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Equity REITs are Ready for Institutional Prime Time | October 2012

September was a volatile month for the REIT universe. The second half of the month eliminated all gains from the Fed's announcement of their third installment of Quantitative Easing (QE), causing the MSCI US REIT Index (RMS) to finish the month down 1.8%. Year-to-date (YTD), the RMS total return to investors stands at +14.9%, which is now lower than the S&P 500 at +16.4%. REITs have certainly exceeded our expectations for the year, as artificially low interest rates have driven up values for yield-oriented investments. In turn, investors that may have dismissed REITs in the past are now starting the education process in a search for yield.

Since the creation of securitized real estate, questions have been raised on where REITs fall in the traditional asset class system. Are they real estate? Are they equities? Are they fixed income? Many institutions have favored direct real estate investing in place of owning public REIT securities, which may partly be due to difficulty in properly classifying REITs. In fact, such institutions would benefit by using public REITs for a larger part of their strategic real estate allocation.

Real Estate Enhances Portfolio Risk-Adjusted Returns

Investment committees, consultants, and institutional investors have long been aware of the benefits of adding commercial real estate to investment portfolios. The attributes of low correlations with stocks and bonds, as well as some inflation protection, serve as aphrodisiacs for proponents of Modern Portfolio Theory (MPT). For the period January 1, 1978 to June 30, 2012, a portfolio consisting of 60% S&P 500 and 40% Barclays Aggregate Bond Index produced an annualized total return of 10.4% with a standard deviation of 9.8%, which equates to a Sharpe ratio of 0.50. However, a portfolio which substitutes a 10% allocation to real estate, as represented by the FTSE NAREIT Equity REIT Index (FNER), in place of the S&P 500 changes the portfolio return to 10.7% with a standard deviation of 9.4%, which equates to a Sharpe ratio of 0.54. Note the large drop in standard deviation and increase in return, which drives the increase in Sharpe ratio. Appropriately, commercial real estate investment has become an essential component of diversified, long term investment portfolios. The next step for a consultant or investment committee is how to gain exposure to the asset class. As an exercise, let's pretend we are all on an investment committee for a school endowment that has to pay 5% of the portfolio value out each year as scholarships.

FIGURE 1: PERFORMANCE FOR THE PERIOD JANUARY 1978 – JUNE 2012

Hypothetical Portfolio (Rebalanced Annually)	Annualized Return	Standard Deviation	Sharpe Ratio
60% S&P 500 / 40% Barclays Aggregate Bond Index	10.42%	9.78%	0.50
50% S&P 500 / 10% FTSE NAREIT Equity REIT Index / 40% Barclays Aggregate Bond Index	10.66%	9.35%	0.54

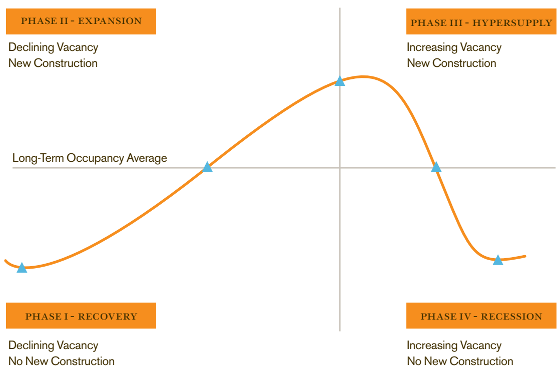
SOURCE: MORNINGSTAR

Meeting Investment Objectives

First, the investment committee must determine the objectives of the portfolio. For a school that wants to give out scholarships each year for the foreseeable future, the time horizon is infinite. Given that, the committee should not allow short term performance to dictate investment decisions. Since the portfolio will make a 5% distribution per year, the committee needs to plan on generating cash either from income or capital gains. Furthermore, the portfolio will likely need to be rebalanced from time to time in an effort to maintain the strategic allocation. Last, the investment needs to be diversified so that the loss of a tenant or an extreme weather event would not endanger the scholarships.

By nature, real estate has a long investment horizon. If properly maintained, a building can last for a lifetime or longer. Despite the opinions of the creators of Generally Accepted Accounting Principles (GAAP), quality real estate often appreciates over time. However, real estate also demonstrates cyclical behavior. The availability of debt and equity drives construction of new product and supply eventually exceeds equilibrium with demand, which drives down rents and occupancy until demand again warrants construction. See Figure 2 for a depiction of the commercial real estate cycle. Because many private real estate funds have a finite life of 8-10 years, timing will be a key driver of returns. Additionally, valuation can be a concern as we will have to carry our investment at the appraised value, which may only be disseminated annually and with a lag.

FIGURE 2: THE REAL ESTATE CYCLE



SOURCE: MUELLER, REAL ESTATE FINANCE (1995)

Annual distribution requirements have influenced many investment committees to incorporate heavy fixed income allocations. Equities can also help with distributions by paying dividends or providing liquidity if a sale needs to be made. However, a private real estate fund does not normally pay a regular distribution to investors.

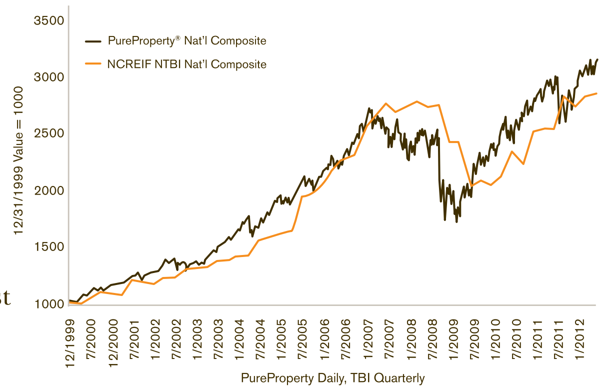
To properly implement MPT, a portfolio must be rebalanced periodically to recalibrate the overall exposure back to the original strategic allocation. If the value of the real estate portfolio is static while stocks or bonds are depressed, it is the responsibility of the investment committee to allocate away from real estate and into the depressed asset class. A 100% allocation to private real estate would make this difficult.

Lastly, the real estate portfolio should minimize tenant, property type, and geographic risk through diversification. To be properly diversified across geographies and property types, an investor would need to find large funds with wide mandates or find 20 to 30 funds that cover the full spectrum of the top Metropolitan Service Areas (MSAs) and the 9 property types: Office, industrial, apartment, health care, lodging, shopping centers, regional malls, technology, and self-storage. Not to sound repetitive, but rotation between property types and geographic regions would be difficult due to the lack of liquidity and current income.

Can Public REITs Fit the Needs of Institutional Portfolios?

Despite high fees, no liquidity, and unpredictable income, private real estate investment has been the most popular way of gaining exposure to commercial real estate for institutions. Public REITs are liquid, pay quarterly dividends, and carry low G&A loads on average. But do they provide the same exposure as private real estate investments? According to numerous studies, the answer is yes, over time. Figure 3 plots the performance of the underlying unleveraged real estate held by REITs (PureProperty® National Composite) versus the NCREIF NTBI National Composite, which tracks all commercial real estate transactions, both public and private. Other than a slight lag, it is easy to see how closely the lines follow each other.

FIGURE 3: CUMULATIVE TOTAL RETURNS—NCREIF NTBI INDEX VS PUREPROPERTY® INDEX



SOURCE: MIT CENTER FOR REAL ESTATE

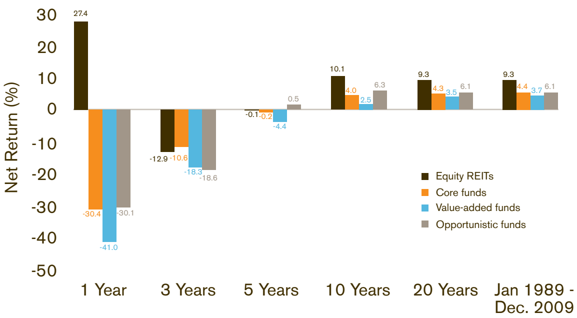
For the time period of February 2007 to March 2009, public REITs did not provide a good approximation of actual values of real estate. However, according to 'The Long-Run Dynamics between Direct and Securitized Real Estate', "...the longer the investment horizon is, the greater the degree of substitutability between REITs and direct real estate in a mixed-asset portfolio."[1] In a study titled 'Are REITs Real Estate? – Evidence from International Sector Level Data', the authors use regression analysis to prove that, "REITs are likely to bring a similar exposure to various risk factors as direct real estate into a long-horizon investment portfolio."[2]

In addition to providing instant liquidity, public REITs pay a dividend yield of 3.4% according to the FNER as of September 28, 2012. A portfolio of 20 to 30 REITs would contain thousands of properties diversified by tenant, property type, and geography. Public REITs have an infinite investment horizon, and therefore management teams have long term total returns as the highest priority throughout the cycle. If a management team proves itself by making value-creating decisions with astute timing, investors can be further rewarded by the REIT trading at a premium to net asset value (NAV). The transparency and regulatory oversight for public entities should give our hypothetical investment committee confidence in management and the board of directors.

Can REITs and Private Real Estate Investment Coexist?

There are still some things that private real estate investment can do better than public REITs. Because they do not have the obligation of quarterly dividend payments, they can go farther out on the risk curve with development or non income-producing real estate. There is certainly a place for both in a diversified real estate portfolio. In the previously cited study 'The Long-Run Dynamics between Direct and Securitized Real Estate', the authors state, "Diversification gains are made possible by the existence of temporary deviations from the long-run relation (between the NAREIT and NCREIF Index)."[1] Therefore, an investment to both would provide further diversification for the real estate portfolio.

FIGURE 4: TOTAL RETURN COMPARISON—CHART OF PUBLIC REIT PERFORMANCE VS PRIVATE REAL ESTATE VEHICLES



SOURCE: MORNINGSTAR, AS OF 12/31/2009

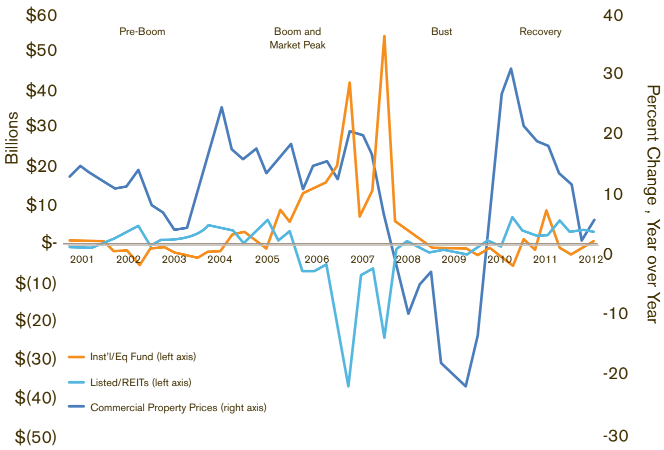
However, a comparison of the average private real estate fund with public REITs in Figure 4 shows that the returns of public REITs are still superior over the long term. With public equity REITs approaching $500 billion in market capitalization, institutional investors can no longer ignore the space for a portion of their real estate allocation in our view. At the very least, the component of a portfolio allocated to 'Core' should include a heavy weighting toward REITs due to the efficiency provided to investors in low fees and portfolios unmatched in quality. Admittedly, 'Opportunistic' and 'Value-add' real estate may be better executed in the private sector.

Gaining Popularity: REIT Industry Balance Sheet Approaching $1 Trillion in Assets

REIT management teams continue to demonstrate smart capital allocation decisions. The most impressive example occurred in the 2006-2007 period when REITs realized $122 billion of enterprise value in public to private transactions at the peak of the previous real estate cycle. Noteworthy companies that went private included Equity Office Properties and Archstone Smith Residential. In the aftermath of the recession in 2008 and subsequent collapse of real estate values, equity REITs have raised $80 billion of equity. After leverage ratios were brought down to near historical averages, public REITs went on a buying spree. REITs, with full access to debt and equity capital, both public and private, were well positioned to be opportunistic buyers ahead of traditional players and before commercial real estate values increased. As shown in Figure 5, listed REITs were net sellers between 2006 and 2008, while their private counterparts were actually net buyers. Thanks to their superior access to capital, listed REITs were able to be net buyers again in 2010 while the market was in recovery mode. This enabled an expansion of total assets by over $65 billion in 2011 or roughly 11%. In this same time period, the All Property Index as published by Green Street Advisors rose from 67.2 to 91.7 (or 36.5%). In 2012, REITs have only grown assets by 3% as of June 30, indicating good discipline as accretion relative to the blended cost of capital has diminished.

Declining interest rates continue to provide REITs with a source of earnings growth. The REIT balance sheet stood at approximately $664 billion of total assets as of June 30, 2012 based upon historical cost basis[3]. This number understates current market value by approximately $230 billion according to recent NAREIT data. Therefore, the total

FIGURE 5: NET ACQUISITIONS AND COMMERCIAL PROPERTY PRICES



SOURCE: NAREIT ANALYSIS OF REAL CAPITAL ANALYTICS DATA ON ACQUISITIONS AND DISPOSITIONS AND FTSE PUREPROPERTY® INDEX DATA ON COMMERCIAL PROPERTY VALUES.

REIT balance sheet, if expressed on a current value basis, should be very close to $1 trillion by the end of this year. Debt and preferred stock approximate $300 billion of the $664 billion. For each 1% decline in borrowing costs, REITs enjoy annual savings of $3 billion. To put this number into perspective, equity REITs pay dividends on common stock and operating partnership units (OP units) close to $15 billion annually. Thus, holding all other variables constant, declining borrowing costs help support dividend growth in a significant way. The Federal Reserve recently embraced the policy of maintaining low interest rates at least until 2015 providing REITs a unique opportunity to lock in low borrowing costs well into the future.

Dividend Growth Ahead of Expectations

In the Chilton REIT Outlook for June 2012, we illustrated our four year estimated dividend growth for the REITs in our composite should average 8.0% per year. Thus far in 2012, 16 REITs in our composite of 28 total names have increased dividends. The weighted average of the dividend increases equates to 9.5%. By sector, residential REITs have produced the best growth rates and every constituent in this sector has increased dividends this year. We view above average dividend growth as one of the most important factors supporting valuations in the foreseeable future. According to Cohen & Steers, public REITs grew dividends from 1993 to 2007 at a rate of 5.9%, far above the long term inflation rate of 2.6%[4].

Given that REIT provide income AND growth to investors while approximating the returns on real property, we classify REITs as part of the real estate asset class. The Chilton REIT Team would make a recommendation to the hypothetical investment committee FOR the inclusion of both REITs and private real estate to ensure diversification, liquidity, income, transparency, and regulatory oversight, which would satisfy the investment objectives.

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RMS: 1249(9.28.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)

Sources:

1) Elias Oikarinen, Martin Hoesli, and Camilo Serrano. *The Long-Run Dynamics between Direct and Securitized Real Estate.* Zicklin School of Business, Baruch College. http://aux.zicklin.baruch.cuny.edu/jrer/papers/pdf/forth/accepted/The%20Long-Run%20Dynamics%20between%20Direct%20and%20Securitized%20Real%20Estate.pdf

2) Martin Hoesli and Elias Oikarinen. *Are REITs Real Estate? Evidence from International Sector Level Data.* Swiss Finance Institute. http://ssrn.com/abstract=2034377

3) NAREIT Monthly Statistical Publication on the REIT Industry. *REIT Watch.* July 2012. http://returns.reit.com/reitwatch/rw1207.pdf

4) Cohen & Steers Whitepaper. *The Case for Real Estate Securities.* August 2012. http://www.cohenandsteers.com/insights/read/the-case-for-real-estate-securities

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton REIT Outlook are available at www.chiltoncapital.com/publications.html