# The Impact of Rising Interest Rates on REITs

CONTRIBUTOR

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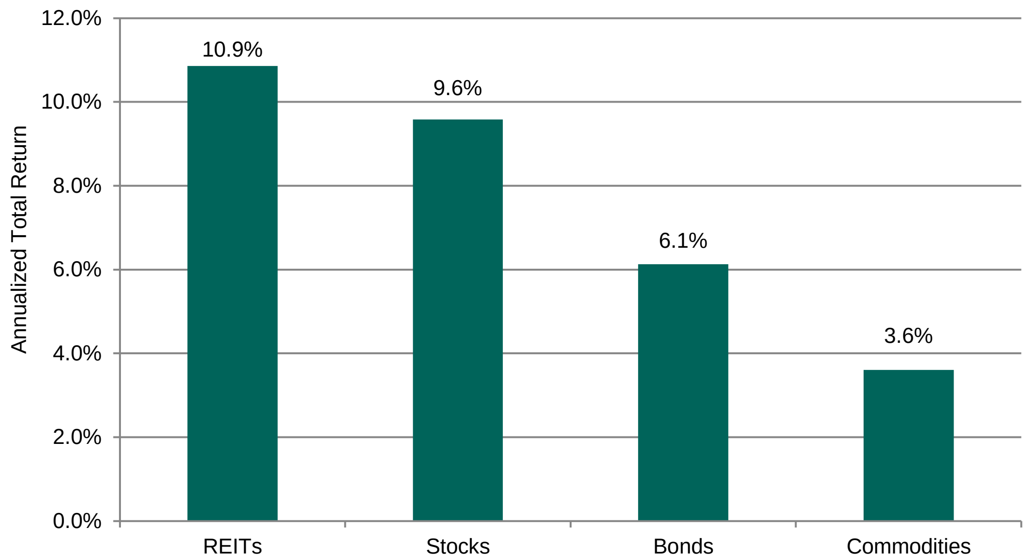
Over the past two decades, real estate investment trusts (REITs) have emerged as a popular and efficient way for investors of all stripes to access the real estate asset class. Strong long-term total returns, combined with other key investment characteristics such as liquidity, high dividend yields, and their potential to increase diversification and to hedge against inflation, have contributed to the appeal of REITs. Today, however, there is growing concern about how REITs will perform when interest rates ultimately rise from their current subdued levels.

**Exhibit 1: REITs Outperform Other Major Asset Classes (September 1994 – September 2014)**




Source: S&P Dow Jones Indices LLC; Barclays Capital. Data as of Sept. 30, 2014. REITs, Stocks, Bonds and Commodities are represented by the Dow Jones U.S. Select REIT Index, the S&P 500, Barclays Capital U.S. Aggregate Index and the S&P GSCI, respectively. Past performance is no guarantee of future results. It is not possible to invest directly in an index, and index returns do not reflect expenses an investor would pay.

It is commonly asserted that REITs are destined to underperform when interest rates rise. However, an examination of the historical record suggests that this is a misconception. Although interest rates certainly affect real estate values and, therefore, the performance of REITs, rising interest rates do not necessarily lead to poor returns.

Since the early 1970's, there have been six periods during which U.S. 10-Year Treasury Bond yields rose significantly. In four of those six periods, U.S. REITs earned positive total returns, and in half of those periods, U.S. REITs outperformed the S&P 500®. In one of the periods, U.S. REITs and the S&P 500 essentially posted identical performances, and in only two periods did the S&P 500 outperform U.S. REITs (see Exhibit 2).

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**Exhibit 2: REIT Performance During Sustained Periods of Rising Interest Rates**

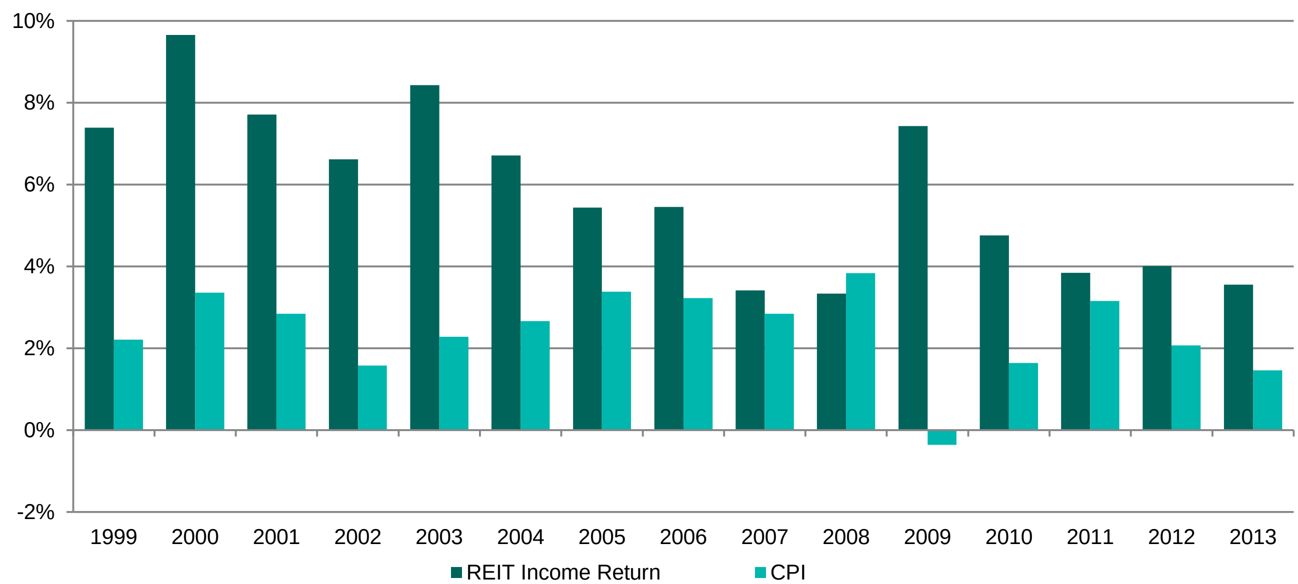
| U.S. 10-Year Treasury Yield | | | | Cumulative Total Return Over Period | | |
|---|---|---|---|---|---|---|
| Time Period | Beginning Yield (%) | Ending Yield (%) | Change (%) | REITs (%) | Stocks (%) | Difference (%) |
| December 1976-September 1981 | 6.9 | 15.3 | 8.5 | 137.4 | 46.0 | 91.4 |
| January 1983-June 1984 | 10.5 | 13.6 | 3.1 | 35.6 | 16.5 | 19.1 |
| August 1986-October 1987 | 7.2 | 9.5 | 2.4 | -10.1 | 10.9 | -21.0 |
| October 1993-November 1994 | 5.3 | 8.0 | 2.6 | -10.3 | 0.1 | -10.3 |
| October 1998-January 2001 | 4.5 | 6.7 | 2.1 | 27.4 | 27.8 | -0.4 |
| June 2003-June 2006 | 3.3 | 5.1 | 1.8 | 108.2 | 37.6 | 70.6 |

Source: S&P Dow Jones Indices LLC, Bloomberg, The Federal Reserve. REIT total returns are based on the FTSE/NAREIT Equity Index from Dec. 31, 1971 to Dec. 31, 1986, and they are based on the Dow Jones U.S. Select REIT Index after Dec. 31, 1986. Stock total returns are based on the S&P 500. Past performance is no guarantee of future results. It is not possible to invest directly in an index, and index returns do not reflect expenses an investor would pay.

Undoubtedly, rising interest rates pose challenges for REITs. All else being equal, higher interest rates tend to decrease the value of properties and increase REIT borrowing costs. In addition, higher interest rates make the relatively high dividend yields generated by REITs less attractive when compared to lower-risk, fixed income securities, which reduces their appeal to income-seeking investors.

While it would require a much more detailed study to attempt to determine why REITs have generally fared well in rising interest rate environments, it is clear that rising interest rates are associated with other factors that positively affect REIT fundamentals. For example, rising interest rates are frequently associated with economic growth and rising inflation, both of which are likely to be positive for real estate investments. Healthy economic growth tends to translate into greater demand for real estate and higher occupancy rates, supporting growth in REIT earnings, cash flow and dividends. In inflationary periods, real estate owners typically have the ability to increase rents, and REIT dividend growth has historically exceeded the rate of inflation as a result. As depicted in Exhibit 3, the income component of REIT returns has exceeded inflation (as measured by the Consumer Price Index [CPI]) in 14 out of the past 15 years.

**Exhibit 3: REIT Income Growth Has Outpaced Inflation**




Source: S&P Dow Jones Indices LLC; The Bureau of Labor Statistics. REIT Income Return is calculated as the annual difference in return between the DJ U.S. Select REIT Price and Gross Total Return Indices. Past performance is no guarantee of future results. It is not possible to invest directly in an index, and index returns do not reflect expenses an investor would pay.

## A Note on Unexpected Short-Term Interest Rate Changes

When expectations about future interest rates change suddenly, REITs (as well as other asset classes) have often experienced high volatility and rapid price changes. This phenomenon was evident in May 2013, when Fed Chairman Ben Bernanke suggested that the QE taper could start earlier than most market participants expected. The Chairman's comments led to a sharp selloff of REITs and of some other asset classes, such as emerging market equities, that were viewed as reliant on "easy money" from the Fed. The Dow Jones U.S. Select REIT Index dropped 15.8% from its peak on May 21, 2013 (the day preceding the Fed comments), to its 2013 low on June 22, 2013. However, as markets calmed, the index recovered most of its losses by mid-July 2013 and has reached new highs in 2014.

## Conclusion

Ultimately, whether interest rates are rising or falling does not seem to be the key driver of REIT performance over medium- and long-term periods. Rather, the more important dynamics to address are the underlying factors that drive rates higher. If interest rates are rising due to strength in the underlying economy and inflationary activity, stronger REIT fundamentals may very well outweigh any negative impact caused by rising rates.

## About the Dow Jones U.S. Select REIT Index

Introduced in 1987, the Dow Jones U.S. Select REIT Index is one of the oldest and most widely used REIT benchmarks. It is designed to measure the performance of publicly traded U.S. REITs and serve as a proxy for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate.

### Index Methodology Overview

#### Inclusion Requirements

1. A company must be both an equity owner and operator of commercial and/or residential real estate.
2. At least 75% of total revenue must be derived from the ownership and operation of real estate assets.
3. The company must have a minimum float-adjusted market cap of USD 200 million.
4. The ratio of a company's one-month total value traded to its float-adjusted market cap must be at least 15% for the three consecutive months prior to the rebalancing.

#### Exclusions

1. Mortgage REITs, hybrid REITs, specialized REITs (including net-lease REITs, timber REITs, railroad REITs, tower REITs, prison REITs, etc.).
2. Real estate finance companies, home-builders, mortgage brokers and bankers, commercial and residential real estate brokers, real estate agents and large landowners.
3. Companies that have more than 25% of their assets in direct mortgage investments.

#### Constituent Weighting

The index is float-adjusted market cap weighted.

#### Rebalancing

The index is rebalanced quarterly after the close on the third Friday in March, June, September and December.

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