The role of REITs in a portfolio
A “core plus plus” real estate allocation

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IN BRIEF

Over the long term, REITs act like private real estate, supporting their inclusion in investor portfolios as a proxy for or complement to a private commercial real estate allocation.

REITs should most likely be paired with core real estate allocations, but with the acknowledgment that their volatility moves them to a unique position on the risk/return spectrum of core, core-plus, value-added and opportunistic real estate:

- The underlying real estate quality, operations and debt-to-assets leverage of a typical REIT most closely resemble core plus.
- However, on a performance basis, REITs deliver core-like income returns and opportunistic-like price appreciation—“barbell” performance, though with higher volatility.

Unlike bonds, REITs can grow cash flow and payouts. This not only supports appreciation, but can help REITs outpace growth-induced inflation. U.S. REIT dividends could, in our estimation, grow about 6% per year, on average, for the next five years.

It appears to be a good time, tactically and strategically, for investors to consider adding international real estate securities to a U.S. REIT allocation.

The debate has long raged as to whether REITs are equity or real estate, and related to that judgment, where they fit in a portfolio.

When REITs are viewed as equity, investors will often leave the sector to their equity groups and, rather than funding an independent allocation, may accept the exposure they get naturally through their allocations to small-cap, mid-cap and, more recently, large-cap allocations. On the other hand, if REITs are viewed as real estate, then the REIT investment may reside in the real estate allocation, earning a place in a separate sleeve that complements the fund’s private property investments, or for retail investors, serves as the sole source of real estate exposure.

Given investors’ search for yield and the growing popularity of alternative investments, including real estate—the REIT market’s private analog—this paper offers insights on the place and role for REITs in investor portfolios. Additionally, it explores why REITs still make sense for income investors, given the historical response of REITs to an uptick in inflation.
REITs are real estate...over the long term

In the short term, REITs tend to move in line with equities. But over longer periods, REIT returns tend to be positively correlated with real estate returns and lowly-correlated, even negatively correlated at points, with equity returns.

Exhibit 1 compares the correlations of rolling returns (quarterly data) for U.S. REITs with those for private real estate and large-cap equities. Rolling returns were created for multiple hold periods, starting with one year and moving in six-month increments to ten years. The chart depicts the resulting correlations between U.S. REITs and real estate and U.S. REITs and equities for each hold period series. The two key takeaways are (1) as the hold period lengthens, REIT correlations to real estate generally move upwards, but decline, sometimes even turning negative, versus equities; (2) while increasingly smoothed and positive returns over longer hold periods are more likely to result in the convergence of correlations between multiple asset classes, these two series do NOT converge.

Why? In the short term, REIT price movements are impacted, like equity price movements, not only by the performance of the underlying property assets, but also by market factors. Over longer-term holds, however, the impact of these factors is washed out, allowing the performance from REIT property portfolios to come to the fore. In fact, as of December 2011, U.S. REITs delivered 10.2% annualized performance over the past ten years while the S&P 500 only generated 2.9% total returns a year. This outperformance makes sense when put in a real estate context: From 2004 to 2008, REITs benefitted significantly from the most dramatic private real estate bull market documented since the private real estate index data started in 1978 (Exhibit 2). The search for yield may be supporting current REIT markets, but it is only one part of the explanation for ten years of REIT outperformance.

Exhibit 2 offers further support for the case that REITs are real estate. The chart compares returns (indexed to December 1995) for U.S. REITs (both levered and delevered) and real estate (unlevered), from December 1995 (a point of equal valuation for REITs and their underlying portfolios) to December 2011. (See source note to Exhibit 2 for detailed methodology.)

The results are enlightening: The cumulative delevered returns for the 1995–2011 hold period for unlevered REITs and real estate (as measured by the index shown) are essentially the same, while the levered REIT index lies above them. In other words, the underlying returns of U.S. REITs tracked private real estate returns; the outperformance of the U.S. REIT index (levered, as published by NAREIT) over the period shown can be attributed almost exclusively to the use of leverage.

The fact that REITs act like real estate over the long term seems simple when investors consider that property is the
source of REIT cash flows. In fact, REIT returns, when decomposed into income and appreciation, look very similar to real estate returns, the key difference being an appreciation premium for REITs that we believe is largely explained by leverage (Exhibit 3).

EXHIBIT 3: REITS HAVE HISTORICALLY OFFERED A BLEND OF YIELD AND APPRECIATION THAT LOOKS LIKE REAL ESTATE RETURNS

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<td>Equities</td>
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<td>U.S. REITs</td>
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Where do REITs fit in this risk/return, yield/appreciation private real estate investment landscape? If ones looks at the real estate, operations, and leverage of a typical REIT, the answer is “core plus.”

First, REIT portfolio exposure to “top quality” primary metro markets is roughly equivalent to that of the NCREIF Property Index, an index of privately-held core commercial properties (Exhibit 4).

The ability to quantify the “quality” of any real estate portfolio has long been an aspiration of the real estate investment community. We believe the approach used here—calculating how much of a portfolio’s value is in a select group of primary metro markets traditionally favored by real estate investors—is directionally correct. Exhibit 4 compares the percentage of the total cost basis for U.S. REIT properties concentrated in six core) through lease up of vacant space, renovation or repositioning to another use (e.g., converting from office to hotel space). Yield is important, but appreciation is emphasized. Leverage may approach 40% to 60%.

• **Opportunistic** investing, the riskiest flavor, involves either developing new property or buying existing assets at steep discounts before repositioning (like value-added) to create value gains that will significantly outstrip the contribution of yield.

REITs are real estate... but what kind?

The real estate says...

Let’s assume investors now accept REITs as a viable proxy for a long-term investment in commercial real estate. Institutional investors, with the ability to invest in both REITs and private real estate directly, would likely face another round of internal debate as they scrutinized the place of REITs in their overall real estate allocation.

Institutional real estate investors have long categorized direct investments along a risk/return spectrum comprised of core, core-plus, value-added and opportunistic real estate.

• **Core** investments are typically limited to higher-quality property with strong income returns and roughly 0% to 35% leverage in order to minimize risk.

• **Core plus** is simply a core mandate with between 40% to 60% leverage to amplify return on equity.

• **Value-added** investments usually involve acquiring properties that offer an opportunity to improve the quality of the asset (i.e., taking it from secondary-level quality to
primary metros with the exposure, to those same cities, measured by market value, for the NCREIF Property Index. While total cost basis (accounting) and market value (appraisal) may not be directly comparable, it is meaningful that U.S. REITs have about 47% of their portfolios in those property markets, very similar to the 41% exposure for the private property index.

Secondly, contrary to some investor perceptions, REITs, generally, do not appear to be involved in a relatively high-level of ancillary and higher-risk real-estate related activities (such as renovation, ground-up [new] development, and even debt investment [mezzanine, secured private loans]). A comparison of the value of land and development for U.S. REITs (Exhibit 5) versus their gross asset value (estimated value of a REIT company’s assets, including short-term assets, property, land, etc. once marked to market) is, once again, not dissimilar to that exposure in core open-ended private real estate commingled funds.

Finally, REIT leverage, as measured by total debt to gross asset value, generally trends around 40% to 50%. This would put REIT leverage in the core plus range.

But the performance says...

While real estate itself is perhaps critical to long-term performance, ultimately, actual performance should have a say (or THE say) on where REITs should fall along the real estate risk spectrum. Interestingly, on this measure REITs offer “barbell” performance—a blend between core income and opportunistic appreciation.

Exhibits 6A and 6B compare U.S. REIT performance to the returns for core, value-added and opportunistic real estate, on both a quarterly and annual basis. The comparison is over the trough-to-trough period for the real estate long-cycle that bottomed at the end of 1995, and again in March of 2010 (per the ODCE value index). The analysis focuses on quarterly and one-year returns to see where shorter-term relationships were strongest between REITs and the various types of real estate investments considered. The key finding is that REITs deliver income returns over the period that are “core-like,” but price returns that are most highly-correlated to opportunistic investments. (Note: The income correlations are highest for value-added, but value-added income is 0.96 correlated to core income over the period, and therefore, is itself, core-like. Please, see the box on value-added and opportunistic return indices).

VALUE-ADDED AND OPPORTUNISTIC
RETURN SERIES

While we have utilized the Townsend value-added and opportunistic return series in analysis presented in this paper, there are acknowledged weaknesses to those indices. First, these indices are comprised largely of closed-end funds, which do not face the same pressure to accurately and frequently revalue assets as do open-end funds. In particular, valuations post-financial crisis are questionable.

These indices may also not capture fund-level leverage appropriately, such as subscription lines, so the series are probably under-levered in the history, which would understate appreciation in up markets, but underage losses in down markets. Similarly, the participation of funds from quarter-to-quarter is not necessarily consistent, nor is the individual fund reporting of the required data elements.

The opportunistic series does, perhaps, offer some confidence that it is measuring something very different from the higher-integrity NFI-ODCE Index (core) because the income returns trend lower than core, and the appreciation is both significantly higher and more volatile than that of the core series. These are both to be expected. The Value-Added Index, on the other hand, demonstrates very little differentiation (thus, it is almost “core-like”) from the core series in both aspects.
In Exhibit 7, a comparison of the annualized returns for all three categories from 4Q1988 through 3Q2011 provides further evidence of this phenomenon: Over this period, REITs delivered an income return very similar to core and a positive appreciation return approaching that of opportunistic.

We believe this “barbell” risk/return profile is largely explained by significant REIT leverage. While REIT debt to gross assets is right in the core plus range, the picture changes if another measure of leverage, Debt-to-EBITDA, is used.
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Exhibit 8 shows the U.S. REIT weighted average Debt-to-EBITDA multiple from 1996 to 2011. While that multiple sat below 4x in 1996, it recently peaked at 7x, and has just started to improve as REITs have trimmed debt and EBITDA has started to rebound (note: total debt fell in 2009 and 2010 as REITs used equity to reduce leverage, but recent additions to the index have brought total debt back up in 2011). By this measure, REITs are highly levered compared to their own history, and remain so. Given that higher leverage should, theoretically, result in higher equity volatility, the recent REIT volatility premium to the S&P 500 seems a foregone conclusion. It will not likely recede until REIT leverage is reduced, a goal we advocate.

REITs offer stability of income + the ability to weather inflation

Real estate straddles both sides of the typical 60/40 stock/bond portfolio, spanning performance between the two. Over time, real estate has demonstrated that it can generate yields that are not only competitive with other fixed-income alternatives, but also exhibit a long-term stability that contributes to both income generation and total returns. Conversely, when economic prospects improve and inflation increases, real estate and REITs can grow cash flow to deliver price appreciation like equities.

Exhibit 9 provides evidence that higher-yielding investments can offer defensive qualities for longer-term investors by helping to offset price declines. This analysis uses five-year rolling returns, and identifies periods where those five-year holds experienced annualized negative price returns. It is remarkable that, on average, direct real estate and REITs generated enough income to offset those losses (like bonds) and deliver positive annualized returns. As would be expected, bonds performed best over these periods, and equities fared the worst given their low dividend.

Exhibit 8: Measured by Debt/EBITDA, U.S. REIT Leverage is High Compared to its Own History

Notwithstanding this higher volatility, our conclusion stands that REITs offer investors barbell performance, in which a platform of primarily stabilized core real estate delivers core-like income, complemented by volatile, but significant value gains that approach expectations for opportunistic investments. In short, REITs can be characterized as a core-plus fund that has exceeded the high range of its leverage target. It should most likely be paired with core real estate allocations as a unique “core plus plus.”

Exhibit 9: REITs, Like Real Estate And Bonds, Generate a Bond-Like Yield that Underpins Stable Positive Returns Even When Price Returns Are Negative...Equities Do Not


Uses NAREIT Equity Index to represent U.S. REITs, the S&P 500 Index for equities, the Barclays Aggregate Bond Index to represent U.S. Bonds, and the NFI-ODCE Index (levered) for private real estate. The U.S. Bond income return includes the impact of paydown.
Out of the six periods covered, only two, both of which were in the 1990s, saw REITs suffer losses over the entire 13-month period, of roughly -2% to -4%. Investors waiting another 12 months, however, would have ultimately earned positive annualized returns in both periods of between 7% and 12%.

And right now the REIT dividend yield is moving in the right direction

While U.S. REIT dividend yields (3.6% as of March 28, 2011 for the MSCI U.S. REIT Index) are near historic lows, the last two years have seen strong growth in cash dividend yields, and our top-down and bottom-up forecast calls for continued growth of around 6% on average over the 2012–2016 time period.

The analysis shown in Exhibit 12 uses a regression of U.S. REIT annual dividend growth on annual U.S. job growth ($y = 2.4819x - 0.0091$, $r^2=0.56$) for the period from the start of the Modern REIT Era (1992) through to the end of 2008. The 2008 endpoint is chosen to isolate the normalized relationship between the two variables prior to the Great Recession. The regression formula and actual job growth for 2009, 2010, and 2011 plus job growth and dividend growth are shown in Exhibit 11.

However, when inflation and interest rates begin to rise, REIT prices may suffer an initial “reset,” as investors sell and ask questions later. Improving cash flow growth driven by an improving economy (Exhibit 10) can support accelerated appreciation thereafter, helping to offset or even eliminate the initial price declines. In fact, Exhibit 11 shows the results of an analysis of periods since the end of 1992 (considered the beginning of the Modern U.S. REIT Era) in which the market suffered two-standard deviation increases, about 55 basis points, in the 10-year Treasury yield. On average, REITs suffered about 7% declines (total return) in the first month, but quickly recouped those losses over the following 12 months to finish almost 15% up from the starting point prior to the spike in interest rates.

Exhibit 11: U.S. REITs typically rebound from the initial “reset” when inflation and interest rates spike


Exhibit 12: U.S. REIT dividends are facing a period of potentially strong recovery


* Forecast

Note: Uses regression analysis of calendar year job growth (x-variable) and US REIT absolute dividend growth (y) for the period from 1992-2008 (1992 = beginning of the Modern REIT Era). Then use the regression formula ($y = 2.4819x - 0.0091$, $R^2=0.59$) to predict dividend growth for 2009 through 2016 based on actual employment growth for 2009 through 2011, and Economy.com forecasts for 2012–2016 (see above).
growth forecasts are then used to predict dividend growth for 2009–2016. The results are the grey bars (2009 not shown). We call this “organic” growth, as it is explained by the normalized relationship of REIT dividend yields to job growth. However, the blue bars are the difference between that estimate and the ACTUAL cash REIT dividend growth from 2010–2011. This is the portion of growth that is “unexplained” by the model, likely due to some exceedingly unusual events. For instance, in 2009, the IRS ruled that U.S. REITs could pay out up to 90% of their required dividend in stock. Several REITs, including large-capitalization Simon Property Group, opted to do this. However, REIT index providers, including NAREIT and MSCI, made the decision NOT to count such stock payouts as actual dividends. Thus, the “cash” dividends excluded stock payouts, reducing the reported dividend dramatically. When these companies returned to 100% cash dividend payouts in 2010 or 2011 (depending on the company), the cash dividends jumped dramatically. Another factor may be that REITs cut too much, or more than the model would have ever anticipated, leaving dividend coverage ratios above historic averages.

Our analysis attempts to quantify that “unexplained” element. Assuming the model is correct, we assume that the market “overreacted” in 2009, a year in which the model predicted a -11.3% decline in absolute dividends but the actual decline was -40.2%. Given this differential, an estimate of +48% “unexplained” upside was calculated for the U.S. REIT dividend. However, given our investment team’s estimate that the market suffered about 20% dilution from equity issuance by REITs to shore up balance sheets in 2009 through 2010, we reduced this 48% to approximately 34% upside. A portion of the remaining unexplained upside is applied to the model’s predicted return for both 2010 (roughly 16.4%) and 2011 (about 10.9%) to achieve actual results in 2010 and 2011. The remainder (roughly 7%) is applied to the model growth prediction for 2012. The model’s predicted return is used for the years 2013 through 2016.

The conclusion is that U.S. REIT dividends could grow about 6% on average per year for the next five years. This would theoretically support a total return of 9% to 10% per year given a dividend yield of 3% to 4%. It should be noted that this kind of rebound in dividend payouts is not unprecedented: REIT dividend yields grew 6.2% per year from a cycle bottom in January 2004 through to the pre-crisis peak in March 2008. Given the unprecedented scale of the recent recession and dividend cuts, 5% to 6% growth from here seems reasonable.

International REITs look inexpensive versus equities, real estate and U.S. REITs

EXHIBIT 13A: NOMINAL DDRS–MARKET CAP WEIGHTED

EXHIBIT 13B: GLOBAL REIT PREMIUM/(DISCOUNT) TO NET ASSET VALUE—EQUALLY WEIGHTED, NORMALIZED*


Note: Estimated Dividend Discount Rates (DDRs) are IRRs calculated by setting J.P. Morgan analyst long-term cash flow/dividend estimates against current share prices. These DDRs are calculated for J.P. Morgan coverage. The DDRs are weighted by market capitalization within each country, FTSE EPRA NAREIT country and regional market capitalizations are used to weigh global and international regional results for both equities and real estate securities to make as comparable as possible.

* “Normalized” refers to our Net Asset Value (NAV) estimates for the stocks under coverage at the midpoint of a cycle, so essentially our estimate of “fair value” for the underlying real estate. Comparisons to current estimates of Net Asset Value may differ.

Past performance does not guarantee future results.
But aren’t REITs expensive?

U.S. REITs do not currently offer value versus equities, and have been trading in a range that goes from slightly expensive to slightly discounted relative to the value of their underlying portfolios. Having said that, the dividend growth described above combined with measured but improving strength in the U.S. economy and U.S. commercial real estate market (i.e., improving occupancy and rent growth) should support positive returns, even while U.S. REITs underperform the broader equity market and, perhaps, international REITs.

However, there continue to be interesting opportunities in markets outside the U.S. Exhibit 13 provides two measures of value for real estate securities: 1) a comparison of J.P. Morgan’s own Dividend Discount Rates (DDRs) for our REIT coverage to DDRs for global equities and 2) our own estimates of the premium or discount of REIT share prices to the estimated value of their underlying property portfolios. What is immediately apparent is that U.S. REITs are trading at a premium relative to other regions on either measure, but, there are still opportunities to buy good property portfolios at discounts in Asia ex-Japan and Europe.

Finally, it should be noted that International Real Estate Securities have displayed significantly lower volatility than U.S. REITs since roughly late 2004 (Exhibit 14). The diversification benefits of investing in multiple markets combined with lower levels of company leverage in Asia appears to have a beneficial impact on volatility in the international sphere. The obvious implication is that international real estate securities may also be positioned to offer attractive risk-adjusted returns over the mid- to long-term, suggesting it is a good time, tactically and strategically, for investors to consider adding international real estate securities to a U.S. REIT allocation.

Conclusion

REITs ARE REAL ESTATE. In the short term, REITs tend to move in line with equities. But over longer periods, REITs act like real estate, supporting their inclusion in investor portfolios as a proxy for or complement to a private commercial real estate allocation. Additionally, we find that REITs offer investors a high-quality property portfolio that offers a unique barbell investment opportunity, generating “core-like” income but opportunistic-like appreciation and total returns. Finally, while investors are concerned that an uptick in inflation could wreak real damage on REIT share prices, REITs, like real estate, have a distinct advantage versus bonds in combating inflation and rising rates; while REITs offer investors an attractive income return underpinning stable total returns, they also offer equity-like upside if economic growth improves, responding positively to “growth-induced” inflation to grow cash flow and partially or completely offset the potentially negative impact of inflation.
The role of REITs in a portfolio

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The role of REITs in a portfolio

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