REITs Living On Borrowed Time

Those of a certain age can recall an ad for a certain mint whose characterization as either a candy mint or a breath mint was debated. The results, I am happy to report, were that it was in fact two mints in one.

Real estate investment trusts present similar taxonomic hurdles. Like common stocks, they are listed on equity exchanges and are part of benchmark indices such as the S&P 500. Like open-end mutual funds, they have to distribute 90% of their net income in the form of dividends, but nearly all of these dividends are unqualified for the 15% rate applicable to dividends paid from operations; one exception to this rule is a REIT dividend attributable to qualified dividends received by the REIT and passed on to shareholders qualifies for the 15% rate.

REIT valuation has its own metric, funds from operations, or FFO. Generally accepted accounting principles, or GAAP, call for real estate assets to be depreciated; this would understate REITs' operating performance. FFO adds this depreciation and gains and losses from non-recurring items such as property sales back to GAAP net income.

REITs' high dividend yields - the 12-month yield on the streetTRACKS Wilshire REIT Index fund is 5.46% - and the ordinary income treatment of these dividends place them economically into a fixed income sphere. Much like a convertible preferred stock, their current value is their dividend stream plus a call option on the price appreciation of assets in their portfolio.

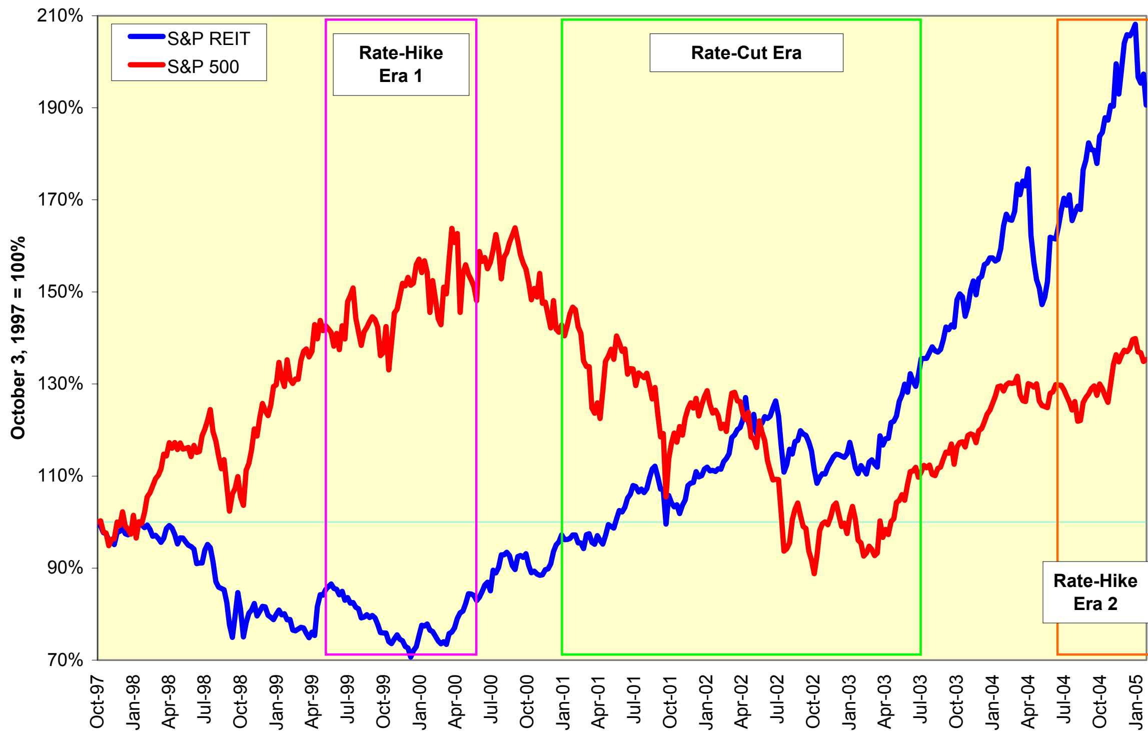
This price appreciation, in turn, derives from three components. One is ordinary inflation; the nominal price of real estate has a measure of inflation protection built into it, but this is offset in part by rising costs of operation and rising tax rates. The second component of price appreciation was discussed here last week, and that is the capitalization of lower interest rates, an effect that obviously can cut both ways. The third component, which also can cut both ways, is an increase in the actual value of the property itself through scarcity, increasing desirability of the location or some other force. After all, real estate is location, location, location.

Factor Exposure

It is easy to see how REIT performance can be a function of interest rates, the shape of the yield curve, inflation, growth rates and even the strength of the dollar: Foreign investors get a bargain whenever the dollar weakens and can reverse the trade by selling appreciated American properties for their currency whenever the dollar strengthens.

Let's take a look at the total return stream on REITs as a function of these variables and see what these relationships imply for ordinary investors. Let's also assume that you are holding REIT shares in a tax-advantaged account to ordinary income taxes on your dividends. The S&P REIT index has outperformed the S&P 500 on a total return basis since late 1997, a statement that would have looked highly unlikely during by early 2000.

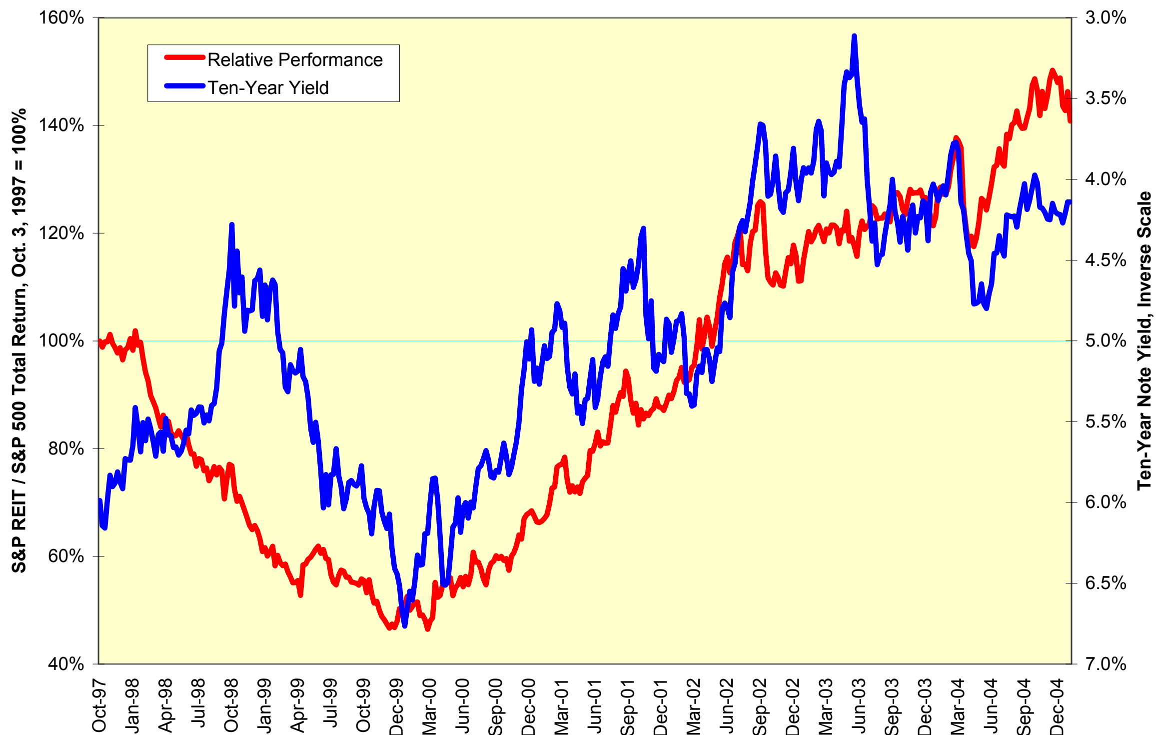
For those tempted to ascribe relative performance to interest rates or to Federal Reserve policy, the following chart should be instructive. While REITs' total return was poor during the 1999-2000 episode of Federal Reserve Rate hikes, it has taken off on both an absolute and a relative basis since the Federal Reserve began raising rates last June. And while REITs outperformed the broad market during the long period of lower federal funds rates, the real outperformance periods occurred after the last rate cut was made and, interestingly enough, during the rate hikes of the past six months. The fear of higher rates produced a short, violent selloff in April 2004.



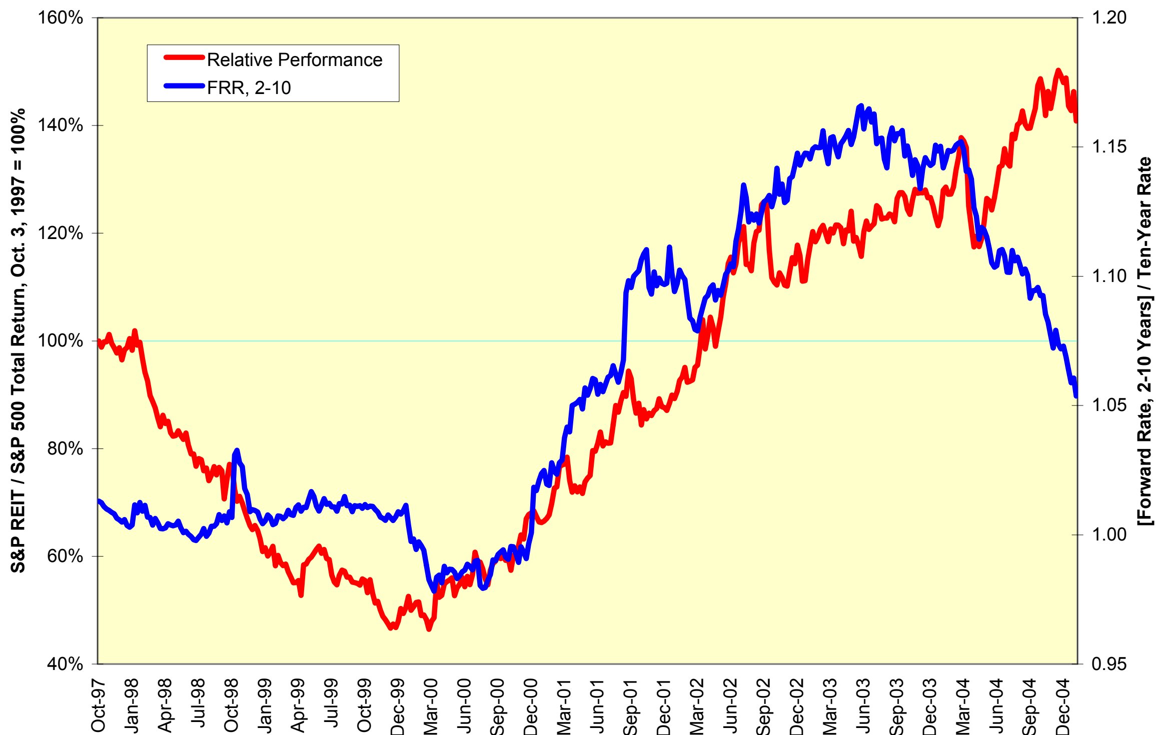
If the federal funds rate by itself does not explain REIT performance, can long-term interest rates themselves? After all, ten-year note yields remained stubbornly high during 2001 as the market feared an imminent economic rebound, and have remained quite low over the past year. Let's compare the ratio of REIT total returns to those of the S&P 500 against ten-year note yields.

The relative total returns of REITs to the broad market have paralleled ten-year note yields since the broad market peaked in March 2000. Prior to that point, REITs underperformed during the bubble - why own a shopping center when you can own a dotcom? - and ten-year note yields themselves were distorted by the effects of the Long Term Capital Management debacle.

This particular comparison makes REITs look slightly overvalued relative to note yields at this point, although not wildly so.



Now let's compare relative REIT total returns to the shape of the yield curve as defined by the forward rate ratio between two and ten years. This is the rate at which you can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself. Relative performance followed this measure closely between the March 2000 peak and the October 2002 trough, but then disconnected. The Federal Reserve's final orgy of free money between October 2002 and June 2003 did nothing to improve REITs' relative performance. The initial interest rate scare of April 2004 affected both measures, but REITs have ignored the flattening yield curve ever since.



We could dismiss REITs' ignoring of the yield curve if we had reason to believe FFO was accelerating to offset the narrower spread on funding costs. This does not appear to be the case universally. For example, while the Simon Property Group and the Vornado Realty Trust are rated as having 12.75% and 17.84% FFO growth potential, respectively, the comparable number for Equity Office Properties is (15.18%).

Real estate famously is a game of "other people's money." We can see from recent history how REITs can ignore both the Federal Reserve and, for now at least, the yield curve. We can make no such statement about ten-year note yields themselves. When presented with the threat of higher yields, REITs will abandon the dual nature and start trading like a bond.