REITs As Macro Indicators

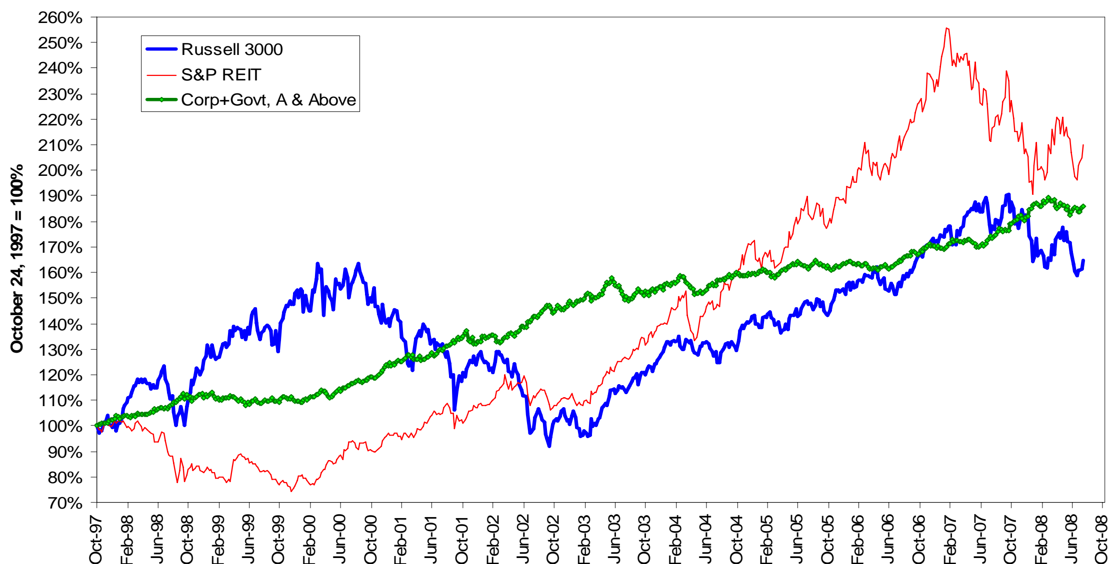
The subprime mortgage mess, housing bust and credit crunch of 2007-2008 notwithstanding, it is safe to say investors in general and American investors in particular have a love affair with real estate of all kinds. There is a kind of certainty associated with being able to open the door on an investment and walk into it. And while stocks or bonds are a representation of an income-producing asset, real estate is an income-producing asset.

We are not talking about your home here, but rather the investable pools of real estate known as real estate investment trusts, or REITs. For all but the very wealthiest of us, REITs are the only way to participate in shopping malls, office buildings, medical centers, hotels and other forms of commercial real estate. A REIT is a pass-through vehicle for rental income; so long as it distributes 90% of its income to investors, it does not pay taxes itself. You as the investor do, which is why REITs best are held in a tax-deferred account such as an IRA.

Even though REITs are listed as stocks, throw off heavy income like bonds and have a modicum of inflation protection by virtue of both the properties and rents being able to rise over time, they tend to be valued and priced off a different set of metrics, such as funds from operations or FFO, than either stocks or bonds and hence do not behave like either stocks or bonds. Their value both as an absolute return investment and a diversifying asset is apparent when we compare the total returns of the S&P REIT index, the Russell 3000 stock index and the Merrill Lynch index of corporate and government bonds rated A or higher.

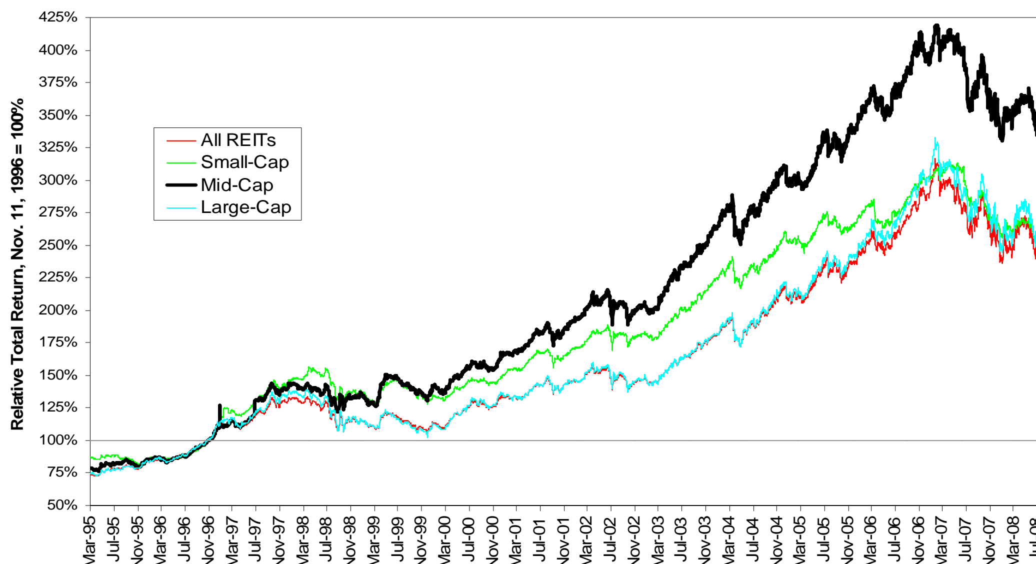
One final attribute of REITs became very important once the credit crunch set in during 2007. A famous acronym in real estate is OPM, Other People's Money. Real estate is very credit-sensitive and as major developers are highly leveraged, REITs and indices such as the CMBX, an index of credit protection costs for collateralized mortgage-backed securities, became critical for the asset class.

Comparative Total Returns



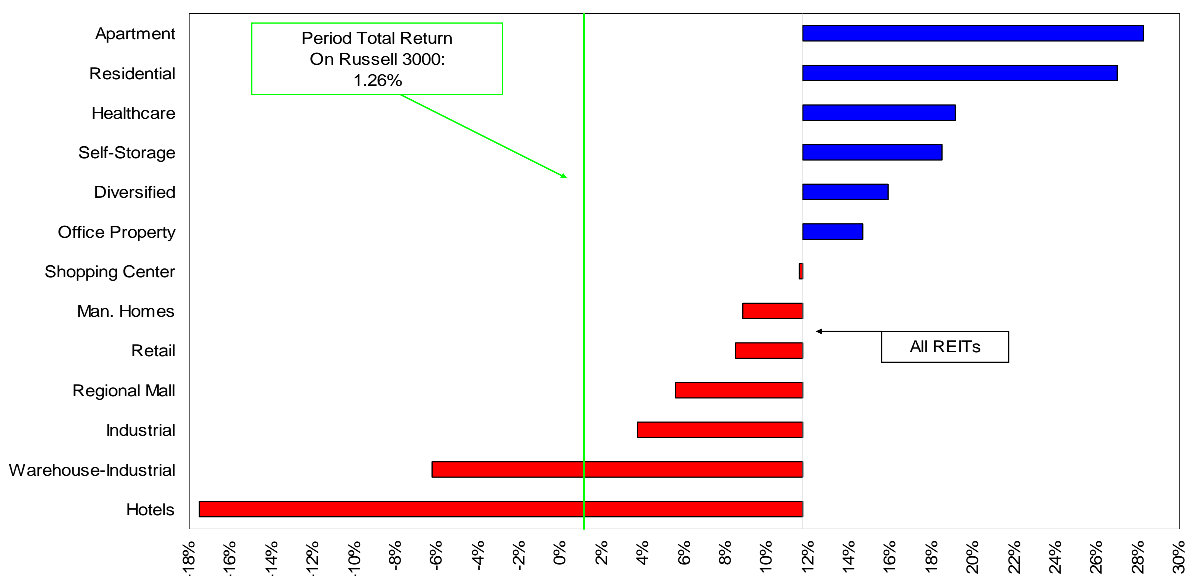
A Market Of REITs

An apparent law of nature in investing is if there is an index we must subdivide it to death. This certainly is true for stocks, and it is true for REITs, too. *Bloomberg* maintains capitalization-weighted indices for REITs, and if we compare their total returns re-indexed to November 1996, we can see strong outperformance lasting for years by the mid-cap index. This suggests there might be further division of performance and information we can retrieve therefrom.



REIT Groups

Bloomberg also maintains REIT classifications by specialty. How did these groups perform between the January 22, 2008 market low and August 8, 2008? The total return on the Russell 3000 index of all stocks was 1.26% over this period, and the total return for all REITs was 11.7%.



The top-performing group over the period was apartment REITs; this is an ironic consequence of the horrendous real estate market. As more and more marginal homeowners returned to or never left the world of tenancy, apartments increased in value. The strong performance of self-storage REITs, those too-creepy places that seem to invite crime scene investigators, reflects shift in residency patterns as well. The same can be said for residential REITs. Two of the top five members of the strong mid-cap REIT index are self-storage REITs; as Americans are getting displaced by the brutal housing market, investors in self-storage REITs are the beneficiaries.

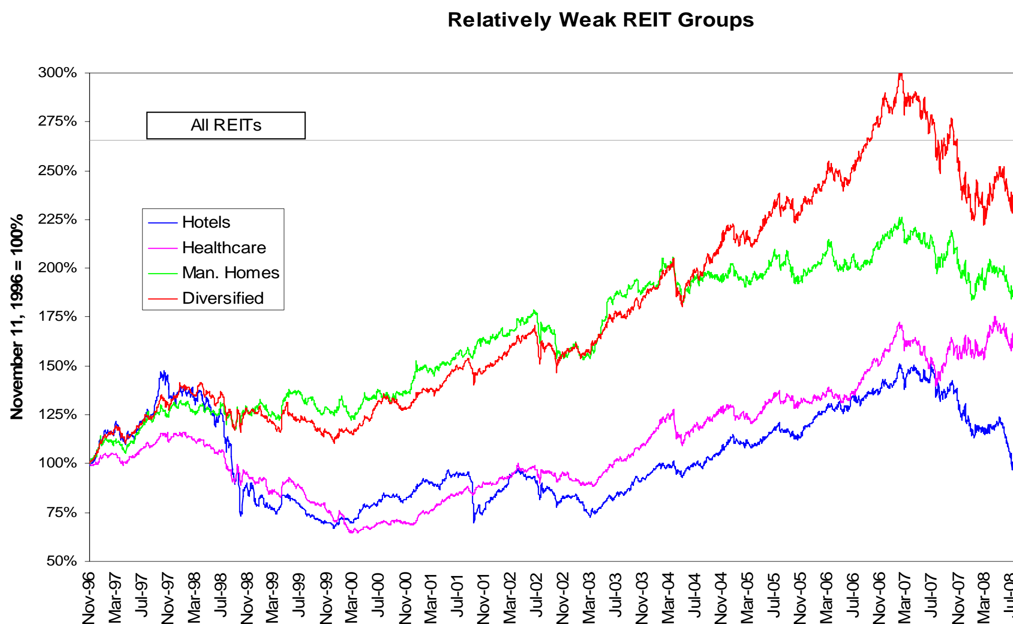
Consumer-related REITs, those involving retailers, regional malls and shopping centers underperformed the REIT average but outperformed the Russell 3000 by a wide margin. This raises an interesting question: If the American consumer has been squeezed by rising energy prices and falling asset values for stocks and their own homes, then why have these REITs done so well on an absolute basis? One answer is simple: A shopping center does not have to

prosper for its investors; it just needs to generate sufficient net rental income to keep the dividends coming. This is similar to why the bonds of a company whose stock is performing poorly can continue to do well.

Which REITs have trailed in the performance derby? Hotels have been the loser by a wide margin; this reflects the disastrous state of the travel and tourism markets. The warehouse-industrial group was the only other group to post a negative return, and industrial REITs were third from the bottom. It is fairly safe to say these REITs reflected a slowdown of significance in the industrial sector of the economy.

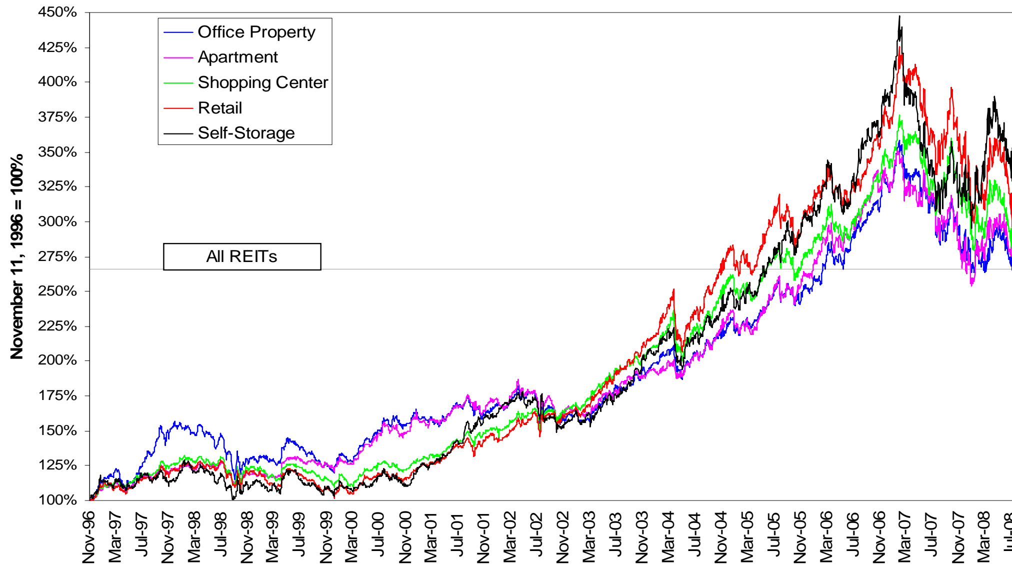
Relative Performance

If we go back to November 1996 and compare the long-term total returns of REIT groups, we can divide them into three categories, the underperformers, the strong performers and the very strong performers. Hotel and healthcare REITs have been underperformers for years, as has been the manufactured homes group. Next time you pay an inflated hotel bill or see an exorbitant medical charge, just remember that investors in manufactured home REITs have done better than the owners of these facilities.



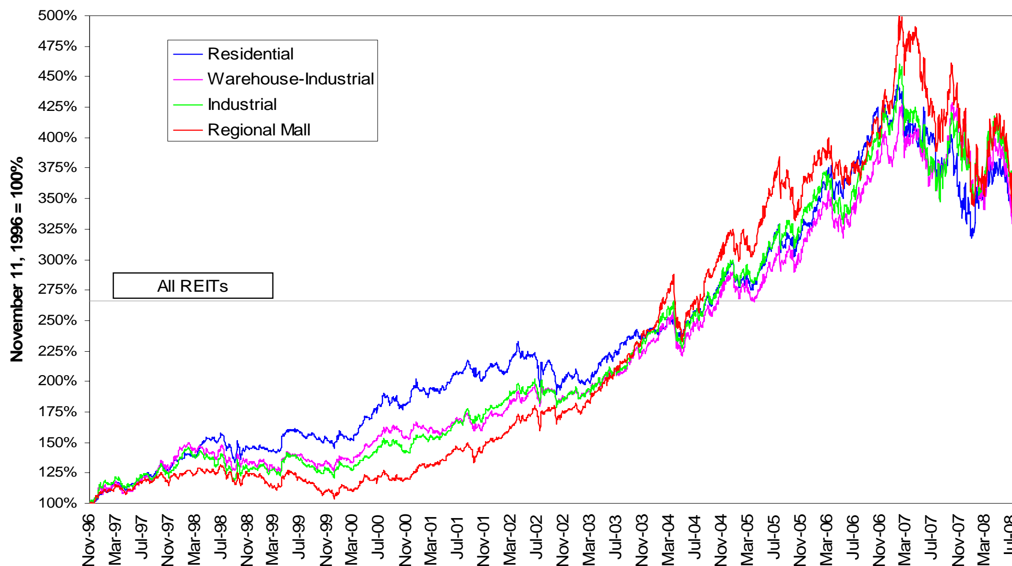
The strong performers include what most of us think of when we think of REITs, offices, apartments, shopping centers, retail and self-storage centers. These groups were hit quite hard in 2007's downturn and are most sensitive to both credit conditions and the general health of the economy. The reasons behind the strength of apartment and self-storage REITs were noted above.

Relatively Strong REIT Groups



Finally, the very strong outperformers include regional malls, industrials, warehouse-industrials and residential. Given the comments above about the relative performance of consumption- versus production-related REITs, we must emphasize this ranking encompasses almost twelve years, not just the post-January 2008 sample.

Relatively Very Strong REIT Groups



If you are not familiar with industrial and warehouse REITs, you are missing one of the more interesting developments in the American economy. Just-in-time inventory management places an emphasis on highly automatic distribution systems. The degree of automation possible with RFID (radio frequency identification) tags, robotic forklifts and truck-loaders and Internet-based supply chain management is right out of science fiction.

In addition, the increasing share of the American economy involved in foreign trade has made industrial and warehouse REITs at or near ports and intermodal transfer points for containerized cargo critical. This component of the economy is linked to currency exchange rates and our trade policies. A rise in protectionism could have devastating consequences to these REITs.

The three most important words in real estate are location, location, location, and the three most important words in investing are diversification, diversification and diversification. REITs allow you to play all aspects of the economy, and their relative performance provides clues to financial markets. Besides, the next time you drive by

one of those self-storage centers that looks like something from a police-blotter show, you can nudge the person next to you, point, and say, “I own that.”