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The REIT Way to Measure Risk | September 2015

The advent of Modern Portfolio Theory in the 20th Century, along with fully functioning stock exchanges and computers, created a golden era for data analysis, return expectations, and optimizing portfolios for the highest return at a given level of risk. Who wouldn't want the highest return and lowest risk? While understanding the calculation of historical returns is somewhat ubiquitous, the word 'risk' can have different meanings to different people.

Standard deviation is the most common unit of measurement of risk for investing. The historical standard deviation of REITs has been relatively high, which has contributed to a conclusion that public REITs are more 'risky' than S&P 500 (Bloomberg: SPX) equities. Consequently, public REITs are often only a 0-10% allocation in investor portfolios. We would argue that there are other factors to examine to determine 'risk' which we believe would cause investors to change their REIT allocations from 0-10% to 10-20% or higher.

Using Modern Portfolio Theory, a series of monthly returns for various investments and asset classes can be input into various formulas to find the optimal combination that will result in the best future performance at a given level of risk. Called "portfolio optimization", many consultants, industry experts, and financial advisors use such formulas as the foundation for asset allocation decisions. However, using only a series of historical ***one-month*** returns to make broad asset allocation decisions is dangerous without carefully considering the inputs, especially with real estate.

Go Long (Term)!

Real estate is a long term asset. Despite the ability to trade properties in a portfolio today by the millisecond, performance of a REIT portfolio should be measured in years; not days, months, or even quarters. Similar to a major league baseball team, each REIT has underlying contracts with tenants that take years for a new owner to position it to win. As a Houston-based REIT team, we have had an up-close view of how long it can take to reposition a franchise. The Houston Astros (also known as the "Lastros", or "Disastros") finished in last place for three straight years (2011-2013), producing the most losses in a three year period of any team in Major League Baseball history.

As of August 19, 2015, the Houston Astros are in first place in the American League West Division, boasting a strong possibility of making the playoffs. Waiting for below-market leases to expire, re-positioning space, and signing a new tenant can take years. Selling individual properties, exiting markets, and entering new markets are similarly long processes. Therefore, REIT performance and risk should be measured over a full cycle, typically averaging about 10 years. Coincidentally, 2005 was the last time the Astros made the playoffs - exactly 10 years ago.

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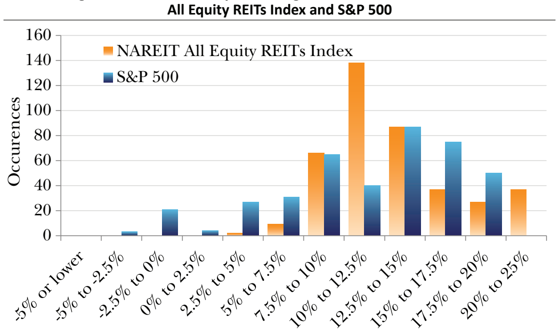
Steady and Smooth

Relative to the S&P 500, public REITs as measured by the FTSE NAREIT All Equity REITs Index (Bloomberg: FNER) have had a higher standard deviation than the S&P 500 over the trailing 5, 10, 15, 20, 30, and 40 year periods. But, did an investor take on more risk? The standard deviation of the 403 monthly periods of ***10-year*** annualized total returns since 1972 has been only 13.7% for the FNER, far less than the 19.1% for the S&P 500. Even using only 10-year periods ending after 2008 (chosen because they include 2008's extreme volatility), the FNER standard deviation of 10-year total returns was only 6.6% versus 13.4% for the S&P 500.

Derived from dividends and Net Asset Value (or NAV) growth, our long term projection for REIT annual total returns is +6-8%. Historically, the FNER produced annualized 10-year total returns above the midpoint (7%) of that range 98% of the time. The S&P 500 was only able to exceed 7% in 81% of the 10-year periods over the same time frame. Additionally, the worst 10-year period since 1972 for public REITs produced an annual total return of +3.4%, which compared to -3.4% for the S&P 500.

Therefore, for those who have a longer holding period, public REITs have more predictable returns, better downside protection, and less risk – even using the all-powerful standard deviation metric.

Figure 1: Annualized 10-year Rolling Total Returns of FTSE NAREIT All Equity REITs Index and S&P 500



Source: Bloomberg, January 1972-July 2015

Volatile Earnings, Volatile Returns

REIT earnings are more predictable and less volatile than comparable metrics for the S&P 500. As such, REIT earnings have had much lower volatility than S&P 500 companies, as measured by REIT FFO growth vs S&P 500 earnings growth. From 2001 to 2014, the standard deviation of REIT FFO growth (according to NAREIT) was only 12.1%, while the S&P 500's earnings growth had a standard deviation of 18.0%! In contrast to many S&P 500 companies (excluding the 24 REITs in the S&P 500 of course), REITs enter into contracts that lock in revenues for periods of up to 20 years, depending on the property type. The contractual nature of REIT revenues protects the rental payments, even as the earnings and stock prices of a REIT's underlying tenants may be declining. It is generally accepted that rent is on of the last expenses to be cut by a company looking to cut costs.

Additionally, the diversification within a REIT, and especially a portfolio of REITs, provides further protection if a particular geographic market, property type, or tenant industry is experiencing a decline. The companies in the Chilton REIT Composite as of June 30, 2015 owned 6,539 properties across 10 property types, not including the cell tower REITs (each owns thousands of towers) or the franchised/managed hotels by Starwood Hotels (NYSE: HOT). Excluding multifamily, self storage, and lodging, the portfolio has well over 20,000 tenants spread across all industries. Geographically, the portfolio is spread across the country in all regions and over 170 metropolitan service areas (or MSAs). New York City is the largest MSA by square footage, and accounts for less than 10% of the portfolio.

Valuation Techniques

We have lauded the effectiveness of using NAVs for valuing REITs many times in this publication. In addition to filing a 10-Q, each REIT issues a 'Supplemental' each quarter with 10-50 pages of company details which make future REIT earnings predictable and NAV calculations feasible. Public REIT values are somewhat tied to their NAVs, which has prevented them from becoming too overvalued or undervalued (except for 2008-2009 when it happened for all asset classes). Unfortunately, NAV is not applicable to many other companies outside of REITs. Instead, investors are expected to determine fair value via other methods, most commonly an earnings multiple.

In our June 2015 REIT Outlook titled 'Multiple Problems with Claims that REITs are Expensive', we explained the danger of using historical multiples to determine fair value of a company. Ultimately, the multiple used is a best guess opinion that rarely has substantial comparable transactions to use as evidence. Its inexact nature increases the probability that market multiples will be more volatile and experience swings too far in one direction or another. An investor should feel more confident in the future earnings and fair value estimates of REITs than those of S&P 500 companies, which we believe implies less risk.

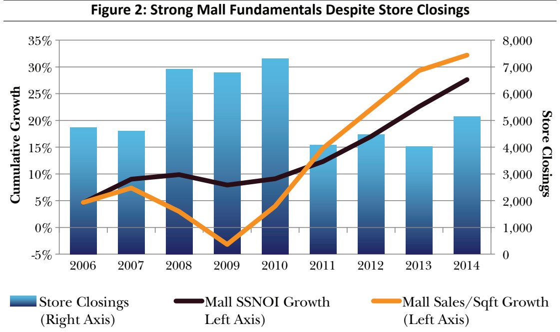
Less Obsolescence

Well-located real estate has possibly the least obsolescence risk of any industry. Sometimes referred to as 'irreplaceable', the values of such properties have very little downside risk for long term investors. While its tenants may succumb to competition, a well-located property will almost always be able to re-lease an empty space, and often at a premium to the prior tenant's rent!

For example, FAO Schwarz closed its doors at the GM Building (767 Fifth Avenue in New York City) on July 15 after almost 30 years. During that period, FAO Schwarz filed for bankruptcy twice, and now it is owned by Toys R Us, another struggling retailer. The private equity investors in FAO Schwarz and Toys R Us have likely lost a considerable portion of their investment. However, the owner of the GM Building, Boston Properties (NYSE: BXP), will be able to replace FAO Schwarz with a tenant or tenants paying a much higher rate.

FAO Schwarz was paying about $20 million annually, or $323 per square foot (sqft), on its 62,000 sqft footprint. Though BXP has not given any estimate on the new rent the space could garner, the 14,000 sqft on the ground floor alone would produce annual rent of over $30 million assuming a rental rate of $2,250 per sqft, a conservative estimate given that asking rents for street retail on Fifth Ave as of June 30 were over $3,400 per sqft. Upon fully re-leasing the space, we believe BXP will receive $25 million more in net operating income than it was under the prior lease with FAO Schwarz. At a 4% cap rate (again conservative for the most valuable office building in the world) and adjusting for its minority partner's 40% interest, re-tenanting the FAO Schwarz space would add $375 million to BXP's net asset value (or NAV), or $2.20 per share.

Figure 2: Strong Mall Fundamentals Despite Store Closings



Source: Company Reports, Green Street Advisors, Bank of America Merrill Lynch

The above scenario happens constantly for mall REITs, as all of their tenants are subject to changing trends that may make them obsolete. In most cases, investors in the retailers that went bankrupt or had to close stores experienced significant losses, while the REIT landlord benefited from the ability to replace an underperforming tenant at a higher rate.

REITs are Homebodies

S&P 500 equities have significantly more international risk than public REITs. According to S&P/Dow, approximately 40% of S&P 500 company revenues are from outside of the US. While it can be argued that international exposure adds diversification, it also brings additional risk. A slowdown in China, Japanese deflation, falling commodity prices (Brazil and Russia), Middle East violence, and Greek insolvency can significantly alter corporate and consumer behavior. In addition to geopolitical risk and economic risk, currency fluctuations against the US dollar also change earnings when translated into US Dollars. In contrast, US REITs derive only 3% of their value from abroad according to Green Street Advisors. With little to no currency risk and a lack of exposure to more volatile economies, REIT earnings and valuations are well-insulated from crises and recessions that may significantly affect traditional equities.

Shareholder Capital Allocation

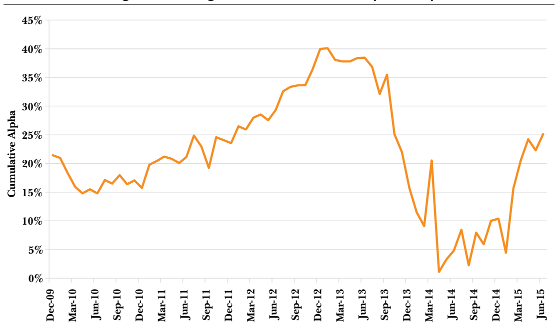
We have emphasized capital allocation in several REIT outlooks, even constructing a decision tree for REIT CFOs in our February 2015 REIT Outlook titled "The Importance of Capital Allocation within REITs". Most companies have stated leverage and external growth goals, along with a property type and geographic focus, that should give investors comfort that the management team is not going to stray from any of the characteristics that may have made the company attractive. For example, an investor who likes Essex Property Trust (NYSE: ESS) because of its West Coast multifamily exposure can feel confident that the management team will not buy or invest in properties outside of that geographic area. In addition, in the REIT sector, investors can feel more comfortable that their interests are aligned with management –the average insider ownership of 181 REITs analyzed by SNL Financial was 7.2% as of December 31, 2014. In comparison, the average insider ownership of the S&P 500 was 1.8% as of the same date.

Furthermore, putting cash in the hands of the shareholders via a higher dividend yield gives them the power of capital allocation and increases the probability of reaching the desired return. Historically, the REIT dividend has accounted for about half of the total return. Going forward, if an investor is already receiving 4% in cash annually and the target return is 7%, a 3% appreciation in stock price is more probable than 5% appreciation from the S&P

500 after receiving only a 2% dividend yield.

Chilton Capital Allocation
As active managers, the power of capital allocation is extremely important. The liquidity provided by trading public REITs gives us the ability to shift the portfolio toward geographic markets, property types, and management teams that we believe will produce a return above that required by our assessment of risk. If no opportunities are available, we can hold cash until one presents itself. This disciplined approach has consistently produced a total return above the benchmark, while taking less risk. In fact, since inception in 2005, the Chilton REIT Composite has outperformed the MSCI US REIT Index over every 5 year period, net of all fees and expenses. We are proud of our consistent track record, and believe our best years are yet to come.

Figure 3: Rolling 5 Year Chilton REIT Composite Alpha



Benchmark: MSCI US REIT Index. Start Date: 12/31/2004. Alpha is Cumulative. Net of fees. As of 6/30/2015.

Cozy up to a Higher REIT Allocation
We by no means would advocate throwing all risk metrics out of the door, nor are we trying to paint the picture that every S&P 500 company is more risky than every REIT. REITs have been associated with risk and volatility in the past, but we believe that should not be the case, especially today. After looking deeper into the available data, REITs offer a similar or better return profile to the S&P 500, but with less risk.

"...REITs offer a similar or better return profile to the S&P 500, but with less risk."

An investor with a time horizon of 10 years or more should seriously consider a minimum 10% allocation to REITs, and should feel comfortable with 20% or more. To put a 20% allocation in perspective, commercial real estate comprises about 15% of the US economy, and over 18% when excluding residential real estate from the denominator. With predictable earnings, high transparency, well-covered dividends, record low leverage, and a lack of international exposure, an investor should have confidence in long term positive REIT fundamentals and ignore short term volatility that can give the appearance of above average risk.

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RMS: 1589 (8.31.2015) vs. 1710 (12.31.2014) vs. 346 (3.6.2009) and 1330 (2.7.2007)
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