REITs March To A Different Drummer

Turn your mental clock back seven years to the peak of the NASDAQ extravaganza and try to remember your investment thought process. Going short had been unproductive to say the least, adding new longs at ever-higher prices for ever-more ragged stocks was a tough play, and even if you did nothing your portfolio was going to be affected by the NASDAQ regardless of its composition.

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, your account statement says otherwise.

I entitled a February 2005 column, "REITs Living On Borrowed Time." The logic offered two years ago was simple: REITs are a total return instrument offered by highly leveraged commercial real estate operators. As the yield curve was continuing to flatten under what would eventually be 17 consecutive rate increases by the Federal Reserve and as long-term rates appeared poised to rise further, REITs would be squeezed. One thing that is never different is cash flow – REITs are valued principally on their funds from operations, or FFO – is discounted by interest rates to arrive at a present value. You do not get to argue with the market on this point. I concluded:

> *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 their dual nature and start trading like a bond.*

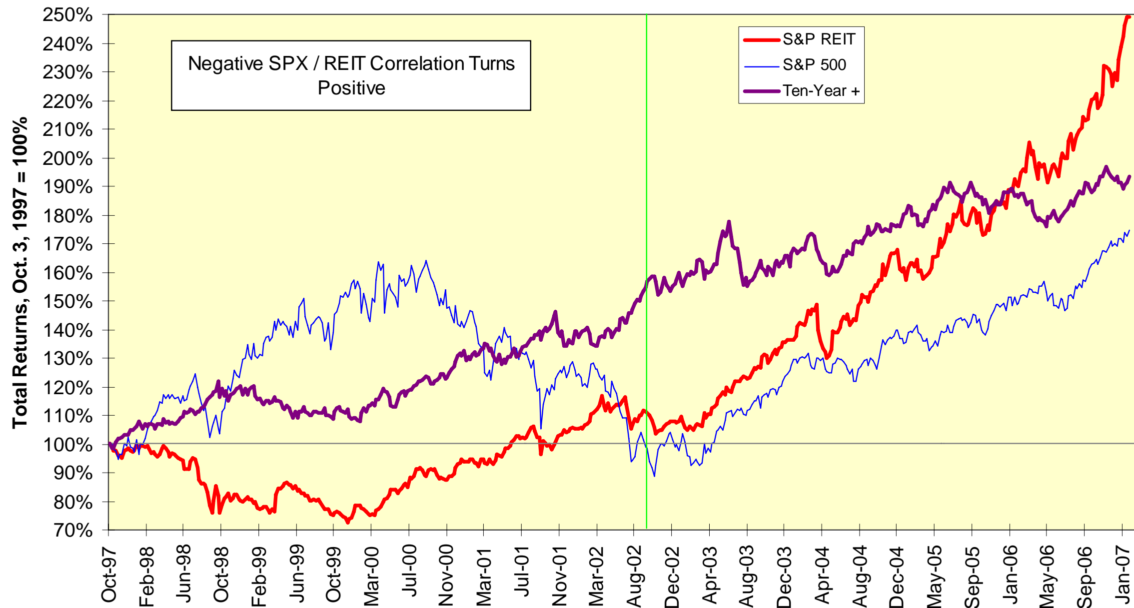
Onwards And Upwards

The average annual total return on the S&P 500 REIT index has been a cool 35% since that article was written. The yield on the ten-year note was 4.14% then en route to today's 4.688%. The yield curve as measured by the forward rate ratio between two and ten years, the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year yield itself, was 1.0606 en route to today's slightly inverted .99285.

Now that we have seen the sort of news often associated with market tops, Blackstone Group's acquisition of Equity Office Properties over a competing bid by Vornado Realty Trust, let's step back, update things from two years ago and see how REITs have fared against the macro backdrop. And as an aside, I do not subscribe to the argument that you had better ditch REITs because EOP's Sam Zell is a really smart operator and if he is selling, so should you. I am going to guess Vornado's Steven Roth and Blackstone Stephen Schwarzman both can handle their affairs just fine, thank you.

First, let's compare the total returns of the S&P REIT index, the S&P 500 and the Merrill Lynch index of ten-year+ Treasuries. Three things jump out of the chart below. First, long-term Treasuries have outperformed the S&P 500 handily since October 1997. Second, what had been a negative relationship between stocks and REITs turned positive after the start of the Iraq War in March 2003, marked with a green line; this is when stocks joined REITs in a bull market. Third, and most striking, is the acceleration of the REIT bull market in the past year.

REITs Outperformed Both Stocks And Long-Term Treasuries

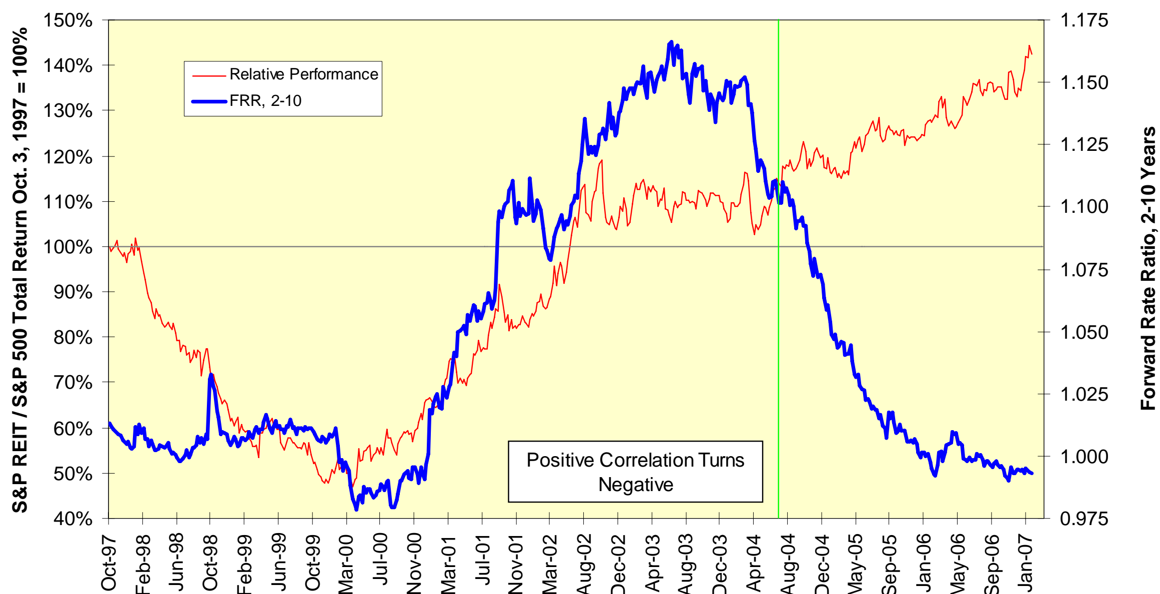


Do Not Suspect The Usual Suspects

The term "excess liquidity" has joined China and hedge funds as the all-purpose answer for everything in finance without a better ready explanation. Of course, if there really was a lot of money sloshing about, we would expect it to manifest itself in a more positively sloped yield curve, greater inflation expectations and significantly higher bond yields. Yet neither the yield curve nor long-term rates, both of which include inflation expectations, are acting as if too much money is chasing too few financial assets.

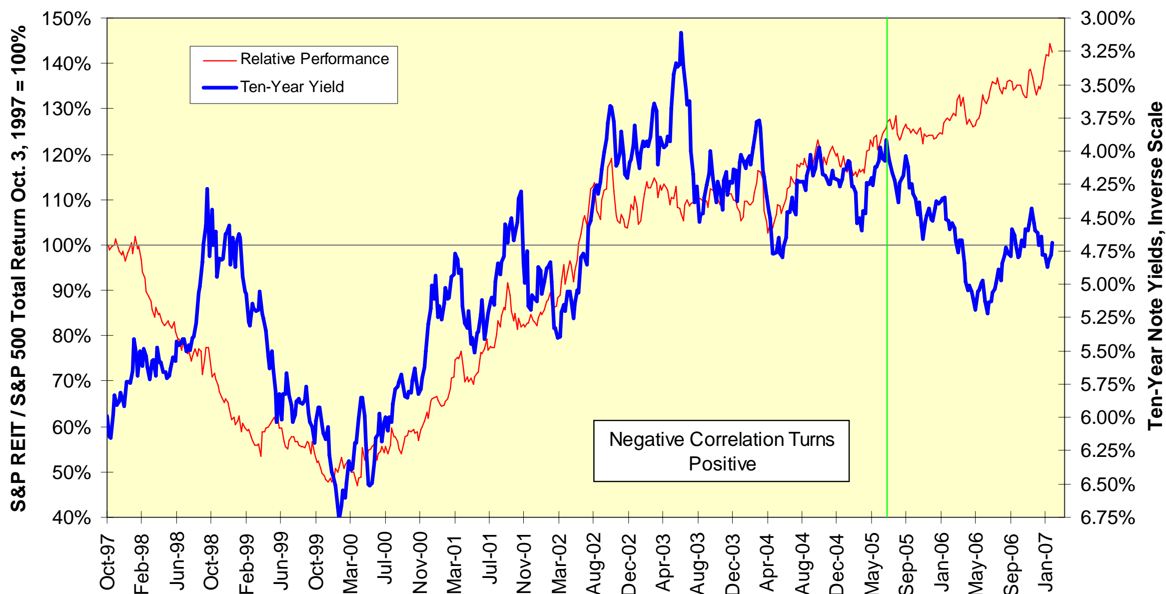
If we index the relative performance of REITs to the S&P 500 and map it against the forward rate ratio, we see a definite change in correlation at the end of July 2004, marked with a green line. The REIT market took off relative to stocks at the very time when the Federal Reserve's rate-hiking intentions were becoming clear. The one explanation possible for this, other than complete mania, is a flatter yield curve is associated with a strengthening economy, one able to support higher office rents.

Relative REIT Performance As A Function Of The Yield Curve



Finally, we can map the relative performance of REITs to the S&P 500 against ten-year note yields plotted inversely. Here the expected negative correlation turned positive at the end of June 2005. Many have noted the

current yield spread between REITs and Treasuries is historically narrow, and this is indisputable. We can posit REIT investors recognize the floating nature and potential for both capital returns and a modicum of inflation protection in REITs and have concluded, reasonably, the narrow yield spread is simply an unimportant statistic.



The Foreign Connection

One little-discussed aspect of REITs is how attractive U.S. commercial real estate is to non-American investors. The massive American capital account surplus, the mirror of our current account deficit, is a claim on U.S. assets. Those claims have to be spent somewhere, and if you do not find holding pieces of paper attractive, you might find holding Class A office buildings or prime shopping centers attractive. Behavioral finance theory allows for different preference functions such as this. In an age where bond yields are low and stock valuations are not cheap and large corporations can disappear quickly under technological change, commercial real estate can be very comforting.

Whenever you see a parabolic rise in a market and start hearing reasons why logical stop signs are being ignored, you know the end is coming into view. Shopping malls are being built on top of shopping malls, much in the style of Russian *matrioshka* nesting dolls, in the northern suburban area of Chicago where I live.

The late Herb Stein, Richard Nixon's chairman of the Council of Economic Advisors, famously said, "If something can't go on forever, it won't." 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.