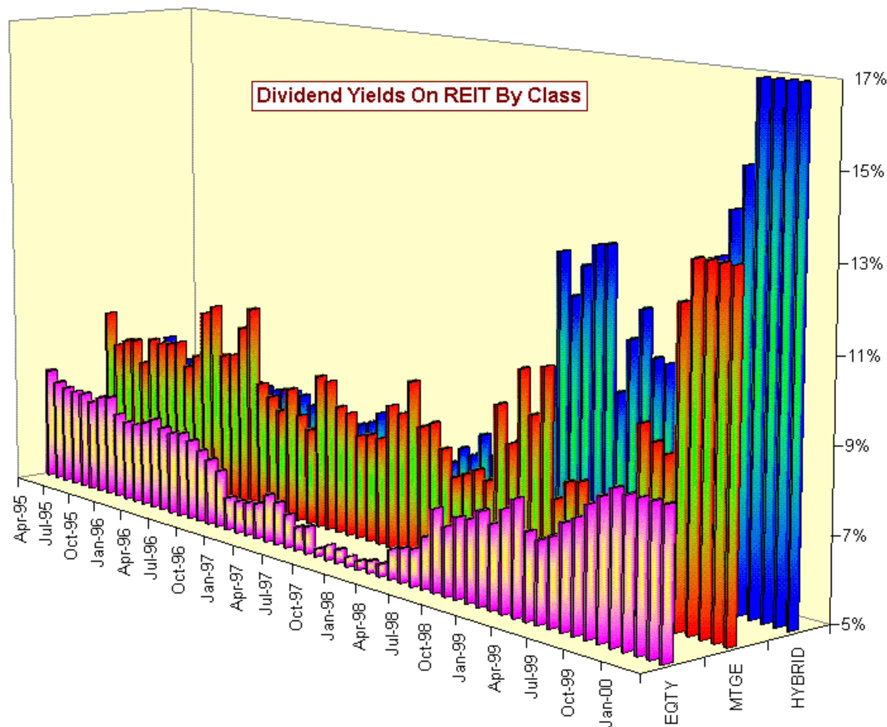
Treats in REITs?

Great insights frequently derive from spectacular error and occur, more often than not, within proximity to familiar plumbing fixtures. The great Japanese real estate bubble of the 1980s, which went hand-in-hand with their stock bubble, was justified by some with the observation: "You can make more Japanese, but you can't make more Japan." This conclusion was massively incorrect, and prompted some thinking about real estate as an investment.

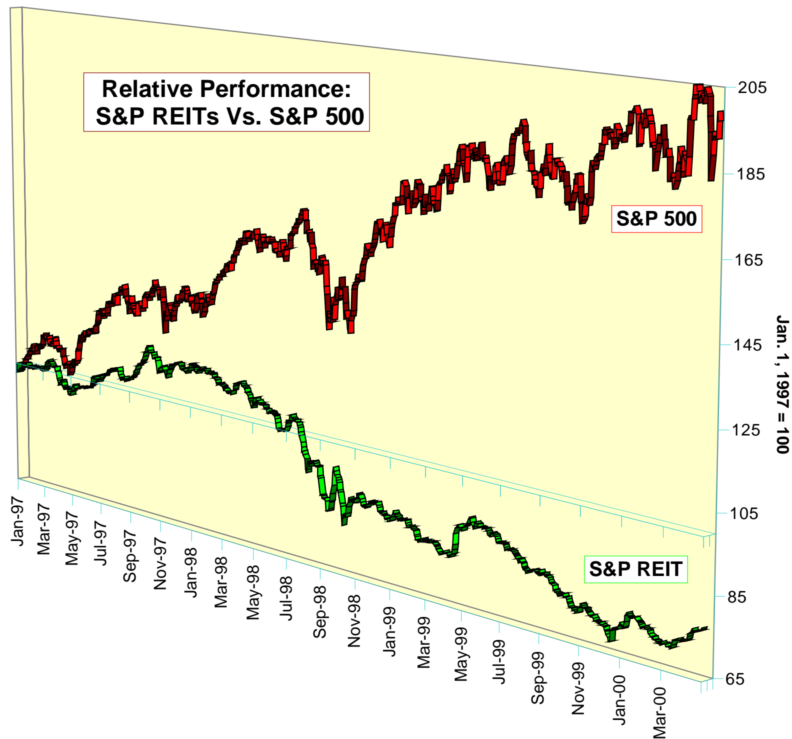
Real estate is always an odd asset. We all know the old saw about location, location, location, and it's true: Every parcel of real estate is unique, not only by itself but also in association with its neighbors. Those who came of age during the 1970s associated real estate with appreciation, but nothing could be further from the truth on an intrinsic basis. This apparent appreciation was nothing more than an inflationary effect, as we shall see. Structures, like all physical entities and most people, depreciate over time and require significant holding costs. Land may acquire a scarcity value, but any owner of farmland can tell you this is not a one-way street. Most assets have a discretionary component -- you don't have to own stocks, bonds, collectibles, etc., but you do have to live and work somewhere.

One thing real estate can do, and do well, is throw off a stream of income from rents. Real estate investment trusts (REITs) act like mutual funds for a portfolio of properties, and like mutual funds have to distribute a minimum of 95% of their rental income to their holders each year. Unlike most bonds, their performance is linked to the value of the underlying asset, and unlike many of the stocks we have come to know and love, real assets, sales, and income streams back the securities.

The dividend yield on REITs has been pretty healthy. Dividends on mortgage REITs have jumped since the fourth quarter of 1999, and yields on hybrid REITs, which hold mortgage securities in addition to properties, have skyrocketed to emerging market debt levels. Equity REITs, whose owners participate in price appreciation, also have witnessed a jump in dividend yields of late.



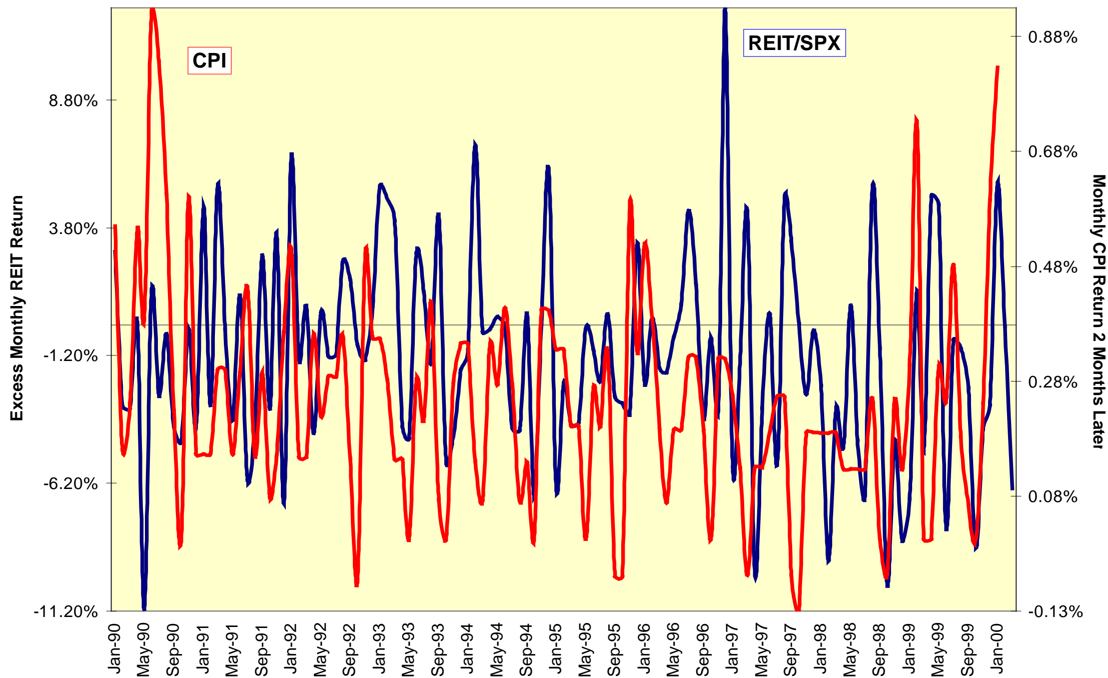
It all sounds pretty good. So why have REITs been such underperformers for so long? Since the beginning of 1997, the S&P 500 has returned 26.07% annually, extraordinary by any historical standards, while the S&P REIT index has lost 8.92% annually before dividends. Even if we throw the dividend yield, which will be taxed at your ordinary income rate, back into the pot, the REIT index is still an underperformer.



An Inflation Hedge?

Let's return to inflation, a topic always in the financial news. A physical asset will generate an apparent return when the expected rate of inflation exceeds the holding cost, usually short-term interest rates. This situation has not prevailed since the 1970s, but financial markets so fear inflation that they price assets accordingly. Since REITs pay large dividends and most other stocks have long stopped paying attractive dividends, we'll need the total return -- price appreciation plus dividend yield -- barrier. We can do this by comparing the monthly returns on a REIT index, in this case the Wilshire Associates index which has data going back to December 1989, relative to the returns on the S&P 500.

If markets perform their discounting function correctly, any relative increase of the Wilshire index should lead the change in an inflation index, in this case the non-seasonally adjusted urban CPI. The results of this comparison, presented below, indicate the relative performance of the REIT index leads changes in the CPI by two months, which is certainly a reasonably horizon for this sort of economic relationship.



A jump in REIT relative performance in January led the big jump in the March CPI reported on April 14. Interestingly, that jump in REIT relative performance was a one-time affair so far, at least on a monthly basis. The daily basis, shown in the first graph comparing the S&P REIT index to the S&P 500, is less encouraging. The REIT index looks as if it has formed a long-term bottom, while the S&P 500 is struggling to make and hold gains.

Some words of caution are in order. Even if we do return to an inflationary environment, we are unlikely to see a repeat of the 1970s real estate market. The combination of much higher marginal tax rates and a bond market that, incredibly, did not price inflation correctly provided borrowers with negative real after-tax costs of capital. In addition, tax and depreciation rules for real estate were more generous then; these breaks were eliminated in the 1986 tax law. Regardless, almost any tangible asset will outperform almost any financial asset in an inflationary environment: The top performing investment of the 1970s was Ming vases. How's that for a wasted decade?