs and follow-on stock offerings) from 1990 through 1996. The industry's equity market capitalization increased from \$13.0 billion at the end of 1991 to \$88.8 billion at the end of 1996, representing a compound annual increase of 37.7 percent.

Professional Money Managers Discover REITs

The advent of professional money managers into the REIT market was a critical component of the industry's growth and evolution. In 1985, Cohen & Steers, Inc. (NYSE: CNS) created the first real estate–“dedicated” mutual fund, and was the sole real estate–dedicated mutual fund until 1989. As Figure 7.2 demonstrated earlier in this chapter, investors have increased their allocations to real estate–dedicated mutual funds dramatically since the late 1980s. Today, hundreds of institutional money managers invest in a vast array of REIT-dedicated mutual funds.

Improvements to the REIT Structure Aligned Management with Shareholders

Part of the reason REITs were small and micro-cap companies prior to the 1990s was that the REIT structure was flawed. In the late 1980s and through the 1990s, the structural impediments that hampered REIT growth were resolved. *The Tax Reform Act of 1986* (the “1986 Tax Act”) often is cited for giving the U.S. economy a nasty case of whiplash when it eliminated certain tax deductions, such as the ability to recognize passive losses generated by real estate limited partnership (RELP) investments, which are discussed in Chapter 6. However, it also dramatically improved the corporate structure and governance of REITs. Prior to the 1986 Tax Act, REITs were required to be externally advised and managed by third parties; as a result, REITs were mutual fund–like, passively managed pools of properties. Managers were paid a percent of the book value of assets owned by the REIT, rather than according to profitability. The 1986 Tax Act empowered REITs with the right to self-manage, self-advise, and to provide basic “landlord” services to tenants. Accordingly, REIT management teams became more active managers of their assets, enabling companies to differentiate themselves from other REITs by delivering above-average growth.

The REIT Simplification Act of 1994 further streamlined the REIT structure so that companies could operate as fully integrated businesses run by professional managers who were compensated for creating shareholder value, rather than amassing large portfolios. *The REIT Modernization Act of 1999* (the “RMA”) became effective January 1, 2001, and further increased REITs’ ability to provide tenant services through the use of taxable REIT subsidiaries (TRSs). The result of these Acts was to align the economic interests of REIT management teams with those of the shareholders, making REITs more appealing investments.

Inclusion in Major Stock Indexes Boosted Market Capitalizations and Liquidity

The structural improvements to REITs discussed in the preceding paragraphs, combined with the sector’s attractive total returns, continued to attract an increasing level of capital to the REIT industry in the 1990s. As the average market capitalization of REITs and trading volumes increased, it became cost efficient for a broader array of money managers and pension funds to build and maintain a position in REITs as part of their portfolios. Then in 2001, Standard & Poor’s admitted the first equity REIT to its 500 Index. During the past 14 years, several REITs have been added and, at the end of 2015, the S&P 500 Index included 24 equity REITs (see Table 1.2 in Chapter 1 for more detail). The inclusion of an increasing number of REITs to broader market indexes that money managers use as benchmarks, combined with a strong investor appetite for the safety and yield offered by REITs, sparked a second sustained inflow of funds into REIT-dedicated mutual funds, from 2000 to 2006. REIT generally outperformed other indexes again from 2009 to 2015, years of slow economic growth and lackluster performance from the broader stock market that followed the Great Recession of 2008–2009.

Changes to FIRPTA Tax Law Should Boost Demand for REITs, Beginning in 2016

Congress enacted the Foreign Investment in Real Property Act (FIRPTA) in 1980 in order to tax the gains on sales that non-U.S.

residents realized when selling U.S. real estate, and also to limit the amount of U.S. property and REITs that foreign investors can purchase. In December 2015, the *Protecting Americans from Tax Hikes Act of 2015* (the “PATH Act”), affected three significant reforms to FIRPTA that should increase foreign investor demand for U.S. REITs. According to NAREIT’s analysis, the PATH Act:

1. Increased from 5 percent to 10 percent the ownership stake that a foreign investor can take in a publicly traded REIT without triggering FIRPTA liability (i.e., a tax).
2. Removed the tax penalty that FIRPTA imposes on foreign pension funds that invest in U.S. real estate.
3. Clarified when a listed REIT can be considered “controlled” by U.S. persons so that sales of its stock are not subject to FIRPTA.

The PATH Act also eliminated the tax advantages previously associated with spinoff activity, effectively ending the ability of non-REIT corporations to spin off their real estate holdings into REITs. (REITs’ ability to continue spinning off new REITs, such as Vornado [NYSE: VNO] recently did with its retail properties into a new REIT, Urban Edge [NYSE: UE], remains intact and fundamentally unchanged.) REIT spinoffs by non-REITs became increasingly popular in recent years as corporations sought to maximize their valuations by monetizing their real estate holdings in what was a tax-efficient manner. Such spinoffs, however, violated the spirit of the law that supports REITs, which are not intended to provide a legal means for tax avoidance. If the trend toward real estate spinoffs by non-REITs had continued, it very likely would have damaged the REIT industry’s reputation for good corporate governance, among other things, and tainted the industry in general. It also would have been a massive step backward to the days before 1986, when many REITs existed because they essentially served as financing vehicles for banks that funded real estate projects. By taking away the tax incentives for non-REITs to divest their real estate holdings into make-a-REIT spinoffs, the PATH Act strengthened the overall integrity of the REIT industry and validated it in the eyes of investors.

Creation of Real Estate GICS Sector in 2016 Should Increase Demand for REITs

On September 1, 2016, S&P and MSCI will create a new Global Industry Classification Standard (GICS) sector called *Real Estate*, which should be a watershed event for REITs. In the industry's initial decades, mortgage REITs outnumbered equity REITs. First impressions linger and, while the number of equity REITs and their combined market capitalizations have been greater than those of mortgage REITs since the 1970s, many money managers viewed REITs as being a type of financial institution. In 1999, when S&P established its ten GICS classifications, they formally categorized REITs into the Financials code, cementing this impression. Real Estate will be the eleventh such investment sector; its formation should materially increase investor awareness of REITs, and further broaden the industry's appeal to individual and institutional investors. (Note that mortgage REITs will remain in S&P's Financials sector.)

REITs versus the Attractiveness of Other Investments (Lessons from History)

Demand for REIT shares is also affected by the availability of alternative investments that investors think may offer better returns. REITs periodically have underperformed other investments during certain time periods, not so much because of real estate fundamentals, but because of market forces that drove investor dollars into growth stocks (1998–1999), into U.S. Treasuries (2004–2005), and into people's mattresses (2007–2008). Conversely, when returns on the S&P500 index are uncertain, REITs generally outperform because investors tend to look for investments that offer safety (or certainty) and yield. The annual total returns presented in Table 7.1 at the beginning of this chapter illustrate these distinct trading periods.

Growth Stocks versus REITs, 1998–1999

REIT share prices have been and will continue to be vulnerable to shifts in investor sentiment toward higher-growth sectors. As shown in Table 7.1, from 1993 through 1997 REITs delivered average annual total returns of 18.5 percent, which kept pace with the similarly strong returns in both the S&P 500 Index and the NASDAQ (see area A of Figure 7.4). Investor sentiment—and their

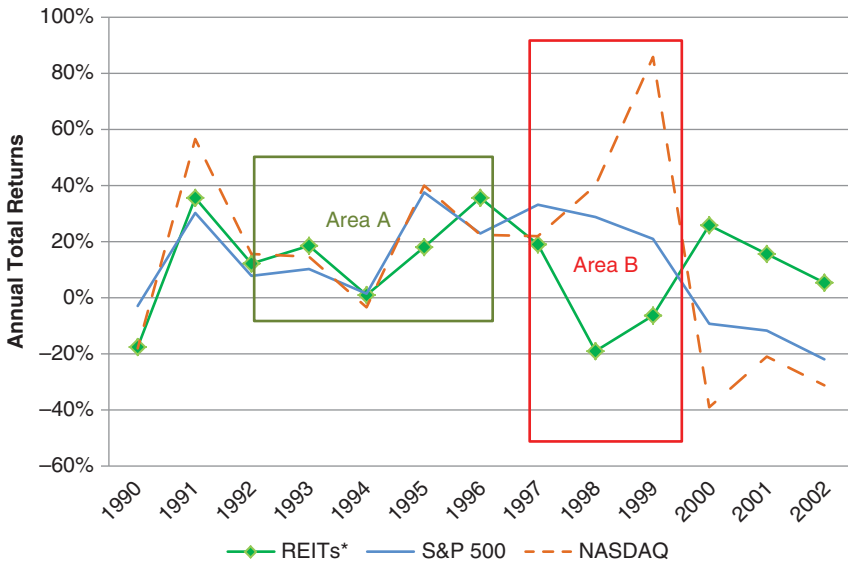


Figure 7.4 REIT Performance versus S&P 500 and NASDAQ, 1990–2002 (Note: Annual total returns on the FTSE NAREIT All REITs Index)

*Annual total returns on the FTSE NAREIT All REITs Index.

Source: NAREIT; S&P Global Market Intelligence.

funds—quickly shifted away from REITs in 1998, however, when the dot-com and tech frenzy accelerated. During this rotation-to-growth, which is also called a *risk-on* trade, investors pulled funds out of defensive investments, like bonds and REITs, and plowed them into the tech-heavy NASDAQ. As Area B in Figure 7.4 shows, REIT returns simply could not compete for investor dollars against the NASDAQ's 40 percent returns in 1998 and their eye-popping 86 percent total return in 1999. Even though fundamental demand for commercial real estate in 1998 and 1999 was strong across all property types, REITs delivered negative total returns of 18.8 percent and 6.5 percent in those respective years. Note that in the spring of 2000, when the dot-com investment bubble burst, investors rotated out of the NASDAQ. This *risk-off* trade by investors is reflected in the NASDAQ's negative 39.2 percent return in 2000 and the REIT industry's positive 25.9 percent total return that same year.

Treasury Yield versus REITs, 2004–2006

Although REITs outperformed the S&P500 and the NASDAQ handily from 2004 to 2006, their returns were muted for several months

from yield investors opting out of REITs in favor of U.S. government bonds. Because REITs offer attractive dividend income, investors will (and should) always compare REIT yields to those of fixed-income investments. Historically, REIT yields have been compared against the yield on 10-year U.S. Treasury notes. From March 2004 through June 2006, notable increases in the yield on 10-year U.S. Treasuries precipitated equally distinct declines in REIT valuations. The drop in valuations was short-term and sporadic. Typically, a decline in REIT valuations in reaction to rising interest rates or Treasury yields turns out to be a compelling buying opportunity for REIT investors, especially those that are patient. (Please refer to *REIT Performance in a Rising Interest Rate Environment* later in this chapter for a more detailed discussion of this topic.)

Safety and Yield, and the Big League of Benchmarks, 2000–2006

The bursting of the technology bubble in spring 2000; the accounting scandals at high-profile companies like Enron (formerly NYSE: ENE) in 2001 and 2002; the tragedy associated with events in the United States on September 11, 2001 (9/11). Each event shook investor confidence and negatively affected the broader stock market. Each event also helped fuel a seven-year rally in REITs, as investors increasingly looked to the group as a source of stable, more visible income. As Table 7.1 illustrated earlier in this chapter, REITs outperformed the broader markets from 2000 through 2006. As previously discussed, investors already were rotating from the NASDAQ into investments, like REITs, that offered safety and yield. From 2000 through 2006, REITs issued \$200 billion of equity, preferred stock, and debt capital, \$65.3 billion of which was common equity. The industry's market capitalization increased approximately 250 percent, from \$124 billion at the beginning of 2000 to \$438 billion at the end of 2006 (see Figure 7.5). The strong demand for REIT shares was driven both by the fundamental investor appetite for safer, higher-yielding investments, such as REITs, and also by a watershed event for REITs: the addition of the first equity REIT, Equity Office Properties (former NYSE: EOP), to the S&P 500 Index. REITs had made it to the big league of benchmarks, and the added visibility from inclusion in the S&P 500 Index supercharged market dynamics that already favored REIT investment.

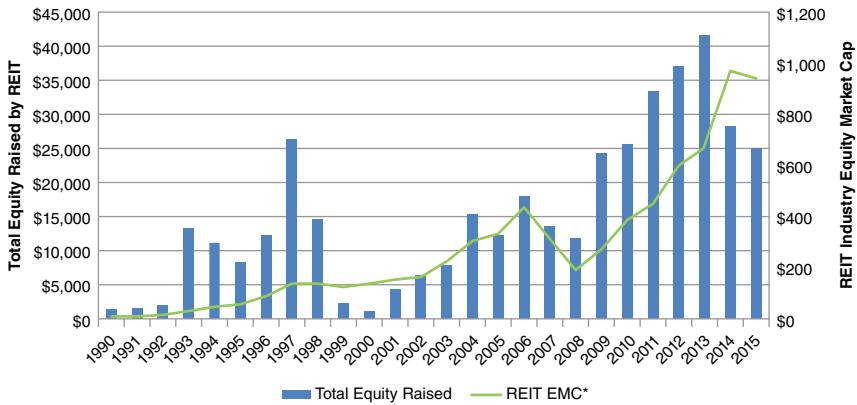


Figure 7.5 REIT Common Stock Issuance and Growth in Industry Market Cap, 1990–2015

Source: NAREIT.

REITs During the Financial Crisis of 2007–2008

One of the most reliable ways investors can gauge market risk is to observe the weekly rate of change in 10-year commercial mortgage-backed security (CMBS) spreads. (If investors do not have access to a Bloomberg terminal, they can request this information from their financial advisors.) When the CMBS spreads increase (or *widen*) over the prior week's level, then the market is factoring in more risk, such as the risk of recession or other events that would affect the broader markets.

Changes in the spreads on 10-year CMBS have proven to be a highly accurate predictor of short-term returns in the REIT market. For example, the 10-year CMBS spreads, which are expressed as a number of basis points above the yield on 10-year U.S. Treasury notes, dramatically widened by 540 percent throughout 2007, from 123 basis points at the beginning of the year, to 790 basis points. By the end of 2008, 10-year CMBS spreads had exploded to 5,362 basis points over Treasuries. As Figure 7.6 and Table 7.1 show, REIT share prices declined commensurately as the CMBS spreads increased. Even though the global financial crisis of 2007–2008 began in the overleveraged housing market, rather than in the commercial property markets, REITs delivered total returns of negative 17.8 percent in 2007 and negative 37.3 percent in 2008.

Investment Tip

If a credit crisis is possible, stocks associated with real estate, such as REITs, are likely to underperform the broader market due to investor fears—real and imagined—about the sustainability of corporate dividends and the risk of defaulting on loans scheduled to mature in the near term.

Investors feared that all companies, including REITs, would either refinance maturing debt at abnormally high interest rates or, worse, that they might not be able to refinance debt “at any price,” in which case management may choose to dilute existing shareholders with an “emergency” equity issuance to raise capital. Any of these pricey refinancing alternatives would dampen future REIT profitability. As discussed in Chapter 3, between 2007 and 2009 only one publicly traded equity REIT entered bankruptcy to restructure its debt, but nearly a third cut or suspended their dividends to preserve capital during these highly uncertain market conditions. Once REITs began issuing new equity—at prices that were highly dilutive to existing shareholders and to future earnings—it became clear that the industry and its constituents would endure. REIT valuations recovered fairly rapidly in 2009, as a result.

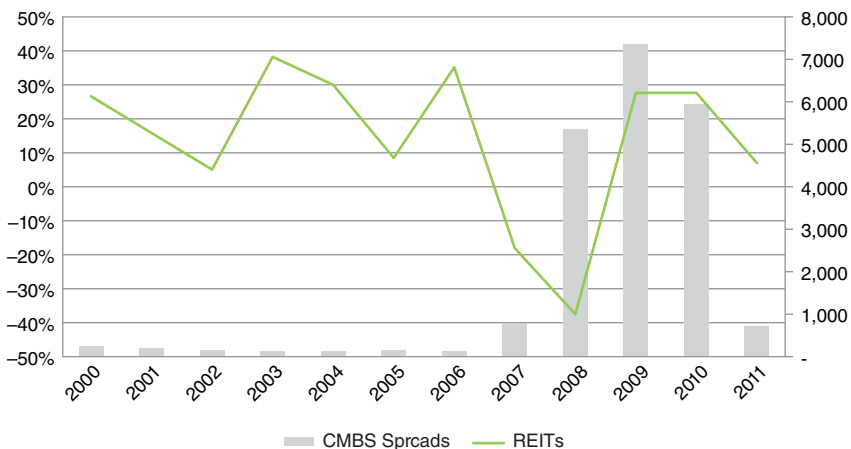


Figure 7.6 REITs Returns versus 10-Year CMBS Spreads, 2000–2011. (Note: REIT performance as measured by the annual total returns for the FTSE NAREIT All REITs Index. CMBS Spreads are for 10-year, BBB notes at year-end, in basis points.)

Source: NAREIT; Bloomberg & Wells Fargo Securities, LLC.

Company Attributes That Affect Performance

The REIT industry comprises an increasingly wide array of commercial real estate. Each REIT in every property sector is governed by three broad forces that affect their performance, both on an absolute basis and relative to other REITs: real estate fundamentals, lease structure and duration, and cost of capital. Real estate fundamentals, and especially the degree to which demand for a property type is consistent throughout different phases of the economic cycle, affect a REIT's profitability over the long term. A property sector like health care, for example, benefits from steady (or *inelastic*) demand for its product; regardless of economic growth, people need access to health-care services. Consistent demand translates into steady occupancy levels, which should translate into a consistently profitable REIT. Different lease structures and durations discussed in Chapter 4 result in different operating margins, which also affect operating profits. Lastly, how a management team finances its operations is an increasingly important factor in determining long-term total returns. When the economy slows or goes into recession, the profitability of any real estate will decline. But stock performance across property sectors and among companies can differ widely due to these three basic extrinsic and intrinsic factors, which the next several pages explain in more detail.

Real Estate Fundamentals and REIT Performance

Real estate is tangible, and investors often take comfort in the visible signs that indicate how the local economy is fairing. A full parking lot at an office building or at a retail center signals times are good; "For Rent" or "Space Available" signs can signal the beginning of an economic slowdown. Often, however, REIT share price performance does not reflect what investors observe. Retailers often go bankrupt during a recession, but retail REITs rarely do. In fact, REIT share prices frequently appear to perform without a direct relationship to what is happening in the underlying property markets. Such counterintuitive behavior typically occurs when the economy is in transition, either going into or coming out of recession. The explanation for this occasional disconnect between REITs and real estate fundamentals lies in understanding the tension that exists between the fact that real estate is a *lagging* economic indicator, whereas REIT share prices (like any publicly traded equity) are functions of *future*

earnings expectations. The following pages address the periodic disconnect between real estate fundamentals and REIT share performance.

The Property Cycle and the Economic Cycle

Market forces discussed earlier in this chapter typically affect REIT performance in the short or medium term. Supply of and demand for commercial space, which are the two primary real estate fundamentals, affect REITs' longer-term operating performance and, by extension, returns for shareholders. When a property market is inundated with too much new construction (*supply*), vacancy rates increase and landlords decrease rental rates in an attempt to keep existing tenants in their spaces. Whether landlords experience increases in vacancy or declines in rental rates (or both), their profit margins decline.

Although assessing the supply of competitive buildings by each property type is an important component of selecting REITs that may outperform (or avoiding those that may underperform), it is difficult for most individuals to gauge new construction in multiple markets with much accuracy. Apart from subscribing to a data provider that tracks supply, most investors rely on anecdotal information gleaned from newspapers and conversations with local real estate brokers. More dedicated individuals may even count cranes they see in cities they visit to assess whether a market may be getting overbuilt. It is far easier to estimate and anticipate demand for property in each market by interpreting current economic data. By understanding how the real property cycle interacts with the economic cycle, it is possible to make smart and timely REIT investments.

The property cycle encompasses how occupancies and rents in a market fluctuate, and whether new construction “makes sense.” Overbuilding of certain property types has precipitated economic declines in the past when demand was not sufficient to fill new buildings, leading to widespread defaults on debt, such as was seen during the S&L crisis. The “housing bubble” and related defaults are often cited for triggering the Great Recession of 2008–2009 in the United States. Setting aside periods of severe market dislocation, the real property cycle generally responds in predictable ways to what is occurring in the underlying economy. Figure 7.7 illustrates how the property cycle responds to the economic cycle. Each phase is then discussed.

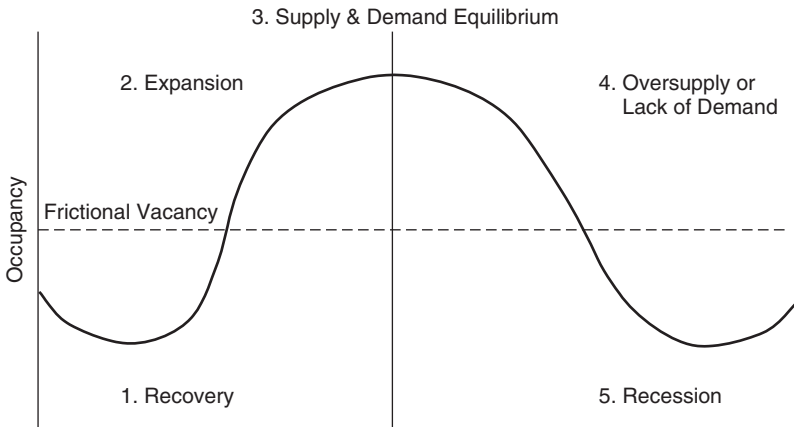


Figure 7.7 The Property Cycle

1. **Recovery**—After the economy emerges from recession, the recovery period for real estate is characterized by a lack of new construction because rental rates are not improved enough, generally, to merit the cost of new development. (Land prices, labor, and construction materials, such as steel, tend to appreciate or inflate over time, making new development more costly from one cycle to the next.) Because demand for space is recovering without the addition of new supply, occupancies rise. REITs with cash on hand (or low levels of debt) are able to buy assets at attractive discounts to replacement cost, enabling them to deliver outsized returns on their investment.
2. **Expansion**—During an economic expansion, occupancy continues to increase but at a decreasing rate from prior periods. Landlords are able to push for higher rents on new leasing to the point that assets can no longer be purchased at discounts to replacement costs. As rental rates rise, new construction begins to become profitable again.
3. **Supply-and-Demand Equilibrium**—This is a state of commercial property nirvana that is rarely achieved, in large part because private developers tend to overbuild their markets (at least slightly) during each cycle.
4. **Oversupply or Lack of Demand**—As the economy begins to slow, property markets continue to add new supply, albeit at

a reduced pace. This is because new construction started during the late phase of the economic expansion frequently is delivered into a softening economy. A “construction cycle” is the time it takes to erect a building, usually expressed in months or years. The longer the construction cycle is for a property type, the greater the risk that the property sector will experience periods of oversupply. High-rise office buildings, for example, can take two or more years to construct, and that is after the developer receives all the zoning and necessary approvals, and then breaks ground on the site. During construction time, the economy may change for the worse, resulting in some office buildings being delivered to a market that no longer has sufficient demand to fill the new space. During periods of oversupply or declining demand, vacancies increase. However, rents may still increase for a period of time because not all tenants’ business will feel the effects of a slowing economy at the same time.

5. **Recession**—An extension of the oversupply phase, property markets can slip into recession if too much supply is delivered into an economy that is in recession. The lack of demand for space, compounded by the new square feet coming onto the market initially, causes some tenants to sublease their unused space. Investors should watch for signs of increasing levels of subleased space, also called “shadow supply,” to signal a market’s decline. Then direct vacancies begin to rise as tenants choose not to renew some or all of their previously leased space. In such an environment, landlords will offer concessions and lower rental rates to maintain as much occupancy as possible. The magnitude of such concessions varies by property type and by market.

Performance by Property Type

As discussed in Chapter 5, in addition to the “basic foods groups” of office, industrial, retail, and apartment buildings, REITs own and operate nearly every type of property imaginable. The drivers of demand for each property type also differ. Table 7.2 summarizes how the different property types of REITs have performed over time. Before discussing how different economic news is likely to affect the performance of different REITs, there are two broad-based factors that influence tenant demand for all types of space.

Table 7.2 Historical Total Returns by Property Sector

Property Sector	Annual Total Returns (a)															Average							
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008		2009	2010	2011	2012	2013	2014	2015
Industrial/Office	16.6%	25.8%	44.4%	27.5%	-14.4%	3.4%	33.4%	7.1%	0.9%	33.3%	25.2%	12.9%	39.4%	-14.9%	-50.3%	29.2%	17.0%	-1.5%	19.1%	6.0%	24.3%	-	13.5%
Office	2.9%	38.8%	51.8%	29.0%	-17.4%	4.3%	35.5%	6.7%	-6.8%	34.0%	23.3%	13.1%	45.2%	-19.0%	-41.1%	35.5%	18.4%	-0.8%	3.3%	5.6%	25.7%	0.3%	13.1%
Industrial	18.7%	16.2%	37.2%	19.0%	-11.7%	3.9%	28.6%	7.4%	17.3%	33.9%	34.1%	15.4%	28.9%	0.4%	-67.5%	12.2%	18.9%	-5.2%	31.3%	7.4%	21.0%	2.6%	12.2%
Office & Other	NA	NA	40.8%	27.9%	-8.9%	-0.7%	32.0%	8.2%	8.6%	31.3%	19.6%	7.4%	28.3%	-33.1%	-34.0%	34.9%	8.8%	2.7%	20.8%	5.6%	23.1%	-	11.7%
Retail	3.0%	5.1%	34.6%	16.9%	-4.9%	-11.8%	18.0%	30.4%	21.1%	46.8%	40.2%	11.8%	29.0%	-15.8%	-48.4%	27.2%	33.4%	12.2%	26.7%	1.9%	27.6%	4.6%	14.1%
Shopping Centers	1.3%	7.4%	33.5%	21.4%	-7.0%	-10.7%	15.1%	29.9%	17.7%	43.1%	36.3%	9.3%	34.9%	-17.7%	-38.8%	-1.7%	30.8%	-0.7%	25.0%	5.0%	30.0%	4.7%	12.2%
Regional Malls	8.8%	3.0%	45.3%	13.7%	-2.6%	-14.6%	23.5%	31.9%	24.6%	52.2%	45.0%	16.5%	23.8%	-15.9%	-60.6%	63.0%	34.6%	22.0%	28.2%	-1.0%	32.6%	4.2%	17.2%
Free Standing	-5.5%	31.6%	30.9%	17.7%	-6.2%	-4.9%	8.9%	24.0%	21.8%	35.9%	32.9%	-0.5%	30.7%	-0.4%	-15.1%	25.9%	37.4%	0.4%	22.5%	7.3%	9.7%	5.9%	14.1%
Residential	2.3%	12.0%	29.5%	16.3%	-8.1%	9.5%	34.3%	9.0%	-6.0%	25.9%	32.7%	13.7%	38.9%	-25.2%	-24.9%	30.8%	46.0%	15.4%	6.9%	-5.4%	40.0%	17.1%	14.1%
Multifamily	2.2%	12.5%	28.9%	16.0%	-8.8%	10.7%	35.5%	8.7%	-6.2%	25.5%	34.7%	14.7%	39.9%	-25.4%	-25.1%	30.4%	47.0%	15.1%	6.9%	-6.2%	39.6%	16.5%	14.2%
Manufactured Homes	3.3%	10.7%	34.9%	18.6%	-0.9%	-2.8%	20.9%	13.7%	-4.1%	30.0%	6.4%	-2.6%	15.3%	-19.3%	-20.2%	40.9%	27.0%	20.4%	7.1%	10.5%	46.2%	25.7%	12.8%
Single Family Homes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1.8%
Diversified	-6.0%	21.1%	34.0%	21.7%	-22.1%	-14.4%	24.1%	12.5%	4.2%	40.3%	32.4%	9.9%	38.0%	-22.3%	-28.2%	17.0%	23.8%	2.8%	12.2%	4.3%	27.2%	-	-0.5%
Hotels	-8.9%	30.8%	49.2%	30.1%	-52.8%	-16.1%	45.8%	-8.6%	-1.5%	31.7%	32.7%	9.8%	28.2%	-22.4%	-59.7%	67.2%	42.8%	-14.3%	12.5%	27.2%	32.5%	-24.4%	10.5%
Health Care	4.1%	24.9%	20.4%	15.8%	-17.4%	-24.8%	25.8%	51.9%	4.8%	53.6%	21.0%	1.8%	44.5%	2.1%	-12.0%	24.6%	19.2%	13.6%	20.4%	-7.1%	33.3%	-7.3%	14.2%
Self Storage	8.9%	34.4%	42.8%	3.4%	-7.2%	-8.0%	14.7%	43.2%	0.6%	38.1%	29.7%	26.6%	40.9%	-24.8%	5.0%	8.4%	29.3%	35.2%	19.9%	9.5%	31.4%	40.7%	19.2%
Triple-Net & Specialty	-5.2%	27.6%	46.1%	27.3%	-24.3%	-25.7%	-31.6%	7.6%	-5.4%	38.6%	26.9%	10.4%	23.6%	14.6%	-25.7%	31.5%	b	-	-	-	-	-	8.5%
Timber	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	7.7%	37.1%	7.9%	8.6%	-7.0%	10.8%
Infrastructure	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	29.9%	20.2%	20.2%	3.7%	18.5%
Data Centers	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1.5%
Specialty	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1.7%
FN Equity REIT Index	3.2%	15.3%	35.3%	20.3%	-17.5%	-4.6%	26.4%	13.9%	3.8%	37.1%	31.6%	12.2%	35.1%	-15.7%	-37.7%	28.0%	28.0%	8.3%	18.1%	2.5%	30.1%	3.2%	12.6%
FN Mortgage REIT Index	-24.3%	63.4%	50.9%	3.8%	-29.2%	-33.2%	16.0%	77.3%	31.1%	57.4%	18.4%	-23.2%	19.3%	-42.3%	-31.3%	24.6%	22.6%	-2.4%	19.9%	-2.0%	17.9%	-8.9%	10.3%
Hybrid REIT Index	4.0%	23.0%	29.4%	10.8%	-34.0%	-35.9%	11.6%	50.7%	23.3%	56.2%	23.9%	-10.8%	40.9%	-34.8%	-75.5%	41.3%	c	-	-	-	-	-	-
FN All REITs Index	0.8%	18.3%	35.8%	18.9%	-18.8%	-6.5%	25.9%	15.5%	5.2%	38.5%	30.4%	8.3%	34.4%	-17.8%	-37.3%	27.5%	27.6%	7.3%	20.1%	3.2%	27.2%	2.3%	12.1%

Source: NAREIT.
 Shaded areas highlight top-performing property sector each year.
 a>Returns are based on monthly returns for 1994-1998, and daily returns for 1999 and thereafter.
 b)NAREIT discontinued tracking Triple-Net/Specialty REITs in 2010, and reclassified the constituent companies into other categories.
 c)NAREIT discontinued its FTSE NAREIT Hybrid and REIT Index in 2010.

Location and Efficiency Matter

Demand for a property is measured by how fully occupied a building is, especially when compared to similar, “competing” buildings in a market. If office building A is 90 percent occupied and office building B is only 80 percent occupied, it is likely that office building A is both more modern and functionally efficient for office tenants than building B, and/or building A may be in a better location than B. The average rents in place at a building also help investors gauge how desirable a property is, as better locations almost always garner higher rental rates. Regardless of whether the underlying economy is expanding or contracting, office building A has the competitive advantages of functionality and location, and should benefit from higher tenant demand throughout the economic cycle than building B.

“Defensive” Property Types Enjoy Steady Demand

Some types of property are considered defensive because they generate consistent earnings and/or maintain fairly high occupancy rates regardless of the economic or business cycle. For example, triple-net REITs (see Chapters 4 and 5) employ long-term leases that provide predictable earnings streams in any economic condition. The only disruptions to the landlord’s cash flows are when a tenant goes bankrupt or does not renew a lease when it expires. Neighborhood or community shopping centers also tend to be defensive assets, owing to the fact that they usually are anchored by a grocery or drugstore, both of which enjoy fairly inelastic demand for their goods. In contrast, hotels have no leases with their customers, and experience higher vacancies when consumers cut back business and leisure travel when the economy slows. Investors, therefore, may enhance their returns by accurately assessing the direction of the economy and aligning that view with REITs in property sectors that are likely to benefit from current and expected economic conditions.

If the economy has a high probability of slipping into recession, property sector returns from the recent global financial crisis are instructive. As Figure 7.8 demonstrates, the more defensive property sectors (net-lease REITs, health-care, self-storage, and industrial REITs) significantly outperformed less defensive asset types (malls, office apartments, and hotels).

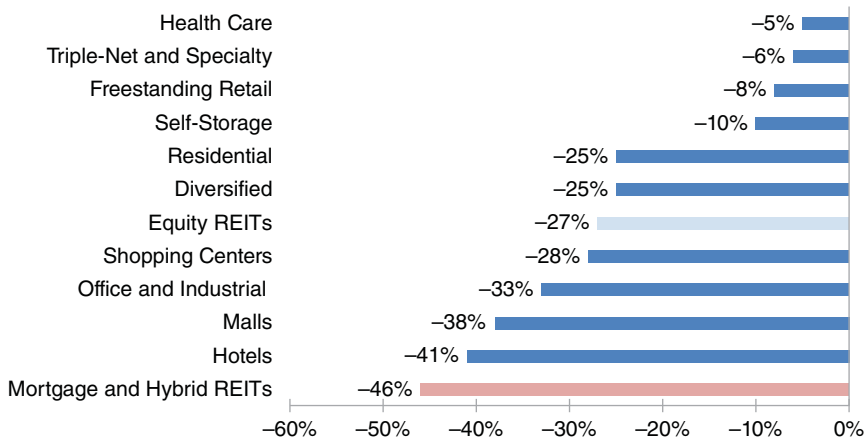


Figure 7.8 Total Returns of Different Property Types During the 2007–2008 Global Financial Crisis

Source: NAREIT.

Recall that Table 7.2 provides historical total return data by property type, and highlights which sectors delivered the higher total return each year. Table 7.3 summarizes how different economic statistics that are in the news typically affect demand for different types of commercial property. Investors can use the information contained in both tables to observe how different property types performed in past economic recessions and recoveries. To facilitate such an analysis, there is a more detailed discussion of how different types of REITs perform during certain economic conditions.

To illustrate the information in Table 7.3, assume the economy is likely to go into recession within the next year, that unemployment will rise, and corporate and consumer spending will decline. Assume for now that interest rates remain stable. (The last section of this chapter addresses *REIT Performance in a Rising Interest Rate Environment*.) The following information is a generalization about how REIT shares in different property sectors are likely to trade in advance of an economic downturn:

- Hotel REITs are likely to underperform because investors will expect reduced spending to result in less travel, or demand for hotel rooms. Because hotel REITs generally have no leases, their stock prices immediately reflect lower expected future profits.

Table 7.3 Economic Drivers of Demand for Real Estate

Economic Indicator	Impact on Demand for Space		
	Direct	Indirect	None
Rising Unemployment	Office (-) Apartments -(+) ^a	Industrial (-) Retail (-) Hotels (-) Self-Storage (+)	Health Care
Decreased Corporate Spending	Hotels (-) Office (-)	Industrial (+) ^b Apartments (-)	Health Care Retail Self-Storage
Decreased Consumer Spending	Industrial (-) Hotels (-) Retail (-)	Apartments (-) Office (-) Self-Storage (-)	Health Care
Rising Interest Rates	Mortgage REITs (-) ^c	Apartments (+)(-) ^{d e} Industrial (-) ^e Hotels (-) ^e Health Care (-) ^e Office (-) ^e Retail (-) ^e Self-Storage (-) ^e	

^aIf unemployment is high for an extended period of time, demand for apartments may increase as some homeowners will need to sell their homes (or be foreclosed upon) and become renters.

^bWhile a prolonged recession likely would result in decreased demand for industrial space to accommodate a smaller volume of goods flowing to market, in the short term, inventories typically accumulate, causing a modest, short-lived increase in demand for industrial space.

^cRising interest rates would lower the positive spreads most mortgage REITs could lock in on investments. The “spread” is the difference between where a REIT can invest capital versus the cost of that capital.

^dA rise in long-term interest rates would make home buying less affordable, which would generate incremental demand for apartments.

^eAn increase in interest rates would negatively affect any REIT that needed to refinance debt, provided that the interest rate on new debt is higher than the rate on the debt that is maturing. However, any such dilution to future cash flow would be limited to specific debt maturities that need to be refinanced, rather than the REIT’s entire debt profile.

- Apartment REITs are likely to outperform because demand for rental properties may remain steady or actually increase, making them a defensive asset class. There are three sources of demand for apartments in a market: (1) newly hired workers who typically rent for a period of time before buying a house, (2) homeowners who need to re-enter the rental market again because they cannot afford the costs of home ownership and maintenance, and (3) “empty-nesters” who decide to sell their houses and move into rental units (usually in more

densely populated cities or town centers) in order to avoid the hassles of homeownership. As long as a market has not become overbuilt with too many new residential units, apartment REIT landlords are likely to fare better than landlords of some other property types.

- Shopping center REITs are likely to outperform other sectors during a slow or soft economic environment because they are also defensive asset classes. Many shopping centers are anchored by grocery stores and/or pharmacies. The essential nature of the goods sold at these stores generates steady traffic at such centers, regardless of the broader economic trends.
- Self-storage REITs are another defensive property type. Demand for space tends to be steady as long as people are moving from one location or household to another, whether it is part of taking a new job or downsizing into a smaller household after children have graduated college, for instance. Stable households also use self-storage to store seasonal and other items that may not fit into their attics and other home storage areas.
- Industrial REITs are a defensive asset class because goods need to be stored and distributed to retailer and consumers throughout the economic cycle. Demand for industrial space is driven by population growth and the associated growth in consumer spending, including the increasing use of shopping online with the Internet. At the onset of a recession, demand for industrial space may actually increase because manufacturers are not selling their goods as quickly, and have not yet adjusted to the lower demand for product. Industrial space demand is not completely inelastic, however, and vacancies do rise modestly during a recession, causing the industrial REITs to sometimes underperform other sectors.
- Office REITs actually perform well for the first year or two of an economic slowdown, which is counterintuitive because demand for office space is correlated to job growth. A decrease in nonfarm payrolls (or office-using jobs) translates into lower demand for office space, but the tenants cannot give back unneeded space until their lease expires. As a result, the inevitable increase in office vacancy during a recession takes a few years to materialize. Once landlords (REITs) begin

experiencing “roll-down” in their rents (meaning the new market rents they negotiate on expiring space is below the rent that was being paid), their stock prices tend to underperform other sectors for two or three years until they have worked through their rent roll-down.

- Health-care REITs are a very defensive asset class because people always use health and medical services, regardless of what the economy is doing. As the population grows, there is more demand for health-care services and, by extension, more need for new, efficient, well-located health-care real estate.

How Lease Length and Structure Affect REIT Returns

Most investors have heard or read that “real estate is a lagging indicator.” Whatever the economy is doing, it takes a number of months or years for an office building or shopping mall to reflect economic changes in the form of higher/lower rents and occupancy levels. The longer the leases the landlord has negotiated with tenants, the longer it will take a property’s cash flows to reflect any change—good or bad—in the local economy. In other words, real estate lags because it has leases.

Existing leases generate revenues even when there is no new leasing or demand for property in the market. As a result, landlords (REITs) can deliver relatively solid 4 to 8 percent earnings growth even as the economy slips into recession. Similarly, when the economy begins expanding again, existing leases cannot be marked to higher current market rents until they expire. So it takes varying amounts of time for changes in the economy to trickle through different property types. Knowing the average lease length and type of lease used by a REIT, therefore, is helpful in determining when to buy or sell its stock.

Real estate performance lags economic conditions, depending on the leases in place. The longer the lease length, the longer the property’s cash flow takes to reflect what’s happening in the economy. Knowing the average lease length and the type of lease structure a REIT employs helps predict how a REIT’s shares may trade during times of economic expansion and contraction.

For example, the longer average lease term associated with office space is the main reason why office REITs often outperform in the early phases of a recession. Their multiyear average lease term delays the effects of current employment trends from manifesting in their rents and occupancies for several years. Assuming the landlord prudently staggers lease expirations throughout the portfolio, five-year leases would translate into approximately one-fifth, or 20 percent of leases expiring (or rolling) each year. Office landlords mark the expiring leases to current market rents, and they try to lease any vacancy their portfolio contains. During the early phase of an economic decline, office REIT returns are buffered by the existence of in-place leases, and the sector tends to outperform the average REIT. Conversely, office REITs tend to underperform the REIT industry during the early stages of an economic recovery, as rents that were negotiated in better economic times expire and roll to potentially lower market rents.

Lease Length and Volatility (Risk)

As a general rule, REITs that own commercial properties with shorter initial lease lengths tend to trade with more volatility—meaning they experience greater percentage change in their daily stock price—than REITs that employ longer leases. Figure 7.9 graphically presents where REITs focused on different types of property rank in terms of trading volatility, which is a proxy for risk. The nature of the demand for each property type, which was discussed earlier in this chapter, also plays a part in a stock's trading volatility. For example, demand for hotels is more cyclical, or dependent on broader economic trends, than demand for warehouse space. People do not have to travel, but goods have to be stored and/or distributed to grocery stores and other vendors regardless of the economic state.

In Figure 7.9, property types in quadrant 1 generally are appropriate for investors who have a higher risk tolerance. REITs in quadrant 4 are focused on property types that are less volatile, making these types of REITs more appropriate for risk-averse investors.

Shares of REITs that own properties with shorter-term leases tend to trade with more volatility than those with longer lease lengths.



Figure 7.9 Riskiness of Different Property Types. (Note: Quadrant #1 = highest volatility/risk; quadrant #4 = lowest volatility/risk.)

Long-Term Leases = Low Volatility

As discussed in Chapters 4 and 5, REITs that use triple-net leases typically rent their properties to tenants for 10 years or longer. During times of economic expansion, the triple-net landlord is not able to mark existing leases to market and misses out on potential windfalls from rent increases. Similar to how municipal bonds and other fixed-income investments generally underperform equities during an economic expansion, REITs that use long-term triple-net leases also tend to underperform other REIT sectors when investors seek growth over safety. However, during tough economic times, long-term leases produce steady, highly visible lease revenue. When investors are uncertain about the economy, they tend to invest in defensive assets—ones that will produce steady returns and/or cash dividends, regardless of the economic environment. During uncertain or recessionary economic times, triple-net REITs tend to outperform other property types. (Note that NAREIT does not have a triple-net REIT classification; as Chapter 5 discusses, REITs that use triple-net leases tend to be those companies in the freestanding retail, health-care, and diversified property types.)

Short-Term Leases = High Volatility

Hotel REIT cash flows are more like those of an operating company than of other REITs. Unlike most traditional REITs that receive contractual rents from leases with tenants, hotel REITs do not have “guest leases.” Guests stay at hotels for business or leisure, and usually only for a night or two. Though advanced bookings by large groups for conventions or weddings can provide a margin of visibility for room demand, hotel operators essentially need to lease up their properties from scratch each day. During flush economic times, hotel landlords can increase prices and achieve strong, double-digit earnings growth. Therefore, when it looks like the economy is coming out of recession, hotel REITs tend to outperform other REIT-asset classes, because investors will pay a higher premium today to participate in the expected strong rent growth they will enjoy. In a down economy, however, hotel operators often have to cut their daily rates (and a portion of their employees) to maintain profitability. Unsurprisingly, hotel REITs tend to underperform when the economy is slowing down and/or at risk of slipping into recession.

Hotel REITs’ Higher Volatility Is an Investment Opportunity

The cyclical nature of demand for lodging is a major reason why hotel REITs trade with greater levels of volatility than the average REIT. This volatility lends itself to greater risks for would-be investors but also to greater potential returns. As Table 7.4 illustrates, hotel REIT annual total returns tend to diverge from that of the broader REIT industry. For example, in 2008 when the U.S. economy was sliding into recession, the average REIT declined 41 percent and hotel REITs fell 63 percent. Conversely, in 2009, when the economy stabilized and started to recover, the average REIT rebounded 27 percent, which was impressive but still paled in comparison to the 63 percent price appreciation enjoyed by hotel REITs.

Because they trade with greater volatility, hotel REITs are one of the few property types investors may want to buy opportunistically when they are at depressed levels, and sell when the stocks—and the underlying economy—are recovered. There is an old expression that the only people who can time the stock market are fools and liars. However, using a contrarian trading strategy with hotel REITs, over time, does seem to be possible and should help investors avoid “buying high and selling low.”

Table 7.4 Hotel REIT performance vs. US GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Hotel REITs ^a	-74%	-14%	-9%	105%	-4%	21%	43%	25%	-54%	-29%	31%	-13%	-5%	25%	29%	6%	23%	-27%	-63%	63%	38%
All Equity REITs ^b	-26%	25%	6%	13%	-4%	7%	26%	13%	-22%	-12%	17%	6%	-3%	28%	24%	7%	30%	-19%	-41%	21%	23%
U.S. GDP ^c	2%	0%	3%	3%	4%	3%	4%	5%	4%	5%	4%	1%	2%	3%	4%	3%	3%	2%	0%	-3%	3%

^a Source: SNL Financial; Price-only.

^b Source: FTSE NAREIT Equity REIT Index; Price-only.

^c Source: Bureau of Economic Analysis.

Recessions years are shaded.

Weighted Average Cost of Capital and REIT Performance

Chapter 1 highlighted the fact that REITs with above-average leverage do not have as much financial flexibility as REITs that operate with lower levels of debt. As a result, the more highly leveraged REITs often are not able to take advantage of opportunistic investments. Research has demonstrated that REIT management teams who operate with more leverage typically underperform their lower-leveraged peers. This section discusses the perils of debt and the overall importance of a REIT's cost of capital.

Debt as a Four-Letter Word

The global financial crisis of 2007–2008 illustrated somewhat dramatically that balance sheets matter. According to an analysis by S&P Global Market Intelligence, of the 128 REITs that were paying a dividend in 2007, 84—or roughly two-thirds—cut their dividend over the following two years. The portfolio of 44 REITs that did not cut their dividends (Keepers) delivered a 135 percent return from the beginning of 2008 through 2015, whereas the cutter portfolio returned only 78 percent. Figure 7.10 plots the performance of these Keeper versus Cutter REITs. Furthermore, studies by numerous reputable firms such as Green Street Advisors have demonstrated how REITs that operate their business with lower levels of debt tend to outperform other, more leveraged REITs.

The 44 Keeper REITs were those that had relatively lower levels of debt going into 2007, before the crisis took hold of the markets. Specifically, the median 2007 debt-to-EBITDA multiples of Keepers was 5.67 times, and for the Cutters it was 7.23 times, clearly demonstrating how higher leverage levels lead to dividend cuts during the global financial crisis. (Debt-to-EBITDA is defined and discussed in Chapter 8.)

Competitive Advantage or Disadvantage—Why Cost of Capital Matters

One of the main reasons why REITs with more highly leveraged balance sheets tend to underperform is that they miss opportunities to acquire assets at deeply discounted prices during times of market dislocation, such as we saw during 2007 through 2009. REITs with too much debt going into a recession or market crisis simply don't have the financial flexibility to capitalize on market opportunities.

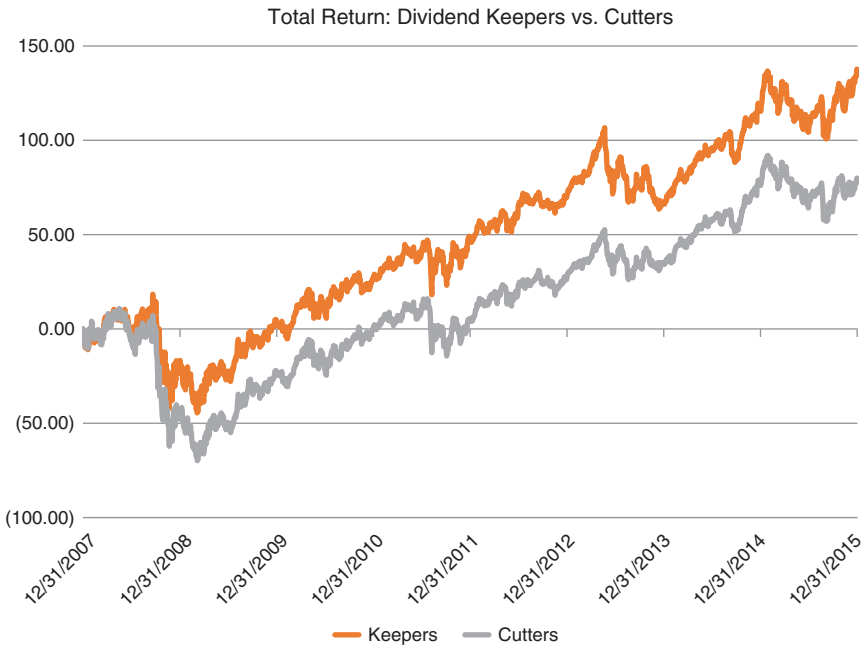


Figure 7.10 Returns of REITs That Cut versus Those That Did Not Cut Dividends, 2007–2009

Source: S&P Global Market Intelligence.

By contrast, REITs with lower leverage can and do, thereby meriting a higher relative valuation from investors.

Even in normal market conditions, a REIT's weighted average cost of capital (WACC) affects stock price performance. As Chapter 8 discusses in more detail, WACC is calculated by adding up a company's debt, preferred stock, and common equity, weighting each portion of capital by the average cost of each piece. Using an oversimplified example, if Rockland REIT has \$50 million of debt outstanding with a weighted average interest rate of 5 percent, \$10 million of preferred stock with a 6.5 percent coupon rate, and \$100 million of common equity with an estimated cost of 9 percent, then Rockland REIT's WACC is 7.6 percent, which essentially is this company's cost of doing business. In order to make a profit on new investments, Rockland REIT needs to invest its capital into opportunities that return more than 7.6 percent. When competing for an acquisition property or development opportunity, REITs that have a

WACC that is less than 7.6 percent will have a competitive advantage over Rockland REIT. Lastly, Rockland REIT's management, if they feel they are under pressure to grow, may commit "unforced errors," such as investing in high-yielding but low-quality assets. Ultimately, a poor allocation of capital into subpar assets will translate into a lower stock valuation for Rockland REIT. Rather than chase growth through questionable investments, Rockland REIT's management would serve shareholders better by paying down debt, which will help lower its WACC to more competitive levels.

REIT Performance in a Rising Interest Rate Environment

Perhaps one of the greatest misunderstandings about REITs is how rising interest rates will affect their future profitability. By extension, some of the most attractive buying opportunities in REITs have resulted when investors erroneously drove down REIT share prices because they expected interest rates to increase. The likely root of confusion is the fact that S&P historically has included REITs in the Financials sector. As discussed in Chapters 1 and 5, mortgage REITs are more like banks and may suffer lower profitability during periods of rising interest rates. In contrast, economics of the leases in place at equity REITs are not affected by rising rates. Equity REIT profitability should only be affected on the margin to the extent they refinance maturing debt at higher interest rates. After S&P launches the Real Estate GICS sector on September 1, 2016, equity REIT stock price performance should progressively de-couple from that of Financials (which will continue to include mortgage REITs) as investors become more educated about how real estate performs in a rising rate environment.

Cohen & Steers (NYSE: CNS) periodically publishes research on REIT industry topics, including how REITs have performed in past interest-rate cycles. The following observations are reproduced with their permission from *REIT Opportunities in a Rising-Rate Market (June 2015)*:

We believe interest-rate-driven corrections may present buying opportunities for long-term investors Share prices of REITs have become increasingly sensitive to bond yields, more often rising as yields fall and falling as yields rise. Since the first hints in 2013 that the Federal Reserve could taper quantitative easing

(“QE”). Correlations between REITs and the broad stock market have declined . . . , while correlations with bonds have risen above historical levels Periods of rising rates may cause earnings multiples to contract—like they did in April [of 2015]—due to fears that higher yields will negatively impact property values. Ultimately, however, we believe REIT performance will be driven by fundamental factors such as cash flows, competitive positioning and the value of a company’s property holdings relative to the private market.

Their report expands on the following conclusions:

- Rising bond yields may cause negative market reactions (among REITs) in the short term. However, REITs tend to recover as time goes on, as higher yields are often a byproduct of improving economic growth, which can lead to stronger demand for real estate.
- U.S. REITs have delivered 19 percent returns on average in the 12 months following corrections that pushed REIT prices below their net asset value (see Table 7.5).

Table 7.5 U.S. REIT Returns After Trading Discounts to NAV

Months When REITs Began Trading at Discounts to NAV After 6+ Months at Premiums to NAV	Discounts to NAV at End of Month	12 Months Later ^a	
		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%	—	—
April 2015	-1.6%	—	—
Simple Average	-3.8%	18.7%	3.9%

At May 31, 2015. Source: UBS and Cohen & Steers.

Performance data quoted represents past performance. Past performance is no guarantee of future results.

^aThere is no entry when less than 12 months of data is available.

Conclusion

Since 1990, REITs have evolved into a liquid, institutional investment class. With greater liquidity comes greater volatility, which when harnessed and interpreted appropriately, can lead to greater returns. As the industry has evolved, company-specific characteristics, rather than broad-brush industry trends, increasingly have driven REIT stock performance. Property type, WACC, and lease structure collectively determine total returns in different economic environments, with property type (that is, fundamental demand) being the dominant governor. Investors can choose REITs based on their outlook for the economy and in accordance with their individual tolerance for risk.