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Real Estate Insight

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The case for REITs as interest rates rise

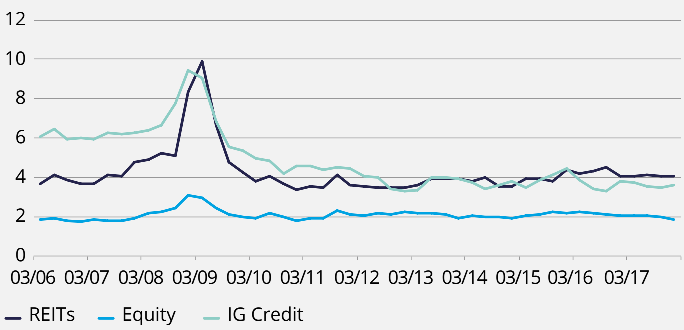
Executive summary

- Investors often consider real estate investment trusts (REITs) as similar to fixed income securities, offering a steady income stream and historically outperforming equities when interest rates fall.
- REITs can also deliver capital growth, benefiting from economic growth to a greater extent than fixed income securities. This could lead investors to believe that REITs will underperform when interest rates rise.
- However, research shows that REITs tend to deliver consistent, positive performance whether interest rates are rising or falling.
- Multi-asset investors should therefore consider any overreaction to rising market rates as a buying opportunity.

Introduction

Investors often perceive REITs as having similar characteristics to fixed income securities. This is true to an extent. REITs offer a consistent income stream, at a similar yield to investment grade credit and ahead of the dividend yield available from equities (see Chart 1).

Chart 1: Income yield



Source: Bloomberg, US REITs, US Equity and US IG Credit

However, a key differentiator for REITs versus fixed income is their potential to benefit from economic growth and outperform fixed income in a rising interest rate environment.

Only a portion of REIT returns come from rental income, with the rest from capital appreciation. As economic conditions improve, the value of buildings owned by REITs rises as businesses seek additional space. Supply of space cannot respond as quickly in response to this increased demand, due to limitations on land availability, planning/zoning restrictions, and long construction lags. This pushes pricing power to commercial real estate landlords, who are able to ask prospective tenants for higher rents and raise distributions to shareholders.

Interest rates generally tend to rise when economies as performing well, to prevent them from overheating. It therefore logically follows that REITs could (and as we will show historically do) perform positively as interest rates rise.

An investment for all seasons

Chart 2 shows the performance of US REITs since 2000 both in absolute terms and relative to equities and investment grade corporate debt. We have split performance into periods where the 10-year US Treasury yield was rising or falling, and where corporate debt credit spreads were widening or tightening. We use the 10-year yield as the measure of interest rate movements, as it is the underlying market 'risk-free' interest rate. Corporate bond yields are comprised of the 'risk-free' rate and a premium to compensate for the risk of default (known as the credit spread). We can use credit spreads as a proxy for economic growth, tightening when economic growth is higher, as there is less general risk of corporate debt defaults. Credit spreads link economic growth expectations with fixed income returns, making them a very useful metric for historical analysis.

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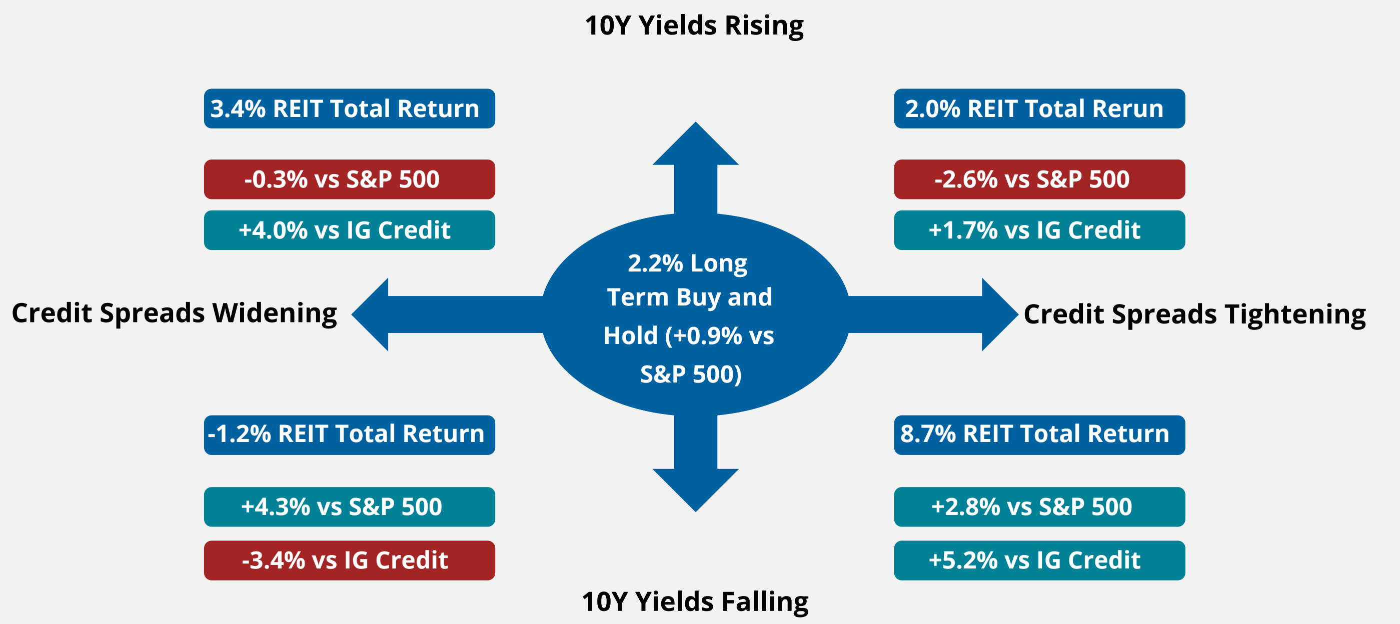
Chart 2: REIT returns in changing credit spread and bond yield environments (2000-2017)

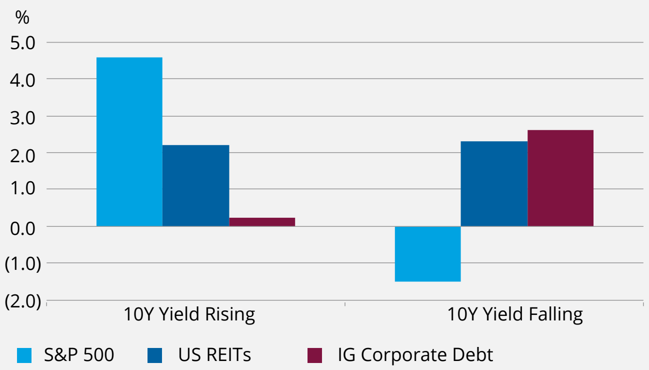


Past performance is not indicative of future returns.
Source: Bloomberg. Quarterly Returns in USD. REITs measured by FTSE EPRA/NAREIT US REIT Index, Equities by S&P 500 Index, and IG Credit by Bloomberg Barclays US Corporate Total Return Value Unhedged USD Index. (Counts (10Y/Spreads) Rising/Widening 5.6%, Falling/Widening 33.3%, Rising/Tightening 41.7%, Falling/Tightening 19.4%)

REITs have performed positively versus investment grade credit when yields are rising, driven by economic growth. In addition, REITs outperformed at least one of equity and investment grade credit in each quadrant. This makes them an attractive proposition when held within a multi-asset portfolio.

Splitting out the two factors (interest rates and credit spreads) shows the performance of each asset class in more detail. Considering interest rates in isolation, REITs perform similarly in both rising and falling interest rate environments (see Chart 3).

Chart 3: Quarterly returns in changing interest rate environments (2000-2017)

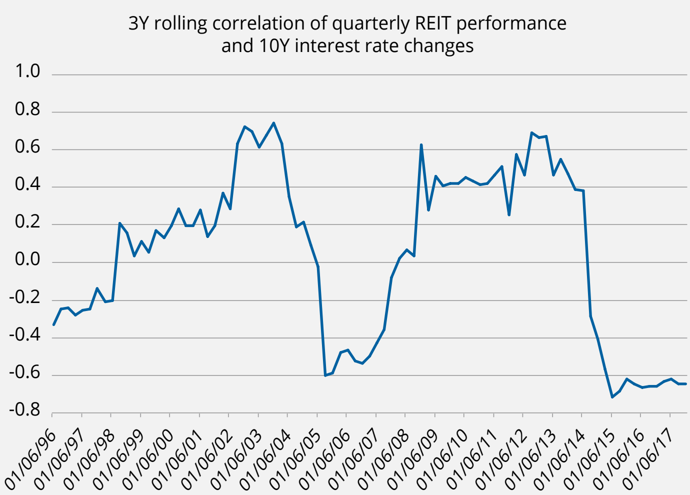


Past performance is not indicative of future returns. Source: Bloomberg. Quarterly Returns in USD. REITs measured by FTSE EPRA/NAREIT US REIT Index, Equities by S&P 500 Index, and IG Credit by Bloomberg Barclays US Corporate Total Return Value Unhedged USD Index.

We see that when 10-year yields are falling, REITs and investment grade credit outperform equities. However, when yields are rising, REITs have historically offered positive returns, outperforming investment-grade credit. Given their strong performance regardless of interest rate moves, multi-asset investors should therefore consider any short-term drop in REITS when interest rates are rising as a buying opportunity.

The finding that REITs perform similarly in rising and falling interest rate environments is confirmed by looking at a rolling three-year correlation of quarterly REIT index returns and changes in the US 10-year rate. The relationship between REITs and government bonds is not consistent, REITS do not always respond negatively to rising interest rates. This could be a function of an abnormally long period of low interest rates. However, the inconsistent relationship was present prior to the global financial crisis and associated monetary policy responses.

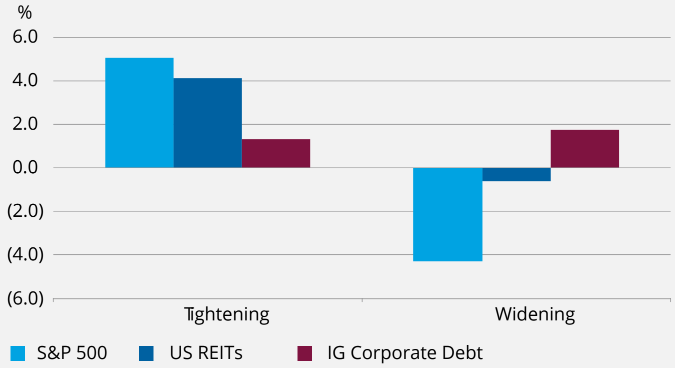
Chart 4: Three-year correlation between REITs and US 10-year interest rate changes



Source: Bloomberg. Quarterly Returns in USD

Turning to credit spreads, changes here have an impact on REIT performance much more than changes in interest rates (see Chart 5).

Chart 5: Quarterly returns versus changing credit spreads (2000-2017)



Past performance is not indicative of future returns.
Source: Bloomberg. Quarterly Returns in USD. REITs measured by FTSE EPRA/NAREIT US REIT Index, Equities by S&P 500 Index, and IG Credit by Bloomberg Barclays US Corporate Total Return Value Unhedged USD Index.

The capital growth element of REITs and the sensitivity to economic growth can be seen clearly, with positive performance (marginally below that of equities) when credit spreads are tightening. Conversely, when spreads widen, REITs deliver a negative return although still outperform equities. For the multi-asset investor, REITs have outperformed one of equities and credit whether spreads are tightening or widening, meaning an allocation to REITS in an equity and corporate debt portfolio has historically boosted returns in either environment.

Summary

When considering REITs within a multi-asset portfolio, it is important to remember that they have historically performed very differently to investment grade credit, despite offering a similar income yield.

REIT returns are linked to economic growth through both capital value increases and increased rental growth. REITs have also historically had higher shareholder returns when credit spreads are tightening than when interest rates are falling.

In summary, REITs capture the benefits of both credit and equities, and have historically been more immune than equities to falls in economic growth (as will benefit from rate cuts), and more immune to rising yields than fixed income (as will benefit from economic growth). If historical trends continue, long-term multi-asset investors could consider any sell-off in reaction to rising yields as a buying opportunity.

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