Global REITs And The Search For Yield

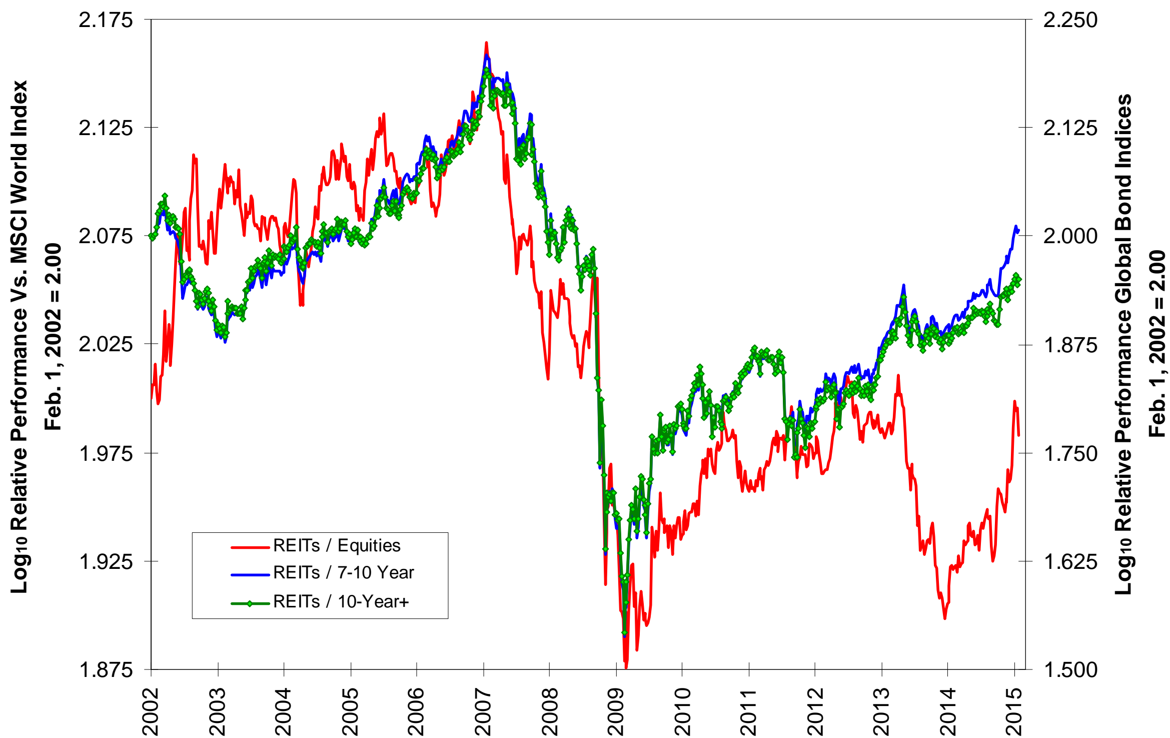
Former cultural icon Mr. T was known for pitying a fool or two, and truth be told, so do I. When asked to produce my F-list, the first entry is anyone who has been lending money to anyone, anywhere, at negative interest rates. But the low-rate environment handed to us all produces some major problems for pension plans, endowments and insurance firms who must try to match their assets to their long-term liabilities. This is a task worthy of Houdini as low rates raise the present value of those liabilities while forcing investors so far out on the risk and maturity curves they will empathize with Wile E. Coyote being forced out on the cliff and looking down in what surely will be both my worst mixed metaphor and longest sentence of the day.

Real Estate As A Long Duration Asset

As REITs are higher-yielding instruments based on long-lived assets and include the possibilities for both inflation protection and capital appreciation (or not, as 2007-2009 showed so brutally) they appeal to long-term investors. The S&P Global REIT index has returned 25.77% over the past year in USD terms. This compares very favorably with returns of 9.43%, -2.58% and 7.53% for the MSCI World Free index and the Merrill Lynch global sovereign bond indices of 7-10 year and 10-year+ maturity, respectively.

Global REITs have underperformed equities and 10-year+ sovereign bond indices since February 2002, however, and only surpassed returns for the 7-10 year sovereign bond index four weeks ago.

Relative Performance Of Global REITs



Two features of global REITs' relative performance since the end of the financial crisis invite comment. First, prior to May 2013, global REITs' relative performance to 7-10 year sovereign bonds was only slightly more volatile than their performance relative to 10-year+ sovereign bonds, beta = 1.0187, r-squared = 0.993. After May 2013, relative volatility increased, beta = 1.528, r-squared = 0.957.

Second, global REITs' relative performance to global equities collapsed between May 2013 and the end of December 2013, only to rebound nearly as sharply from the start of 2014 onwards. As the decline and rebound in this relative measure coincide with the rise and fall of long-term sovereign debt yields and the anticipation and realization of U.S. QE tapering, a relationship between global REITs' performance relative to global equities and the normalized rate gap between 10-year+ and 7-10 year sovereign bonds.

However, a direct relationship exists only after May 2013. The Feb. 2002 – April 2013 relationship was:

$$\log_{10}(RP) = -0.375 * RateGap + 1.064, r^2 = 0.052$$

That changed afterwards to:

$$\log_{10}(RP) = 1.780 * RateGap - 3.084, r^2 = 0.536$$

These two observations combine to suggest, unsurprisingly, global REITs' accelerated performance relative to 7-10 year sovereign bonds and their even sharper rebound relative to global equities are a function of the large-scale bullish flattening of global sovereign yield curves combined with the demand for long-duration assets pensions, endowments and life insurance firms.

While an argument can be made global REITs remain undervalued relative to overvalued long-term bonds and to equities, their reliance on extraordinary monetary conditions to achieve further gains and their demonstrated negative sensitivity to interest rate increases in 2013 argue against overweighting this asset class.