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Security Analysis

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Real Estate Investment Trusts and Their Performance against the S&P 500 and Gold

People are never satisfied in their quest to gain wealth. One way to continue expanding wealth is through investments, which hopefully yield high returns. Nowadays, investors are presented with a plethora of investment options, yet there exists one significant, underlying question: what is the best asset class for investment? On the surface, this seems like a simple question with a simple answer, but on a deeper level, the question is not quite so simple. Some investment professionals may advise that gold is the only safe bet in today's uncertain times, while others may anticipate high future cash flows from the stock market. Investment options are highly tailored to the individual investor, his risk tolerance, his wealth, and his expertise. While no two professionals agree on the "best asset class", there are certain asset classes outperforming market averages and show signs of continuing this performance for many years. I hypothesize that real estate investment trusts have outperformed both the S&P 500 and gold over the past twenty years.

A real estate investment trust (REIT) is essentially a mutual fund of a real estate venture or company. REIT shares can be bought either through traditional, organized stock exchanges, or through over the counter markets. REITS are designed to allow investors become involved in real estate without the high entry costs and liquidity issues typically associated with purchasing property. Instead of buying physical property, an investor can purchase shares in a REIT, allowing him to access any potential returns of the real estate market, while the real estate company shoulders responsibility of management and upkeep for the properties. There are three different types of REITs available for investors to purchase: equity, mortgage, and hybrid. Equity REITs invest in physical property, while mortgage REITs invest in mortgages and mortgage backed securities. Hybrid REITs invest in both property and mortgages. Investors make money on REITs through both capital gains and dividend payments. By law, REITs must offer a 90% dividend payout ratio[1], meaning 90% of REIT income is paid out to shareholders. By contrast, the average company in the S&P 500 has a dividend payout ratio of 31.8%.[2]

Evidence demonstrates that from 1993-2013, real estate investment trusts outperformed both the S&P 500 and gold. The National Association of Real Estate Investment Trusts (NAREIT) collects REIT performance data. NAREIT reported that as of May 31, 2013, equity REITs boasted a 10.84% compound annual total return since 1993[3] and an 11.45% compound annual total return since 2003[4]. By contrast, over the same period NAREIT reported the S&P 500 compound annual total returns were 8.75% since 1993 and 7.58% since 2003[5]. Gold outperformed stocks, yet still lagged behind REITs. From 1991 to 2011, compound annual total return from gold was only slightly better than S&P 500 at 7.6%[6].

This strong performance by REITs is due to a number of reasons. One of the primary reasons REITs are so good to investors is due to the significant dividends they paid out. A minimum of 90% of a real estate investment trust's net income must be paid to shareholders, a percentage far greater than many stocks. NAREIT states "REITs' reliable income returns have been one of the chief drivers in the industry's performance."[7] Another reason is due to the overall strong historical performance of the real estate market. Other than the real estate crash of 2007-2008, real estate is typically a profitable industry. REITs help take advantage of the

[1] http://www.investopedia.com/terms/r/reit.asp
[2] http://finance.yahoo.com/news/dividend-payout-ratios-reach-15-201610159.html
[3] https://www.reit.com/sites/default/files/portals/0/Data-Research/Slide-AM-full.pdf
[4] https://www.reit.com/sites/default/files/portals/0/Data-Research/Slide-AM-full.pdf
[5] https://www.reit.com/sites/default/files/portals/0/Data-Research/Slide-AM-full.pdf
[6] Fidelity Investments CMSG Weekly Market Update and A Case for Total Bond
[7] https://www.reit.com/investing/reit-basics/reit-financial-benefits/reits-and-income

profitable industry by providing investors access to the real estate market, while still maintaining the liquidity of a stock portfolio. This liquidity is also another reason REITs are attractive to investors. Typically, accessing the real estate market means purchasing physical real estate property, thus tying up one's money until one is able to sell the property. If the market is in a down turn, it may take some time to sell the asset and recoup funds. During low market performance property buyers may not break even at all. Buying and selling REITs however, is just as simple as buying and selling stock. This makes REITs much more liquid than traditional real estate and therefore much more attractive to the average investor.

REITs also serve as a method to diversify one's investment portfolio. REITs represent a completely different sector of the economy than stocks do. Even the most diversified stock portfolio is still subject to the tremendous volatility of the stock market. REITs offer an alternative investment that is equally liquid, yet provides increased diversification. Falling oil prices can negatively impact the entire stock market, but falling oil prices would likely have little impact on REITs. NAREIT conducted a study measuring performance of an investment portfolio comprised of 60% stocks and 40% bonds against a portfolio comprised of 50% stocks, 40% bonds, and 10% REITs. From January 1990–December 2014, the portfolio containing REITs experienced 0.25% higher growth and 0.21% less volatility[8]. This is just one example of how diversification with REITs can provide greater return on investment.

One of the main counterarguments to investing in REITs stipulates rising interest rates significantly impede the returns of REITs. In an economy where rates are likely to rise, REITs will

[8] https://www.reit.com/investing/reit-basics/reit-financial-benefits/reits-and-diversification

not experience their traditionally high rates of return. While it is true that, with all else being equal, rising interest rates may negatively impact the housing market, and therefore REIT performance, it is not the case that REITs always perform poorly in such an environment. According to S&P Dow Jones Indices, there have been six periods in the past forty years where interest rates have risen significantly[9]. Even in these six periods, REITs still outperformed the S&P 500 three times, only lagging behind the stock market in two of those six periods. This is because rising interest rates are generally "associated with other factors that positively affect REIT fundamentals."[10] Rising rates usually signal the existence of a strong economy, bringing with it higher rent growth and occupancy rates, which helps real estate investments[11]. While an economy in which interest rates are increasing is certainly not the best environment for REITs, rates are not the overall determinate of REIT performance.

In conclusion, my hypothesis that real estate investment trusts had outperformed the S&P 500 and gold over the past twenty years. When measured in compound annual total returns, REIT's outpaced the S&P 500 by 2.09% in the past twenty years and beat gold by 3.24% over the same time period. This is due primarily to high dividends REITs pay out, as well as the ability of REITs to perform well when interest rates are both rising and falling. Looking forward into the future, I see more of the same concerning the performance of REITs compared with the S&P 500 and gold. That being said, I expect the S&P 500 to narrow the gap in compound annual total returns in the coming months as the market recovers from the chaos caused by low oil

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[9] http://us.spindices.com/documents/research/the-impact-of-rising-interest-rates-on-reits.pdf
[10] http://us.spindices.com/documents/research/the-impact-of-rising-interest-rates-on-reits.pdf
[11] http://money.usnews.com/money/personal-finance/mutual-funds/articles/2015/06/02/3-reasons-to-add-reits-to-your-portfolio

prices. Overall, real estate investment trusts have shown that they are a valuable addition to an investor's portfolio and there is little to suggest they will not be in the future.