FirstPoint Financial

WEEKLY MARKET THOUGHTS

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Investing in Real Estate Through REITs

Most of us have at least some experience with real estate investments. For many Americans, their home is the single largest investment they will make in their lives. In this piece, we'll take a look at real estate investments as a part of an overall diversified strategy. In particular, I will discuss what real estate investing is and how REITs (Real Estate Investment Trusts) work, how they tend to perform over time and how exposure to these investments can impact your portfolio.

Diversify, Diversify, Diversify

Investors consistently hear that they need to diversify their investment holdings. Why? Simply put: to adjust specific risks to which an investor is exposed. ***Diversity of holdings in an investment portfolio may not make one rich, but it may keep one from becoming poor.***

For example, if an investor owns only one stock – their entire fortune rests on the valuation and performance of that one company. The stock could rise in value, in some cases multiplying in value leading to significant wealth creation. On the other hand, that single company's fortunes may plummet, leading to a major decline in the value of the stock, which could be a financial catastrophe for the holder. Herein lies the trade-off of diversity versus the risks of owning major positions in limited asset holdings.

Historically, real estate has acted as a *diversifier of risk as well as a return generator* for many investors. At times, real estate's returns (as measured by the REIT Index) do not correspond directly to the returns of companies in the S&P 500 Index. Indeed, the correlation of REIT returns to the S&P 500 has been falling over the last few years. Currently, the correlation of REIT returns to the S&P 500 is +0.69 as compared to a correlation of +0.95 in 2010. Effectively this means that 69% of the time, REIT investments perform in-line with stock returns. Additionally, this means diversification tendencies of REITs have increased over the last four years, increasing the diversification tendencies of real estate to an equity portfolio.

REIT Performance and Inflation

Historically, one positive driver of real estate returns has been a change in inflation, which may be accompanied by a rise in interest rates. During this type of environment, stock returns have not been as robust as returns generated by REITs. Rents charged to tenants of real estate tend to reflect overall inflationary pressures in the United States. The cash flow generated by REITs is tied to rents. Consequently, REIT returns historically have been highly correlated with a bottoming out and subsequent increase in the Consumer Price Index (CPI).

Since 1989, three periods when REITs have outperformed stocks in general were following troughs in reported inflation, as measured by the CPI. Historically, these have been among the times when holdings have not only provided a certain degree of diversification from an all-stock portfolio, but have also been periods when REITs dramatically outperformed the stock market overall.

Let's take a look at some data. Since 1989, there have been three previous periods when the "headline" CPI annual rate of change has bottomed and started rising – June 2002, October 2006 and July 2009. Following are average returns for the three months, six months and 12 months following each of these inflation-bottoming periods for the REIT Index compared to the S&P 500 Index.

	3 Month Return Following CPI Trough	6 Month Return Following CPI Trough	12 Month Return Following CPI Trough
REIT Index	+14.3%	+13.4%	+24.5%
S&P 500 Index	+1.1%	+2.4%	+8.2%

Bringing It Forward

For real estate investors, it obviously has paid to understand inflationary trends. Since late last year, REITs have dramatically outperformed the broad stock market (as measured by the S&P 500 Index). Over the preceding six months, the rate of change of the CPI had declined markedly. Are we seeing a bottom in inflationary pressure? Based on historical data, the REIT market is saying yes to this question.

Since the beginning of 2014, REITs (as measured by the Vanguard REIT Index ETF) have generated a total return of 12.48% while the S&P 500 has generated a return of 1.39%. Note the comparison of this return spread to the "Three-Month Return" column in the previous table. Additionally, it is noteworthy that the annualized rate of change of the CPI came in at a mere 1.0% last October and at 1.1% in February. Prior to October's reading, the annualized change in the CPI was 1.6% for the previous six months. Additionally, the latest CPI data is showing a 1.5% annualized rate of change, up from 1.0%. As we discussed in our earlier pieces, we expect to see a continued slight upward push in inflationary pressure by the end of this year to the beginning of 2015. For those counting, we expect inflation to average 2.6% over the next three to five years.

Fundamentals

Let's take a look at some current real estate fundamental data. REIT valuation is a mixed bag. REITs are selling at 2.1x book value, a 5% premium to historical average valuation levels. Dividend yields of the REIT Index are currently at 4.1% as compared to the 10-year U.S. Treasury, which yields 2.7%, or a "spread" of 1.4%. The average spread over the last 25 years has been 1.7%.

Analysts are currently expecting the average REIT to experience earnings growth of 8.6% this year and 14.0% next year. Historically, REITs have generated an average earnings growth rate of 7.0% per year. Even if earnings growth expectations prove a little high, the earnings picture is fairly bright for real estate.

Cash flow rather than earnings drives dividends from REIT investments. Consequently, expected cash flow from real estate investments is the focus of expected dividend growth in the real estate space. Currently, the REIT sector is selling at 22x cash flow – as compared to a historical average of 15x.

Looking at the weight-of-the-evidence tells us that REITs are not inexpensively valued, but hold fundamental promise going forward over the long term.

Action Steps

Is now a good time, based on historical trends, to increase real estate exposure? The historical seasonality of returns is interesting for REIT holdings. Traditionally, two of the worst months to own REITS have been May and June. Historically, 64% of the time investors have lost money in REITs during the May-June time frame. However over the four months that follow (July – October), REIT investors have fared much better, generating positive returns 61% of the time.

Is now the time for investors to purchase real estate, either through REIT exposure or through outright real estate ownership? The answer to that question resides in advice from your Wealth Advisor. I cannot in this piece address your individual needs. But from purely a market-driven standpoint, as long as we stay out of recession, select real estate holdings may indeed perform rather well.

Just For Fun

As the topic for today's piece is real estate and investing in REITs, it seems appropriate to close today's piece with the following comments regarding real estate investing.

> *It's tangible, it's solid, it's beautiful. It's artistic, from my standpoint,*
> *and I just love real estate.*
>
> Donald Trump

> *If I am going to get in a cab to go home, and I see a sign for an open house,*
> *I go in. I like real estate because I am the boss.*
>
> Lorraine Bracco

And finally…

> *To my real estate agent, Chernobyl is a fixer-upper.*
>
> Yakov Smirnoff

I am traveling to New York this coming weekend.
We will be back in two weeks with another update.

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