Cost Of Capital, Interest Rate Exposure And REITs

Every now and then the planets align and someone from the usual crowd gets some free publicity by finding this portentous. So saying, some financial risks are starting to align and I thought it would be in the interest of the general public to sound the general alarm.

I took a look last week at which industry groups were most exposed to higher long-term rates. The list, unsurprisingly, was dominated by REITs, utilities and a smattering of consumer staples. A parallel analysis of which industry groups are exposed to higher short-term interest rates is much sparser as we have been in a low- and suppressed short-term interest rate environment for so long these rates have lapsed as a meaningful factor.

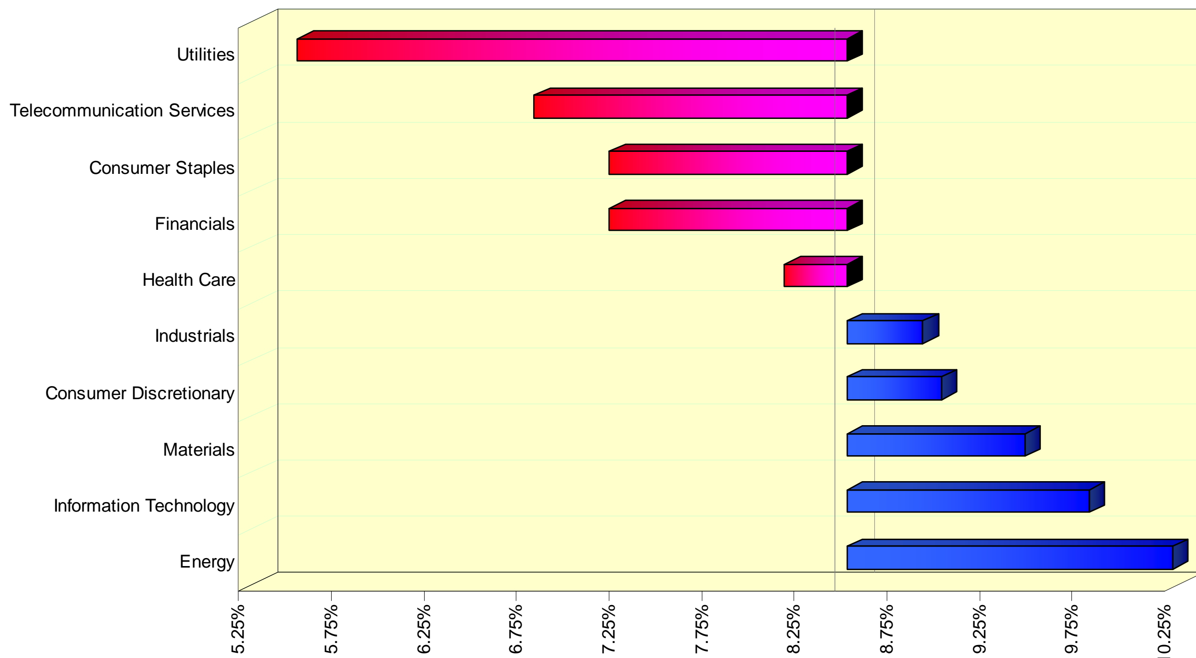
This last point is a risk in itself: While we are cautioned past performance does not predict future results, all data analysis must be based on available numbers from the past if for no other reason future data are so difficult to obtain. Mortgage-derivative models did not assess the risk of nationwide declines in residential real estate properly as no such data sample existed after the 1930s. When the various systemic-risk mavens created by Dodd-Frank gather, they should consider this point…but the betting here is they will not.

Cost of Capital

Now let's revisit an analysis from December 2011 on the weighted-average cost of capital (WACC) for both economic sectors and for industry groups within the financial sector. WACC includes the costs of firms' debt, equity and preferred stock. The relationship between WACC, profitability and returns is not a simple and direct one as staid utility and consumer staples firms can have both a low WACC and then get clobbered in a rising-rate environment or firms with a high WACC in the technology or energy sectors can have a high WACC as investors demand a higher return for their perceived risk.

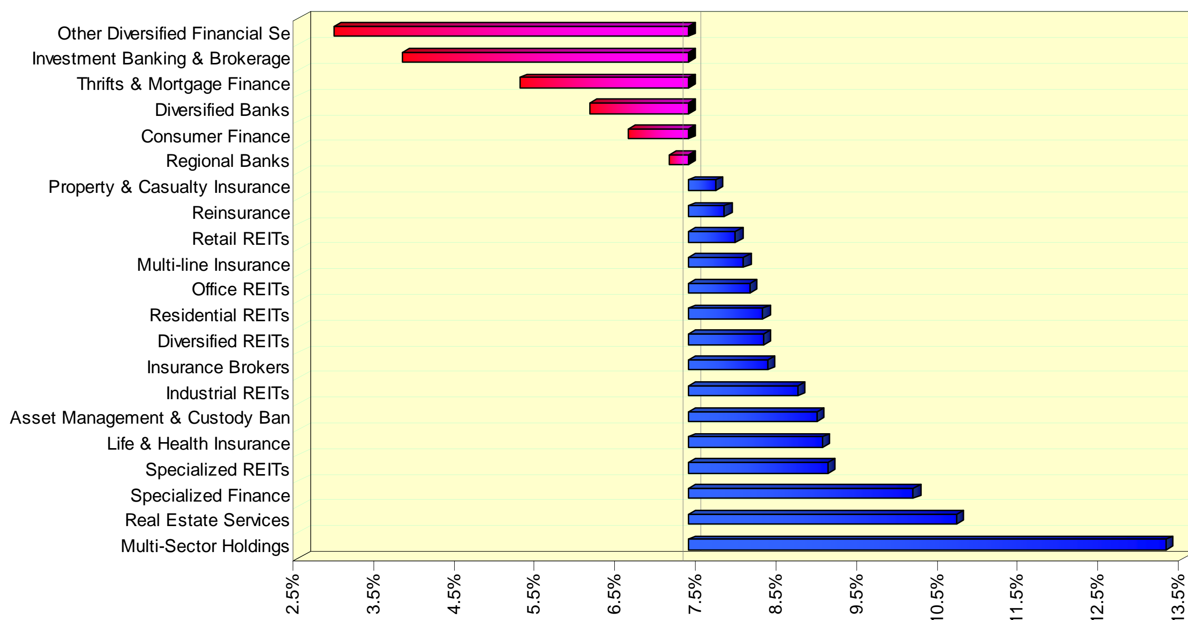
The alignment of WACCs for sectors is roughly what we should expect. Utilities, telecommunications and consumer staples all have WACCs below financials' 7.19%. The WACC of the Russell 3000 of 8.47% forms the internal Y-axis.

Weighted Average Cost Of Capital



Now let's split the financial sector into its groups. As was the case in December 2011, the large banks that proved themselves quite dangerous to the populace have WACCs below the sector's average. The perception of a

government safety net works wonders. The list of above-average WACCs is dominated by REITs and real estate-related groups.



Thus the same stocks with the greatest exposure to both higher long- and short-term interest rates also are penalized with a greater than sector-average WACC. The question of "which REITs?" has a fairly simple answer: All of them. REITs had a tremendous run from the March 2009 low; the iShares U.S. Real Estate ETF (IYR) has returned more than 244% from the March 2009 low versus 165% for the Standard & Poor's 500 Depository Trust (SPDR). That performance was based on free money and the yield-chasing response thereto. All good things come to an end.