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# Resetting the REIT Cycle

## Why Real Estate Should Be on Your Radar as Growth and Inflation Ramp Up

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We see a buying opportunity shaping up in U.S. REITs, as valuations have improved and Donald Trump's election has primed the pump on growth and inflation expectations. While much is still unknown, we see potential for the kind of policy upheaval that could change the shape of real estate fundamentals and values for the better through stronger demand and slower new supply.

### Highlights

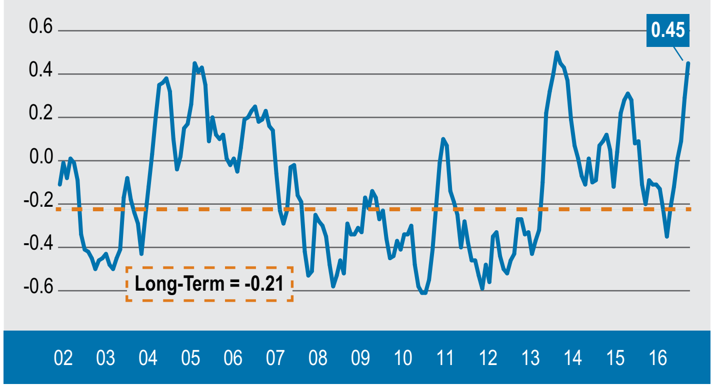
- Backed by a party-aligned Congress, President-elect Trump may move aggressively to enact fiscal stimulus, tax cuts, deregulation and protectionist measures, carrying implications of higher inflation and stronger growth in the U.S., but also adding risks due to uncertainties around trade and geopolitics.
- Increased business and consumer confidence, and consequent spending and job growth, could drive stronger demand for real estate while higher input costs and rising return requirements could reduce the economic incentives to add new supply.
- With REITs offering 4%+ yields and valuations looking better, we believe further volatility could present opportunities to increase real estate allocations. In the 10 times since 1990 that the REIT market has fallen below net asset value (NAV), as it did in October, it has had an average 17% total return over the following 12 months (page 3 sidebar).(1)

### What's Driving the REIT Correction?

REITs have declined 14% since the beginning of August amid concerns of rising interest rates and slowing cash flow growth, along with a stock-market rotation into sectors seeing greater inflection in fundamentals such as banks.(2) While growth is always an important factor, it can take on a greater significance amid rising rates, buffering the effects of higher yields on property values and financing costs. The important thing, in our view, is that rates are rising due to higher growth and inflation expectations, which tend to benefit real estate.

While REITs have historically had low correlations to bonds, they have become more sensitive to changes in bond yields since 2013 due to the end of quantitative easing and zero-percent interest rates (Exhibit 1). In the longer term, however, REIT returns are driven mostly by fundamental factors such as cash flows, competitive positioning and the value of a company's property holdings. With the economy still improving, we believe REITs should be able to perform well based on dividend yields above 4%, continued strong cash flow growth and attractive valuations relative to the private market. And then there's the Trump factor—which could be a game changer for the economy, potentially extending the real estate cycle.

**Exhibit 1: Correlation—U.S. REITs vs. 10-Year Treasury**
Rolling 90-Day Periods, 2002–2016 YTD




**At October 31, 2016.** Source: Morningstar, Cohen & Steers.

*Data quoted represents past performance, which is no guarantee of future results.* The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. Correlation is a statistical measure of how two assets move in relation to each other. Index associations shown below; see page 4 for additional disclosures.

(1) NAV (net asset value) is the estimated market value of a REIT's property assets less any liabilities. (2) All data in this report as of November 17, 2016, except monthly data as indicated, ending October 31, 2016. Index associations shown below; see page 4 for additional disclosures.

**Index Associations for This Report:** REITs: FTSE NAREIT Equity REIT Index. 10-Year Treasuries: Barclays Capital 10-Year U.S. Treasury Bellwethers Index. Stocks: S&P 500 Index. Bonds: Barclays Capital U.S. Aggregate Bond Index. See page 4 for index definitions.

## Trump's Policies Could Hit the Reset Button on Real Estate

We believe policy changes under the Trump administration could speed up the U.S. economy and drive higher inflation, potentially causing real estate fundamentals to improve at a critical time.

Trump's key policy pillars have included more infrastructure spending, lower corporate and individual tax rates, a reduction of regulatory burdens, and protections for low-income workers through higher trade and immigration barriers. With Republicans in control of both chambers of Congress, we see a strong chance that many of Trump's legislative priorities will be implemented in some form.

The details of how these policies are enacted will be critical in determining the ultimate economic impact. In particular, questions about Trump's global trade policy and geopolitical strategy are likely to remain unanswered until he takes office. But gauging from the post-election spike in Treasury yields, markets are already anticipating higher inflation and growth. We believe REITs could perform well in such an environment, after two years of compression in earnings multiples.

Although real estate fundamentals are still strong, the cycle appears to be in its later stages, with increased supply beginning to pressure some markets and external growth opportunities becoming more scarce. We believe higher growth and inflation rates could essentially reset the cycle through accelerating demand and slowing new supply.

On the demand side, more fiscal spending and lower taxes could drive job growth, corporate profits and increased consumption through wage inflation. On the supply side, higher inflation may pressure the environment for construction. Higher costs for labor, raw materials and financing would, in turn, mean a higher cost to replace aging real estate, raising the value of existing properties.

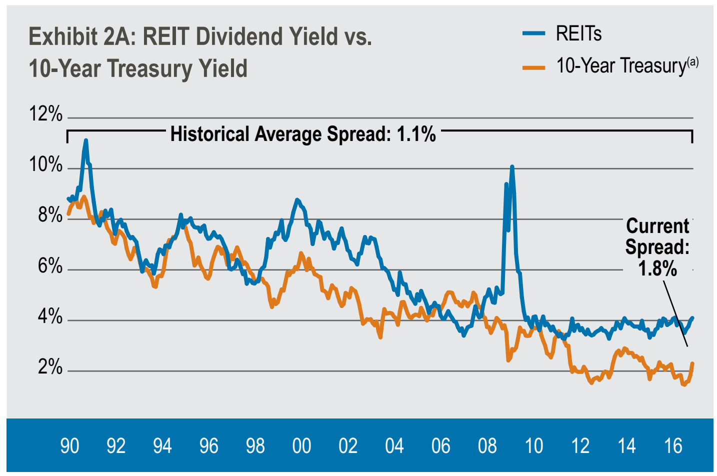
With occupancy rates in the U.S. already at high levels, a tailwind of demand amid reduced supply growth could be an important driver of REIT fundamentals in the long run. For now, we believe REITs have become more attractive due to compressed valuations and the potential for better growth.

Regarding the impact of tax reforms, lower corporate tax rates would generally not benefit REITs as they might for other companies, since REITs are not taxed on distributed income. However, because REIT dividends are taxed as ordinary income for investors, lower personal income tax rates could result in improved after-tax returns on dividends.

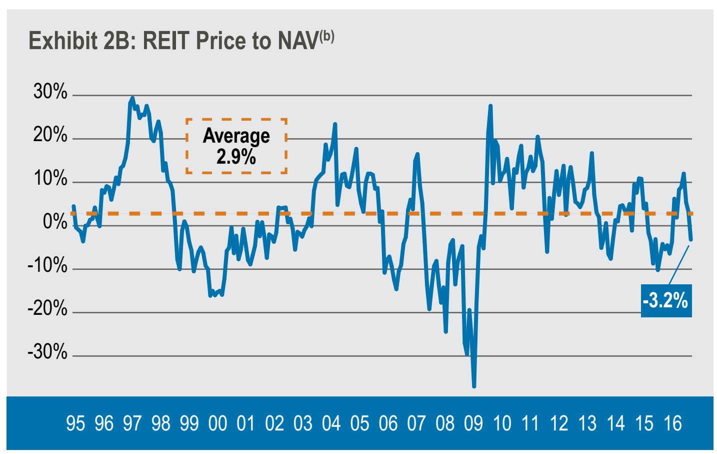
## The Correction in REIT Prices Has Led to Improved Valuations

Absolute and relative valuations have improved significantly since the selloff over the past several months. The REIT market is trading at roughly the same level as it did two years ago, despite achieving cash flow growth in the high single digits. As shown in Exhibit 2A, REITs currently provide a 4.1% dividend yield—a 1.8% premium over the 10-year Treasury, compared with an average premium of 1.1% since 1990.

**REIT Valuations Have Improved Relative to Bond Proxies (2A) and the Private Market (2B)**




**At November 17, 2016.** Source: Morningstar.




**At October 31, 2016.** Source: UBS.

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(a) Treasury yield shown on a yield-to-maturity basis. (b) Price-to-NAV is a valuation metric for REITs, similar to price-to-book value. Book value is based on historical costs and does not reflect the rise/fall of property prices; therefore REITs use NAV. Index associations shown on page 1; see page 4 for additional disclosures.

Investors are also now able to buy real estate through REITs at a lower price than they would likely find in the private market. As shown in Exhibit 2B, REITs ended October at a 3.2% overall discount to the private-market value of their property holdings, as measured by NAV. In the U.S., this is usually not the case, as the listed market typically factors in a premium (see sidebar).

## REITs Have Historically Had Strong Returns After Falling to NAV Discounts

U.S. REITs have generally commanded a premium to NAV. This is due to managements' track record of adding value through acquisitions, property upgrades and development, as well as to operating efficiencies from managing similar assets. Since the beginning of the modern REIT era in the early 1990s, there have been 10 instances where REITs have fallen to a discount to NAV after trading at premiums for at least six months. Most of these discounts occurred when the economy was expanding and fundamentals were strong—as is the case today. In the 12 months following these occurrences, REITs generated an average total return of 17% and ultimately returned to trading at premiums to NAV. To be clear, we are not suggesting that NAV discounts alone are a buy signal, but rather that REIT share prices can see temporary corrections amid broader fundamental bull markets.

**U.S. REIT Premium/Discount to NAV and Total Returns**

| | | 12 Months Later | |
|---|---|---|---|
| **Months When REITs Began Trading at Discounts to NAV After 6+ Months at Premiums to NAV** | **Discount to NAV at Month End** | **Total Return** | **Premium or Discount to NAV** |
| October 1994 | -0.7% | 12.2% | -1.7% |
| November 1995 | -0.1% | 29.2% | 19.0% |
| August 1998 | -7.7% | 2.7% | -9.2% |
| September 2002 | -0.7% | 25.2% | 11.8% |
| December 2005 | -10.8% | 35.1% | 3.8% |
| May 2007 | -3.7% | -11.9% | -3.3% |
| September 2011 | -6.0% | 32.6% | 5.5% |
| August 2013 | -5.1% | 24.1% | 5.0% |
| September 2014 | -1.1% | 9.9% | -7.1% |
| April 2015 | -1.6% | 10.5% | 6.2% |
| October 2016 | -3.2% | – | – |
| **Average** | **-3.8%** | **17.0%** | **3.0%** |

**At October 31, 2016.** Source: UBS and Cohen & Steers.

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If REITs stay at NAV discounts for a prolonged period, it could entice boards of directors to consider mergers and acquisitions that would enable shareholders to realize the value of the REIT's holdings and management platform. Some REITs are currently trading at greater than 15% discounts to NAV, which may invite offers from other listed REITs or private equity real estate investors, providing potential support to valuations.

## What About Rising Interest Rates?

The challenge for investors with respect to interest rates is that while bond yields change quickly, changes in real estate fundamentals take time to work through the system. We believe that as long as the rise in long-term rates is commensurate with improvement in growth, REITs can perform well. In fact, REITs have historically delivered strong returns in periods of rising yields, as these periods are generally characterized by accelerating economic growth.

Looking at the past 20 years, there have been seven periods in which 10-year Treasury rates experienced a sustained rise of 50+ basis points over a period of one year or more (Exhibit 3). REITs had positive returns in six of those periods, and they outperformed the S&P 500 in five.

## Opportunity Amid Rate-Driven Volatility

Too often, we see investors focusing on short-term changes in interest rates, yet losing sight of the bigger picture. As investors look to construct portfolios suited for the current environment, we believe REITs offer attractive attributes:

- Yield with growth potential: The 158 companies in the FTSE NAREIT Equity REIT Index have an average dividend yield of 4.1%. In the S&P 500, real estate is currently the third-highest-yielding sector at 3.5% (28 companies represented), compared with the S&P average of 2.1%. REITs have historically provided steady dividend growth along with capital-appreciation potential.
- Inflation protection: REITs have historically been positively correlated to unexpected changes in inflation, compared to the negative inflation associations with broad stocks and bonds.
- Potential diversification benefits: Since 1990, REITs have had a 0.55 correlation with broad equities and a 0.19 correlation with bonds. Combining assets with different performance drivers offers the potential to improve risk-adjusted returns.

When the economy is improving and fundamentals are strong, yield-driven corrections are often a time to consider adding allocations to real estate securities. While REIT prices may be sensitive to changes in interest rates in the short term, long-term performance depends more on real estate fundamentals and the strength of the overall economy. We believe investors who are aligned to take advantage of temporary dislocations resulting from rising interest rates may be rewarded in the long term.

**Exhibit 3: Asset-Class Performance in Periods of Rising Treasury Yields**

| | 10-Year Treasury Yield | | | Cumulative Total Return During Periods of Rising Rates | | |
|---|---|---|---|---|---|---|
| **Period of Rising Rates** | **Beginning** | **Ending** | **Change (bps)** | **REITs** | **Stocks** | **U.S. Bonds** |
| 12/95–3/97 | 5.6% | 6.9% | 134 | 36.2% | 26.3% | 3.1% |
| 9/98–1/00 | 4.4% | 6.7% | 224 | -7.1% | 39.4% | -0.8% |
| 2/01–3/02 | 4.9% | 5.4% | 50 | 24.0% | -6.1% | 5.9% |
| 5/03–5/04 | 3.4% | 4.7% | 129 | 26.1% | 18.3% | -0.4% |
| 6/05–6/06 | 3.9% | 5.2% | 121 | 19.1% | 8.6% | -0.8% |
| 12/08–12/09 | 2.3% | 3.9% | 160 | 28.0% | 26.5% | 5.9% |
| 7/12–12/13 | 1.5% | 3.0% | 153 | 3.3% | 38.3% | -1.6% |

**At October 31, 2016.** Source: Bloomberg and Cohen & Steers.

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The Barclays Capital U.S. Aggregate Bond Index is a broad-market measure of the U.S. dollar-denominated investment-grade fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities. The Barclays Capital 10-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds used as a benchmark for long-term maturity fixed-income securities and assumes reinvestment of interest. FTSE NAREIT Equity REIT Index contains all tax-qualified REITs except timber and infrastructure REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. S&P 500 Index is an unmanaged index of 500 large-capitalization, publicly traded U.S. stocks representing a variety of industries.

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