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REIT's 20-Year Track Record Shows It Beat Private Equity Funds On a Regular Basis

By Joseph Dobrian

Recently published studies by several research, investment and real estate services firms have revealed that real estate investment trusts (REITs) have outperformed all types of private real estate investment funds in the 20 years of the modern REIT era.

Studies by Morningstar, Cohen & Steers, Kingsley Associates and others suggest that REITs experience stronger "bull markets" than the private funds generally favored by large institutional investors; they recover more quickly from downturns; their fees and other expenses to investors are lower.

Still, San Francisco-based Kingsley Associates's 2011 survey reports that institutional investors plan to place 72.7% of their total real estate allocations into private equity funds, and only 7.4% into publicly traded REITs. An uptick of investment in private opportunistic funds is another noticeable change—despite the fact that many investors took significant losses from those funds in the crash of 2008.

Over the 20-year period that the Morningstar study examined, the average annual return on equity REITs was 9.3%. By comparison, opportunistic funds—the riskiest type of real estate funds—produced 6.1%. Value-added funds, which are slightly less risky, returned 3.7%, while core funds, which invest in the safest properties, gave an average annual return of 4.4%.

"REITs should be part of a long-term investment strategy," says Chicago-based Morningstar analyst Philip Martin. "The incomes are there; the risk/reward ratio is there. Historically, REITs perform well relative to other asset classes in times of rising inflation, slow economic growth and higher interest rates."

Private Funds Problematic

Institutional investors often prefer private equity funds over REITs because a private fund doesn't have a stock price that varies from day to day. It's judged on the perceived market value of its properties, which are appraised every quarter. However, when the market turns down and property values drop, investors in private funds often can't get out of the investment until it's too late.

Mike Grupe, executive vice president of research and investor outreach at the Washington-based National Association of Real Estate Investment Trusts (NAREIT), explains that between 85%



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and 90% of all investment in commercial real estate is done through a variety of private or direct real estate investment platforms—and between 10% and 15% through public platforms, almost all of them REITs. The latter figure would be higher, he suggests, if investors understood that REITs are less volatile than they appear.

"With REITs, you have liquidity in any and all cases," he says. "Moreover, Morningstar compared the performance of public and private real estate investment over the past 18 years through the most recent complete real estate cycle. The comparisons over that long term are dramatic. Added up, equity REITs had a net total return of 801% over those nearly two decades. Core funds returned 272%; value-added funds, 320%; opportunity funds, 617%. Those numbers were calculated net of fees and expenses: not gross returns."

The Morningstar study also showed the numbers on various investment vehicles during the bull market phase of their cycles. Since different investments performed better over slightly different periods, the study examined how each type performed during its bull market, regardless of how other types were doing. Again, based only on peak periods, public REITs took the lead, with opportunity funds running a good second.

"Considering the problems that pension funds face today, it doesn't make sense to underweight the better returns to be had in public markets,"

Mr. Grupe concludes.

Joseph M. Harvey, president and chief investment officer of Cohen & Steers in New York, an investment management firm that specializes in real estate, suggests that institutional investors have a long-standing bias against REITs on the grounds that owning a REIT stock doesn't really count as owning real estate. This, he says, is a mistaken belief.

Driven By Assets

"There's always been this idea that REITs aren't real estate; they're stocks," Mr. Harvey says. "However, the cash flows of REITs are driven by occupancies and rents, and the stock price is driven primarily by net asset value. The only reason why REIT stocks look volatile is that the underlying assets—the buildings—aren't trading hands every minute in an auction environment. You can't compare the volatility of private and public real estate; you have to turn the analysis on its head and look at it on a long-term-hold basis. Over the long haul, returns from REITs are more predictable than those of direct real estate. If you're not troubled by day-to-day fluctuation, REITs are the superior investment."

Andrew Moylan, manager at London-based provider of research and data to the alternative assets industry Preqin, suggests that some investors not only perceive REITs as stocks, but tend to treat them as such—which might be counter-productive.

"Private equity funds are usually seen as an eight- to 12-year investment, with limited liquidity and long-term returns," he says. Investment in REITs might also be part of a buy-and-hold strategy, he suggests, especially if they're tightly focused.

"Private funds provide investors with greater control than REITs do," concedes James Woidat, principal at Kingsley Associates, a real estate research and consulting firm. "Investors value REITs for the remarkable liquidity they provide, but they're challenging if you're pursuing a value-added or opportunistic strategy. With REITs, you have less control over your investments."

REITs might also become more popular investments for pension funds that are moving away from defined benefit platforms (in which actuarial obligations have to be met), in favor of contribution-based 401(k) plans, Mr. Woidat adds.

Private equity funds might still be useful investments for those who seek opportunistic or value-added plays, but REITs will continue to dominate the ownership of Class A or institutional-quality real estate in the U.S., predicts Steven R. Brown, senior portfolio manager for

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Kansas City, Mo.-based American Century's real estate and global real estate funds.

"Real estate's appeal as an alternative/hard asset class is growing," says Mr. Brown. "REITs have daily liquidity and pricing, while private real estate funds have minimal liquidity, and lock-up periods."

"Since 2009, REITs have seen significant recapitalization, acquisition, and growth," says Shelby Pruett, chairman and CEO of Chicago-based Equity Global Management, a private equity real estate investment firm. "However, there are 'haves' and 'have-nots' among REITs. Of those that have gone public in the past 18 months, some have significantly underperformed. They've been handcuffed by a number of things including their initial pricing, which was severe for REITs going out the door, and their capital has proven more expensive than that of their peers. But REITs in general are doing well in today's economic climate because many are seen as low-risk, sustainable dividend machines, and highly attractive fixed income alternatives."