REITs Under The Radar

An experience known to all sellers of hedging instruments to corporate customers is the objection, "But we're self-hedged." What they really mean is one operating subsidiary gains from, say, higher crude oil prices while another subsidiary loses. In that internal focus, they feel they are in a zero-sum game regardless of how the firm as a whole is affected.

I bring this up by my own unwitting wandering into the world of self-hedging in regards to my last column on REITs in February 2007 one week before the end of their spectacular five-year bull market (The S&P REIT index had a five-year total return of 177%; the S&P 1500 Supercomposite's total return over the comparable period was 37%). Consider the following two passages:

> *This is how people get trapped in bull markets: Each time you sell, you sell too soon. Each time you buy, you get rewarded. And while you know it is never really different this time, you account statement says otherwise.*
>
> *At some point, the price of REITs will rise to a point where they no longer make sense. We have yet to see firm technical signs of higher prices being rejected, though, so we must conclude the uptrend remains intact for now.*

Anyone with a REIT position over the following year can be excused for thinking the optimal REIT allocation was zero. Between when that column was penned and their low this January, the S&P REIT index had a total return of -32%. Let's just say the signs of overvaluation were there, as they had been since 2005 at least. But the one standard to which no one should be held is clairvoyance, and that column was written two weeks before the global equity shock two weeks in the distance. That was the first rumbling the credit crunch might be something more than just one of those worries to which everyone pays lip service and then does nothing.

Bad News, Good News

Although the consensus emerged quickly the commercial real estate market would not be hit as badly as the residential real estate market, the sector was not immune to the credit crunch, and indicators such as the CMBX, a measure of stress in the commercial mortgage-backed securities markets, kept moving higher.

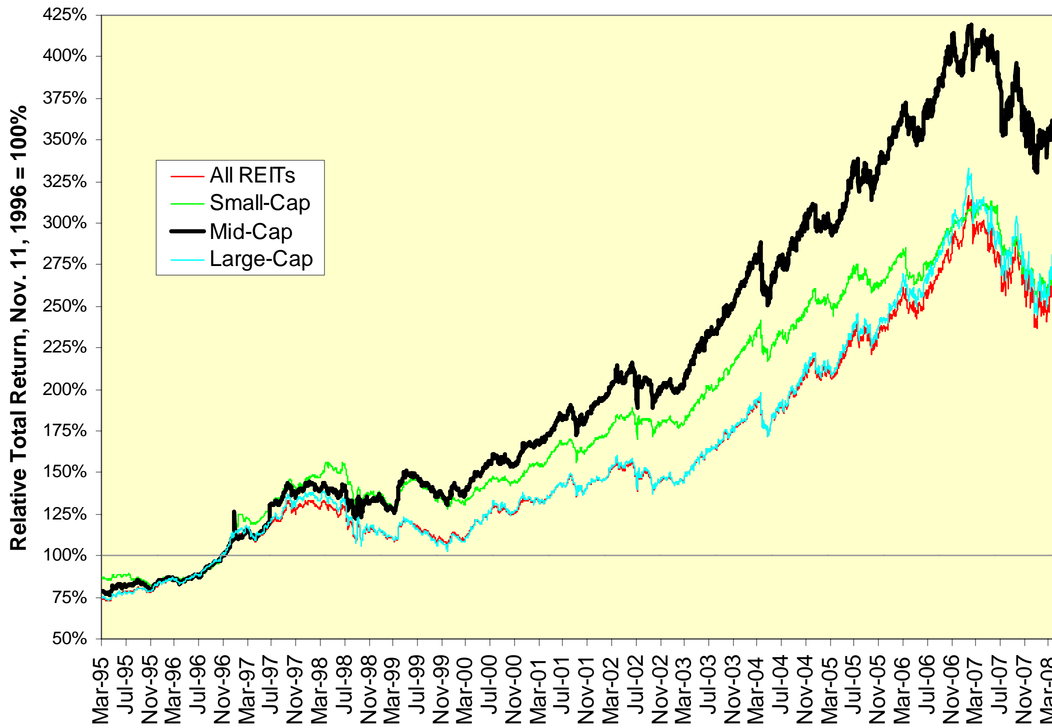
The news, in general, continues to be poor. There are stories about rising vacancy rates, falling rental rates, overbuilding, loan defaults and the unquestionable link between economic growth and commercial real estate demand. So imagine my surprise at seeing both retail REITs and residential REITs in the list of top ten S&P 500 groups for the past three months.

This smelled of two things. First, if beaten-down, credit-sensitive stocks are doing well – and that's an absolute "doing well," not a relative "doing well" – we may be at a tradable low at the very least. The second is all REITs are not created equal. Just as we have a market of stocks and a market of commodities, not a stock market or a commodities market, we have a market of REITs. This invites some detailed analysis.

Capitalization Matters

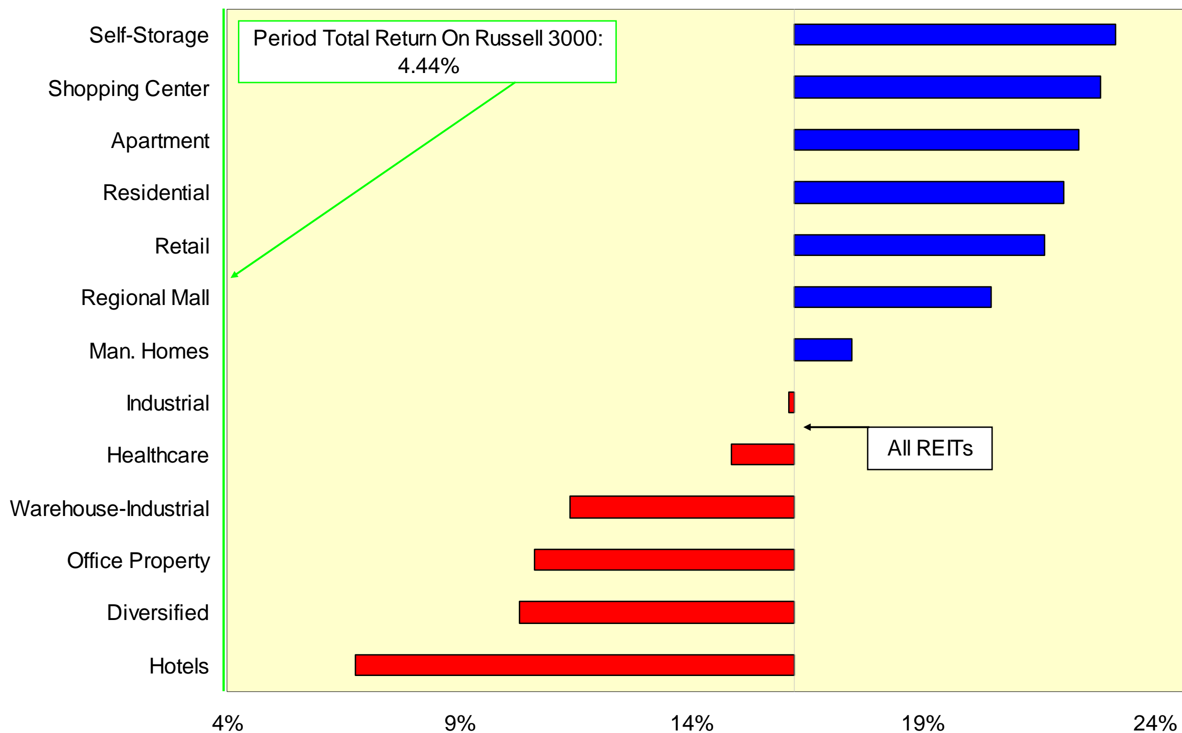
First, let's break REITs apart not by sector but by size. *Bloomberg* maintains capitalization-weighted indices for REITs, and if we compare their total returns re-indexed to March 1995, we can see a profound and puzzling outperformance lasting for years by the mid-cap index. The five largest members of this index at present are Omega Healthcare, Extra Space Storage, Sovran Self-Storage, Saul Centers and National Health Investors.

REIT's Happy Medium



REIT Groups

Bloomberg also maintains REIT classifications by specialty. Thirteen groups are active at present; one, outlet centers, is not. How have these groups performed since the January 22, 2008 market low? The total return on the Russell 3000 index of all stocks has been 4.44% over this period, and the total return for all REITs has been 16.64%.



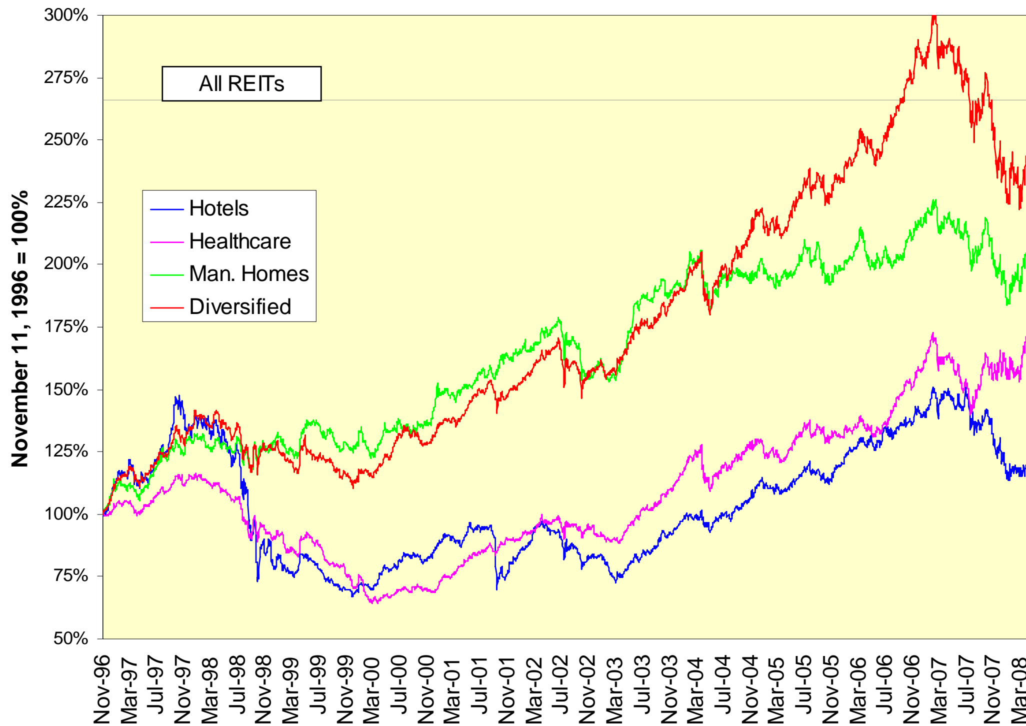
The top-performing group has been self-storage REITs; perhaps it is no accident two of the top five members of the mid-cap REIT index are self-storage REITs. This is followed by regional malls, retail, residential, shopping centers, apartments and industrial REITs. If the American consumer is tapped out by declining asset prices, the subject of a recent column, and is pressured by rising energy prices and a weaker dollar, then why are the REITs related to the great American pastime of shopping doing so well?

Who has been bringing up the rear? Hotels, diversified REITs, office property, warehouse-industrial and healthcare all have generated positive returns and have outperformed stocks, but all are below the 16.64% average return since late January.

The odd conclusion here is REITs related to production and the facilitation of production, such as offices, warehouses and hotels are laggards. REITs related to consumption, all those retail-related groups, are leaders. A mid-20th century Chicago alderman, Paddy Bauler, famously said, “Chicago ain’t ready for reform.” Neither, apparently, is the American consumer.

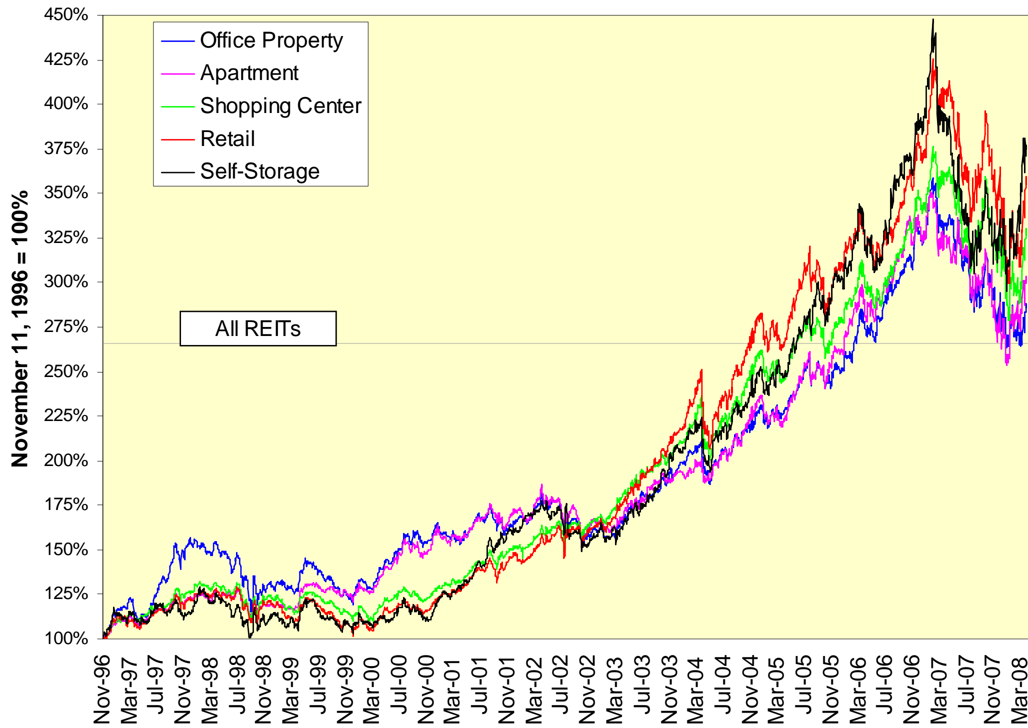
Long-Term View

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. Incredibly, investors in double-wide trailers have done better for themselves than have investors in overpriced hotels.



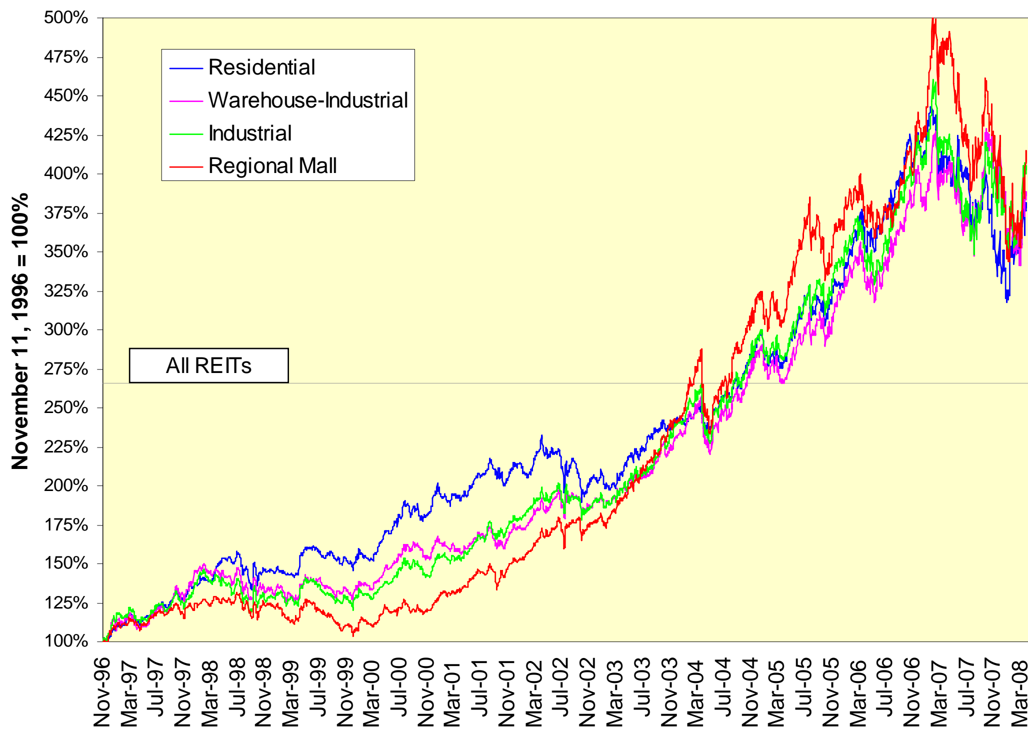
The strong performers include what most of us think of when we think of REITs, offices, apartments, shopping centers, retail…and those creep-me-out self-storage centers. These groups were hit quite hard in last year's downturn. Tellingly, office REITs have been slowest to rebound; the five largest REITs in this category include Boston Properties, SL Green, Alexandria Real Estate, Mack-Cali Realty and Highwoods Properties. If the economy worsens markedly from here, this group's relative weakness is likely to deepen.

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 more than eleven years, not just two months.

Relatively Very Strong REIT Groups



There are two important points regarding the strength of the warehouses and industrials. First, the rise of just-in-time inventory management placed an emphasis on highly automatic distribution systems. Second, the increasing share of the American economy involved in foreign trade has made these groups sensitive to currency fluctuations and global economic conditions as well as to U.S. economic health. An abrupt change in American trade policies could damage these facilities, which are critical components of supply chains extending back to China, Mexico and other exporters. The warehouse-industrial REIT group is largely a two-firm show, Prologis and AMB Property.

Your optimal allocation to REITs is greater than zero; most models have it as somewhere between 5-10% of your portfolio. They are demonstrably and maddeningly different in risk and return characteristics from other conventional assets, and as Roger Ibbotson demonstrated years ago, only common stocks outperform real estate over a long period of time.