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Real Estate Investment Trusts

WHITEPAPER
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Real estate investment trusts (REITs) are a type of investment vehicle that enables investors to gain exposure to commercial real estate via public markets. This primer will define what a REIT is, explain the different REIT property types, discuss the characteristics of the REIT market, and review the historical risk and return profile of REITs. Our focus is on domestic listed public equity REITs, which are highly liquid financial instruments that provide exposures to different parts of the real estate market.

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What is a REIT?

Real estate has long been an attractive asset class for investors due to its return profile, diversification benefits, and protection against unanticipated inflation.[1] However, directly investing in real estate is fraught with complications and risks that many investors are unwilling or unable to bear. Sourcing and closing an investment in a direct commercial real estate property requires considerable knowledge, skill, and capital. To facilitate investment in real estate for a variety of investor types, the US government passed legislation in 1960 that authorized the creation of REITs.

A REIT is an investment vehicle that owns, operates, or finances assets related to income-producing real estate, such as land and buildings. Prior to the creation of REITs, investing in real estate was not a viable option for many investors, particularly those with small amounts of capital, due to practical concerns and untenable risks. The creation of REITs eliminated many of the difficulties that had effectively prevented investors from allocating capital to real estate. Nearly 40 countries have enacted REIT legislation, enabling global investment in this asset class. As of January 2020, REITs owned approximately $3 trillion in gross assets worldwide.[2]

There are two main types of REITs: mortgage REITs and equity REITs. Mortgage REITs earn interest income from the financing of income-producing real estate. Equity REITs, which account for the majority of REITs, earn income through property ownership and will be the focus of this primer.

Listed equity REITs are typically structured as public companies and trade on national stock exchanges. They own properties such as shopping malls, office buildings, apartment complexes, warehouses, and data centers. They collect rent from tenants,

[1] Alternative Investments: CAIA Level II, by Hossein Kazemi et al., Wiley, 2016, pp. 352–354.

[2] https://www.reit.com/data-research/data/reits-numbers.

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and pay out the profits after expenses as a dividend to shareholders. To qualify as a REIT, the investment vehicle must distribute at least 90% of its taxable income to shareholders in the form of a dividend. Retained income is taxed at the normal corporate rate.[3]

[3] For further REIT requirements and qualifications, please see the appendix.

The intent of these provisions and regulations is to ensure that REITs are in the business of investing in income-producing real estate rather than operating like traditional companies. In addition, the provisions and regulations are meant to prevent any REIT from harboring undue risk for investors.

REIT property types

REITs are categorized based on the property types in which they invest. Though some REIT portfolios invest across property types, most REITs focus on holding one particular property type in their portfolio. REITs fall into a dozen subsectors. The different kinds of REITs are listed below.

→ **Office REITs** own and manage office buildings that are leased to tenants, such as businesses and government agencies. Some office REITs focus on specific geographies, or they might specialize in a particular type of tenant, such as software companies.

→ **Industrial REITs** own and manage industrial facilities, such as warehouses and manufacturing facilities.

→ **Retail REITs** own and manage real estate that is leased to retail-related tenants like shopping malls and grocers.

→ **Lodging REITs** own and manage hotels and resorts and can focus on different types of customers, such as business travelers or vacationers.

→ **Residential REITs** own and manage residential properties, such as apartment buildings and manufactured home communities.

→ **Timberland REITs** own and manage real estate involved in the harvesting and selling of timber.

→ **Health care REITs** own and manage properties related to the health care industry, such as hospitals, medical office buildings, and skilled nursing facilities.

→ **Self-storage REITs** own and manage storage facilities for individuals and business customers.

→ **Infrastructure REITs** own and manage properties such as wireless communication towers and energy pipelines.

→ **Data center REITs** own and manage facilities that house data servers that store and protect customer data.

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→ **Specialty REITs** own properties that cannot be categorized based on the other REIT sectors. Specialty REITs can include movie theatres, student housing, and outdoor advertising.

→ **Diversified REITs** hold a mix of properties across the REIT sectors.

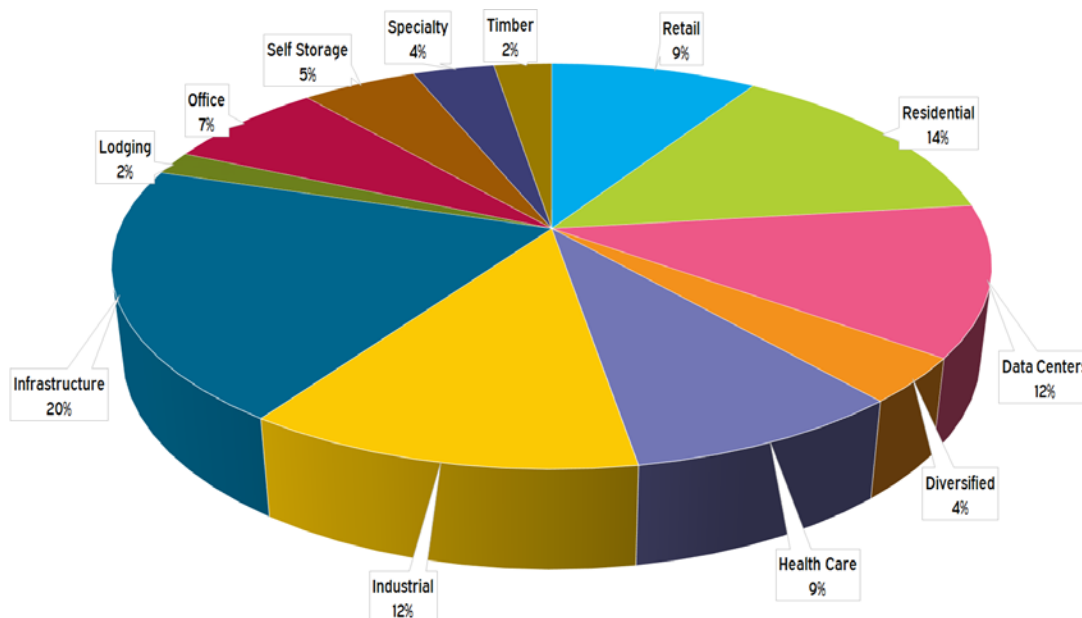

CHART 1
US Listed REITs by Property Type/Subtype[4] As of July 2020

[4] https://research.ftserussell.com/Analytics/FactSheets/temp/9a8f19b5-713f-4ab4-8e72-5c37a11f6f60.pdf

While REITs are collectively subject to certain economic drivers, each category of REITs in the chart above may behave differently depending on the economic environment and the specific elements of their respective balance sheets, governance and management teams. In addition, the different subsectors within these broad categories will be subject to varying economic forces. The REIT universe therefore offers investors exposure to numerous drivers of return and risk.

The REIT market

Since their creation in 1960, the number of REITs and the value of the assets they control have grown considerably. The FTSE Russell NAREIT All Equity REITs Index was created in December 1971 and tracks the universe of publicly listed US REITs. At the time the index was created, it tracked 12 US equity REITs with a total market capitalization of $332 million. By year-end 2019, the number of REITs had grown to 179 and the aggregate market capitalization increased to $1.2 trillion, as shown in the chart below.[5,6]

[5] Source: Nareit.

[6] For a review of the growth of REITs in the 1990s, see: "The Future Role of REITs in Real Estate Finance," Anthony Downs, September 1999, The Brookings Institution.

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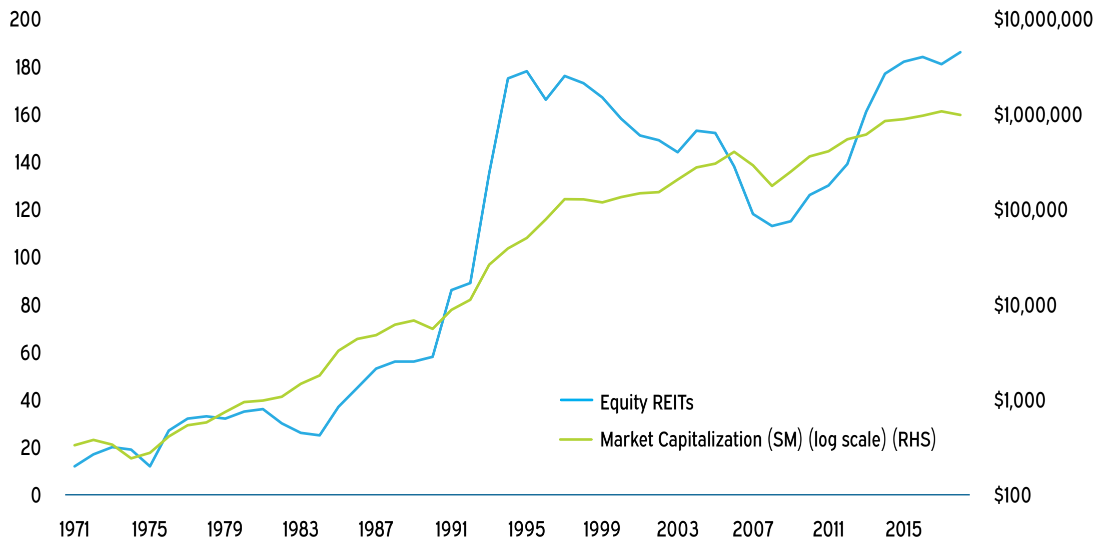

CHART 2

US Listed Equity REITs by Count and Market Capitalization

The impressive growth of the domestic equity REIT universe in the chart above accompanies a growing investor awareness and acceptance of REITs as attractive investment vehicles. As stated previously, real estate has long been an attractive arena for investors. However, prior to the creation of REITs, investing in real estate required a large capital base, specialized expertise, a long investment horizon, and a high tolerance for concentration and liquidity risk. REITs allow investors to bypass many of these hurdles in order participate in the benefits of investing in real estate.

> US REITs own approximately 520,000 properties across the country as of September 30, 2019. NAREIT estimates that REITs own approximately $3 trillion in gross assets, $2 billion of which is attributable to public REITs.

REITs are also a meaningful portion of major market indices.[7] As of January 2020, the S&P 500 Index included 30 equity REITs, which had an aggregate weighting of 2.8%. Real estate, of which REITs comprise a significant portion, was segmented out of the Financials sector in Russell indices in 2019.[8] The Russell 3000 index, which tracks 3,000 US companies, contained 168 equity REITs with an aggregate weighting of 3.8%.[9]

[7] See Appendix for a chart of equity REITs weighting in US equity indexes over time.

[8] "FTSE Russell Announces Enhancements to Its Industry Classification Benchmark (ICB) Following Market Consultation." FTSE Russell, 2017, www.ftserussell.com/press/ftse-russell-announces-enhancements-its-industry-classification-benchmark-icb-following.

[9] Source: FactSet

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REITs have also become an important part of the US economy. According to figures from the National Association of Real Estate Investment Trusts (NAREIT), US REITs own approximately 520,000 properties across the country as of September 30, 2019. NAREIT estimates that REITs own approximately $3 trillion in gross assets, $2 billion of which is attributable to public REITs (listed and non-listed). In addition, US REITs distributed approximately $62 billion worth of dividend income, while investing more than $59 billion in new construction and existing-property maintenance in 2018.

As the market for REITs and their contribution to the economy grew, REITs became an increasingly common holding in exchange traded funds (ETFs) and mutual funds. The first REIT ETF was the iShares Dow Jones Real Estate Index fund, which launched in 2000. There are now more than 20 ETFs that are exclusively focused on REITs. In addition, there are hundreds of real estate focused mutual funds, many of which hold a significant portion of their assets in REITs. The inclusion of REITs in these investment vehicles allows investors to easily and inexpensively diversify their REIT exposure. For investors who seek active managers in the REIT space, the eVestment database contains 67 active REIT strategies with $88 billion in aggregate assets under management as of December 31, 2019.

Advantages and disadvantages of REITs

There are several advantages to gaining exposure to real estate through REITs rather than direct real estate investments.

→ **Yield** Given the requirement that REITs must distribute 90% of their taxable income as a dividend, REITs often have attractive dividend yields, which can provide a source of income for investors (see Chart 3).

→ **Liquidity and transaction costs** REITs are registered with the SEC and trade on national stock exchanges. These characteristics offer liquidity to REIT investors in an otherwise illiquid asset class along with low transaction costs.

→ **Divisibility** The divisibility of public equity REITs into shares enables investors to participate in the real estate markets without requiring large amounts of capital.

→ **Governance** SEC requirements dictate that listed REITs file disclosures regularly in order to keep investors informed of the important elements of their business. The presence of outside directors adds a layer of fiduciary accountability and shareholder representation.

→ **Geographic diversification** Many REITs are diversified across geographic regions.

Public equity REITs, therefore, offer investors an attractive vehicle in which to invest in real estate.

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There are also disadvantages to gaining real estate exposure through REITs rather than direct real estate investments.

- **Limited capital deployment opportunities** Because of the requirement that 90% of earnings must be distributed as a dividend, REITs do not enjoy the same capital deployment opportunities as direct real estate investments. As a result, if a REIT wants to grow, it must have continual access to the capital markets or grow through mergers and acquisitions. Lack of market access during difficult market economic periods can be a problem for growth-oriented REITs. Increased scale often offers opportunities for improved margins.
- **Lower diversification benefits** Because REITs are publicly traded on stock exchanges, they have higher correlations to stocks and exhibit much greater volatility than direct real estate investments, though valuations often converge with those of private real estate during periods longer than 3 years.
- **Deviations from net asset value (NAV)** REITs can trade at a discount or premium to their NAV, which can introduce deviations between the value of the REIT shares and the purported value of the underlying real estate properties.
- **More leverage** REITs often use a considerable amount of leverage, with the average loan-to-value ranging between 30% and 50%. In contrast, most core open-end private real estate funds (i.e., those in the NCREIF-ODCE) use leverage between 20% and 30%. However, leverage for value-add and opportunistic funds can be much higher.[10]

[10] As of December 31, 2019, the FTSE NAREIT All Equity REIT Index had a debt to total market capitalization ratio of 31.4%, and the NCREIF NFI-ODCE index had a debt to total assets ratio of 21.5%.

REIT investors should also be aware that, in the US, the legislation regarding REITs has changed over time. REITs are now allowed to earn more active income than previously (see Appendix).

TABLE 1
Comparison of REITs and Private Real Estate Investments

Characteristic	REITs	Private Real Estate Investment
Liquidity	High	Low
Concentration	Varies	Varies
Transaction Costs	Low[11]	High
Transparency	High	Varies

[11] The low cost is related only to the listed shares. REITs have the same transaction costs as private investments when it comes to buying and selling the underlying assets.

REIT investment performance

Due to the requirement that REITs must earn the vast majority of their income through rental income and distribute profits as a dividend, REITs can provide a relatively stable income stream to investors. As of July 31, 2020, the NAREIT All Equity REIT index had a dividend yield of 3.7%, compared to 1.8% for the S&P 500 index. The chart below shows that REITs have historically had higher dividend yields than several market indices.[12]

[12] Source: FactSet and Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [GS10], FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GS10.

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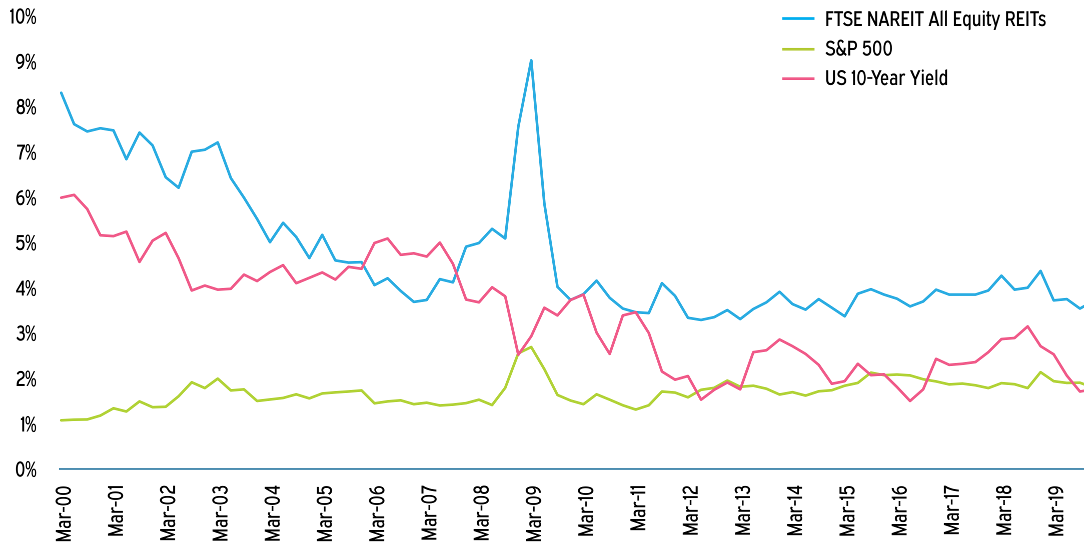

CHART 3

Dividend and 10-Year Yields as of December 31, 2019

The chart below shows the rolling three-year returns for the FTSE NAREIT All Equity REIT Index, which is a capitalization-weighted index of public US listed REITs, and the Russell 3000 Index, which is a proxy for the broad US stock market.

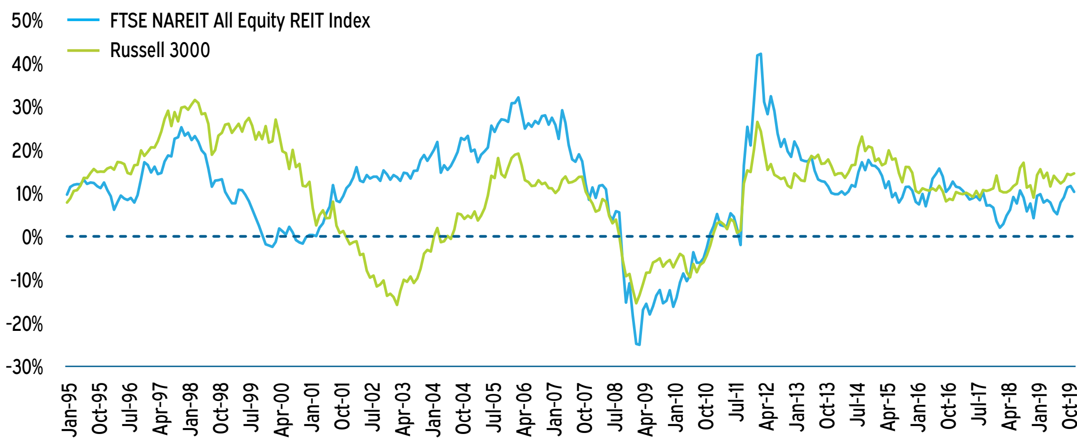

CHART 4

Rolling 3-Year Returns as of December 31, 2019[13]

[13] Source: eVestment Alliance.

US REITs have achieved positive returns in 88% of rolling 3-year periods over the trailing 25-year period. In comparison, US stocks, as measured by the Russell 3000 Index, have achieved positive returns in 81% of rolling 3-year periods over the same period. With the exception of the periods within the Global Financial Crisis (GFC) and its aftermath, REITs have consistently achieved positive returns over rolling 3-year periods.

REITs have achieved competitive long-term returns when compared to other asset classes, as shown in the following table.

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TABLE 2
Asset Class Returns and Risk as of December 31, 2019[14]

[14] Source: eVestment Alliance.

	FTSE NAREIT All Equity REIT		Russell 3000		Bloomberg Barclays US Aggregate		Bloomberg Barclays US HY		Russell 2000		NCREIF ODCE	
Returns	**10 Yr.**	**25 Yr.**	**10 Yr.**	**25 Yr.**	**10 Yr.**	**25 Yr.**	**10 Yr.**	**25 Yr.**	**10 Yr.**	**25 Yr.**	**10 Yr.**	**25 Yr.**
	12.6	10.9	13.4	10.2	3.7	5.6	7.6	7.6	11.8	9.4	11.4	9.0
Risk												
Standard Deviation (%)	13.4	19.2	13.4	16.4	3.1	3.6	6.1	9.2	17.1	20.0	2.2	5.9
Max Drawdown	15.1	65.4	15.3	45.9	3.0	3.0	7.2	27.1	23.1	47.9	0.0	37.8
Risk-Adjusted Returns												
Sharpe Ratio	0.90	0.44	0.96	0.48	1.02	0.88	1.15	0.56	0.66	0.35	5.02	1.14

Over the trailing 25-year period, REITs have achieved higher returns than US stocks, investment-grade and high-yield corporate debt, and private real estate funds, as measured by their respective indices. REIT returns are competitive over a 10-year trailing period, as well, and are exceeded only by the returns from US stocks. See Appendix for a cumulative wealth chart of these indices.

While REITs have provided impressive returns over the long term, the historical risk is worthy of consideration. REITs have experienced higher volatility than every asset class listed in the table above except small capitalization US stocks over the trailing 25-year period. In addition, REITs have experienced the highest maximum drawdown over the trailing 25-year period, which occurred during the Global Financial Crisis.

When interpreting the risk and risk-adjusted return metrics of the indices, it is important to consider that the NCREIF-ODCE index is priced quarterly, and the underlying funds use an appraisal-based pricing methodology. These characteristics will lower the observed volatility, increase the risk-adjusted return metrics, and may result in a temporal lag with respect to actual returns. All of the other indices are priced daily.

> Public equity REITs offer investors an attractive vehicle in which to invest in real estate.

Given the elevated historical risk associated with REITs, investors should consider their historical risk-adjusted returns. The data in the table above indicate that REITs have earned attractive risk-adjusted returns over the trailing 10- and 25-year periods. The Sharpe Ratio, which normalizes returns to each unit of risk (volatility) taken, is useful for comparing asset classes. REITs have an impressive Sharpe ratio of 0.90 over the

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trailing 10-year period and 0.44 over the trailing 25-year period. It is important to note that one of the likely reasons that the Sharpe ratio of REITs resembles that of small capitalization stocks is that REITs have mostly been small capitalization stocks for the measurement period.

REITs have historically provided modest diversification benefits in a broadly diversified portfolio. The following table shows the 20-year historical correlation between REITs and the various other asset classes.

TABLE 3
20-Year Correlations of REITs with Various Asset Classes as of December 31, 2019[15]

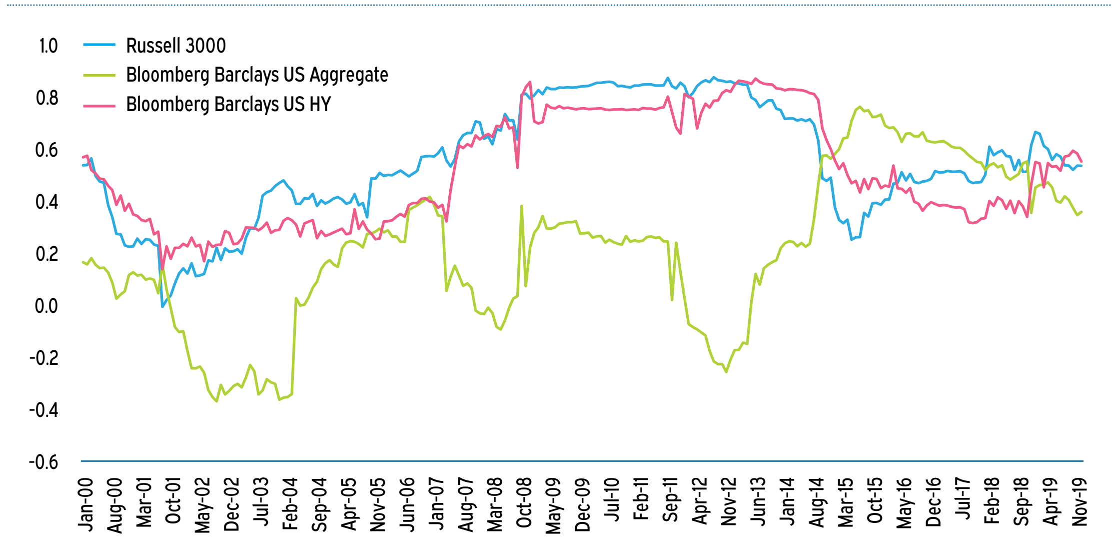
	Russell 3000	Russell 2000	Bloomberg Barclays US Aggregate	Bloomberg Barclays US HY
FTSE NAREIT All Equity REIT	0.62	0.63	0.20	0.61

REITs have exhibited a low correlation to US investment grade bonds over the trailing 20-year period. REITs have exhibited a moderate correlation to stocks and high-yield bonds.[16] The rolling three-year correlations between REITs and the various asset classes, shown in the chart below, demonstrate that the correlations can change over time. Notably, REITs became most highly correlated with other risky assets during the GFC, a period of extreme market stress.

[15] Source: eVestment Alliance.

[16] See Appendix for the relationship between REITs and interest rates.

CHART 5
Rolling Three-Year Correlations of FTSE NAREIT All Equity REIT index and Various Asset Class Indices as of December 31, 2019



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Summary

REITs offer investors a means to gain exposure to commercial real estate via public markets. This makes them accessible to a broader group of investors who have embraced the asset class in recent decades.

REITs have historically generated attractive long-term returns. Their return profile is similar to that of public market stocks, exhibiting fairly high correlations to equities, especially during periods of market stress, and a higher level of volatility than other asset classes. Still, risk-adjusted returns are attractive over the long term.

Investors should consider allocating to REITs if it aligns with their investment objectives. This includes investors who want to allocate to real estate but cannot sacrifice liquidity, as well as investors with a diversified private market real estate portfolio who want to include a liquid allocation within that portfolio.

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Appendix

According to the Securities and Exchange Commission[17], REITs are required to:

[17] https://www.sec.gov/investor/alerts/reits.pdf

- Distribute at least 90% of its taxable income to shareholders in the form of a dividend.
- Be an entity that would otherwise be taxable as a corporation but for its REIT status.
- Be managed by a board of directors or trustees.
- Have shares that are fully transferable.
- Have a minimum of 100 shareholders after its first year as a REIT.
- Have no more than 50% of its shares held by five or fewer individuals during the last half of the taxable year.
- Invest at least 75% of its total assets in real estate assets and cash
- Derive at least 75% of its gross income from real estate related sources
- Derive at least 95% of its gross income from such real estate sources and dividends or interest from any source
- Have no more than 25% of its assets consist of non-qualifying securities or stock in taxable REIT subsidiaries.

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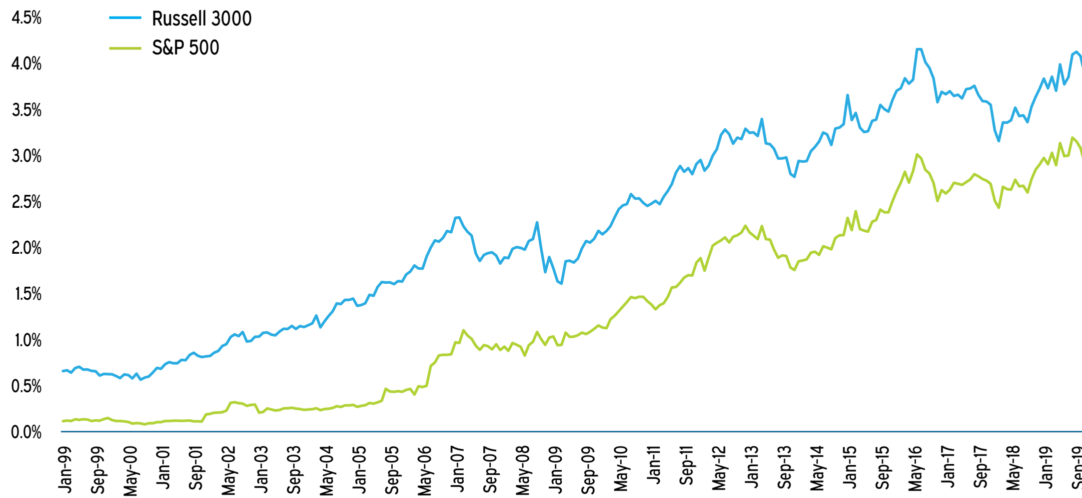

CHART A1

Equity REIT Weighting in US Equity Indexes[18]

January 1999—December 2019

[18] Source: FactSet

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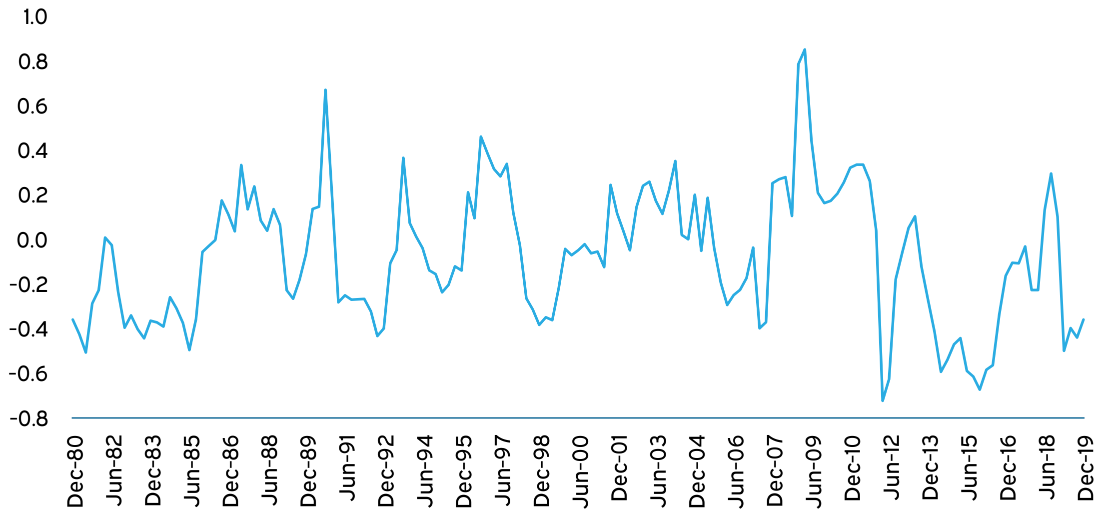

CHART A2

Three-Year Correlations as of December 31, 2019[19]

FTSE NAREIT All Equity REIT Correlation With NCREIF-ODCE

[19] Source: eVestment Alliance.

The correlation between the FTSE NAREIT All Equity REIT index and the NCREIF Fund Index – Open End Diversified Core Equity (NCREIF-ODCE) index is quite low, implying the two are uncorrelated. However, there are major construction and methodology differences between the two indices. For example, the NCREIF-ODCE is based on quarterly appraisals, and is therefore subject to the effects of smoothing and price lag. The FTSE NAREIT All Equity REIT index is priced continuously throughout each trading day.

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Changes to REIT legislation since 1960

The intent of the original REIT legislation was to enable all investors to participate in passive real estate ownership. Many of the restrictions placed on REITs were designed to ensure that REITs earn the vast majority of their income from passive sources like rent, and not from active sources, such as operations and services. However, several pieces of legislation have been passed since 1960 that allow REITs to earn a greater share of their income from active sources. For example, in 1986, the Tax Reform Act allowed REITs to earn income from providing certain services to its tenants through taxable REIT subsidiaries (TRS).[20] In 2007, Congress passed the REIT Investment Diversification and Empowerment Act (RIDEA), which further relaxed some of the restrictions placed on REITs.[21] For example, the REIT ownership limit of TRS increased from 20% to 25% of total assets with the passage of the RIDEA legislation.

[20] Einhorn, David M. "Unintended Advantage: Equity Reits Vs. Taxable Real Estate Companies." *The Tax Lawyer*, vol. 51, no. 2, 1998, pp. 203–228. JSTOR, www.jstor.org/stable/20771956. Accessed 17 Mar. 2020.

[21] Monroe, Patrick. "Reits Amidst The Current Real Estate Crisis: An Analysis Of The Reits Investment Diversification And Empowerment Act." *Journal of Business & Securities Law*, vol. 9 no. 2, 2009, pp. 239–260.

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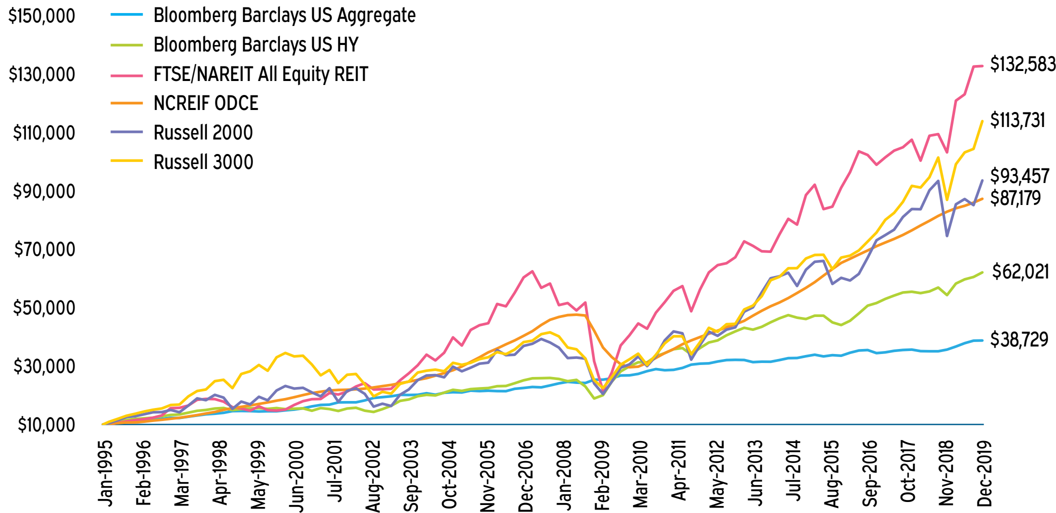

CHART A3

Cumulative Wealth[22]

Growth of $10,000 January 1995 — December 2019

[22] Source: eVestment Alliance.

An investment of $10,000 in the FTSE NAREIT All Equity REIT index in January 1995 would have accumulated to $132,583 as of the end of December 2019. This amount exceeds the amount that would have accumulated in the other indices listed in the chart above.

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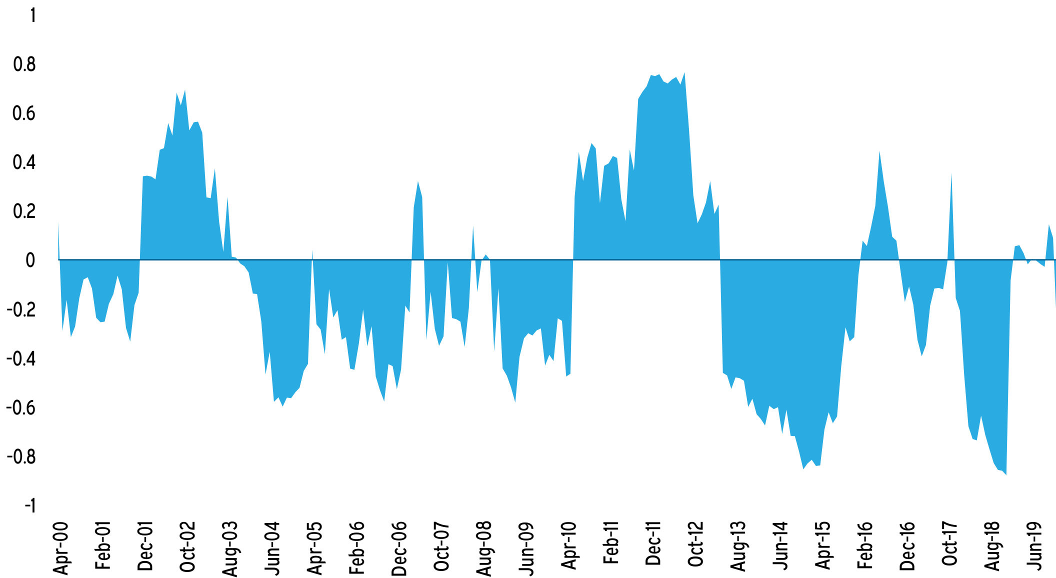

CHART A4

REITs and Interest Rates April 2000 — March 2020

FTSE NAREIT All Equity REIT Total Return Correlation With the Change in 10-Year Treasury Yield

The chart shows the rolling one-year correlation between the total return of the FTSE NAREIT All Equity REIT[23] index and the change in the yield on the 10-Year Treasury Note[24]. It is difficult to make broad generalizations regarding the relationship between REITs and interest rates. Total returns from REITs have historically been both positive and negative with changes in the 10-Year Treasury yield. REITs generally benefit from a growing economy as rents and property values rise. However, a growing economy is often accompanied by rising interest rates. REIT dividend yields become less attractive as interest rates rise.

[23] Source: eVestment Alliance.

[24] Source: Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10.

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