Investment Insights Series

Janus Henderson INVESTORS

REITs
The Missing Ingredient for a Holistic Real Estate Allocation

In recent years, institutional investors have turned to private investments – private equity, private debt and private real estate – in search of higher returns. Simply having the word 'private' in front of any investment seems to conjure up higher expected returns among investors. Asset flows confirm this view: all three private asset classes mentioned have witnessed steady asset growth while listed equities and bonds have witnessed steady outflows.

Interestingly, private real estate stands out from the other two private asset classes in that it has never had to compete for capital with its listed counterpart. Historically, among institutional investors, it was taken as gospel truth that one should go the private route when it comes to real estate investing, in part, because listed real estate is a relatively young asset class with the early 1990s effectively marking its beginning.[1]

At the broad asset class level, it is undeniable that private equities and private debt have meaningfully outperformed their listed counterparts for the past 20 years; however, the same cannot be said of private real estate versus listed real estate. In fact, at the index level, listed real estate (REITs) as represented by the FTSE Nareit All Equity Index (the Nareit Index) has handily outpaced the NCREIF ODCE (Open-End Diversified Core Equity) Index by 2.3% per year (on a gross basis) and by 0.7% per year (on an unlevered basis) for the past 20 years ended 30 June 2019.[2] Our research indicates greater cash flow growth from specialty property sectors, by definition absent from private core real estate funds, primarily explains the historical outperformance of REITs over private open-end diversified core real estate funds.

Key Takeaways

- Since the turn of the century, REITs have delivered low double-digit annualized returns as the asset class has grown and matured.
- Unlike private core real estate funds, REITs offer unique access to 'non-core' property types – traditionally outside private core property sectors – with superior future cash flow growth prospects coupled with daily liquidity.
- Approximately $1.3T in market capitalization, REITs are slightly larger in size to the U.S. high yield market. However, U.S. public plans have allocated almost six times as much capital to U.S. high yield as they have to U.S. REITs.

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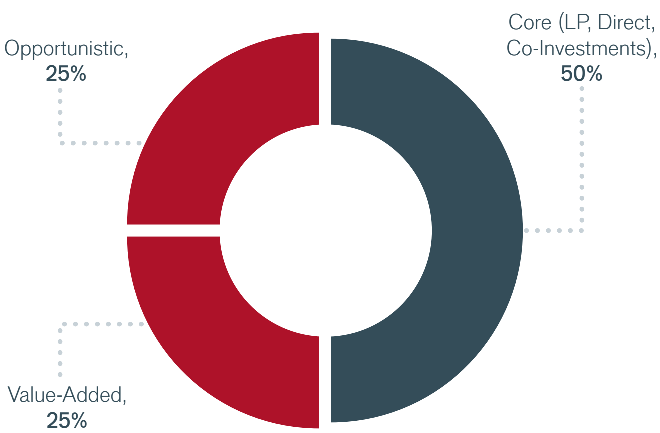
Many private open-end diversified core real estate funds concentrate their investments in retail and office, yesteryear's bellwether properties now subject to oversupply, increasing operating challenges and excessive amounts of required capital investments. In contrast, REITs offer unique access to 'non-core' property types – traditionally outside private core property sectors – with superior future cash flow growth prospects coupled with daily liquidity, regulated financial disclosures and alignment of interests between company managements and investors. That REITs exhibit over 90% correlation to private real estate (when adjusted for performance lag[3]) solidifies REITs as a highly relevant and complementary asset to private real estate for institutional investors in gaining a broader exposure to real estate as an asset class. Therefore, institutional investors who neglect REITs as a return-enhancing strategic asset class risk missing an opportunity to achieve a broader exposure to all real estate sectors – regardless of vehicle type – and to gain access to specialty property with greater growth opportunities such as single tenant net lease, manufactured housing, self storage, cell towers and data centers.

REITs – a Large, but Neglected Return-Enhancing Asset Class

Generally speaking, institutional investors take a core-satellite approach to real estate allocations, as stylized in Exhibit 1.

Exhibit 1: Institutional Real Estate Structure



Plan sponsors obtain their largest real estate exposure through core real estate funds – strategies generally constrained by both property sectors and leverage levels. These core funds offer periodic liquidity and hold stable operating assets across office, retail, apartment and industrial properties. Plan sponsors complement this core allocation with value-added and opportunistic funds – 'go anywhere' closed-end vehicles unconstrained by property type with generally higher leverage profiles. While allocations to private core, value-added and opportunistic real estate strategies have steadily increased over the past 20 years, allocations to REITs have been negligible, averaging about 0.6%[4] of total plan assets.

We observe a cognitive dissonance in institutional investors' asset allocation behaviors. As of 30 September 2019, the market capitalization of the Nareit Index approximated $1.33 trillion USD, comparable in size to the Bloomberg Barclays US High Yield Index's market capitalization of $1.25 trillion USD. Even though slightly smaller, U.S. public plans have allocated almost six times as much capital (between 3.0% and 4.0% of plan assets) to U.S. high yield as they have to U.S. REITs. Hence our assertion: despite its size, institutional investors have historically neglected REITs as a return-enhancing strategic asset class.

REITs Produce the Returns of Their Underlying Commercial Real Estate Properties

"REITs behave too much like equities" has been one of the oldest criticisms and reasons against investing in REITs. What is implied in this statement is that private real estate funds behave differently from REITs; however, the difference in relationships of REITs and private real estate to listed equities is entirely due to the differences in timing and frequency of valuations. An independent study by CEM Benchmarking Inc. (CBI) examining real estate returns and allocations of over 200 U.S. pension funds revealed REITs and private real estate funds exhibit over 90% correlation once unlisted funds' reported returns are restated to more accurately reflect the timing of actual changes in property valuations.[3]

In the past, investors have viewed private real estate investing as a lower-risk strategy when compared to listed real estate strategies, generally not subject to market gyrations; however, the CBI examination demonstrates that this perceived lower risk is entirely due to a long reporting lag relative to when actual changes in underlying property values materialize. This lag in private real estate returns is attributable to the industry's standard practice of appraising only 25% of the underlying properties on a quarterly basis and relying on broker opinions of value for the remaining 75% of the properties to estimate periodic returns. Due to timing and reliance on historical comparable transactions to estimate property values, the performance measurement of private real estate funds is significantly delayed and does not fully reflect the true market clearing price of their underlying properties.

U.S. institutional investors witnessed this lag firsthand during the 2008-2009 Global Financial Crisis – a period characterized by paucity in private market activity. For the 200 U.S. pension plans analyzed by CBI, REITs experienced a sharp sell-off of 38% in 2008. Private real estate funds suffered the same 38% loss; however, they reported the loss over a two year period, publishing a modest loss of 8% in 2008 before reporting a much larger 30% loss in 2009, as shown in Exhibit 2A.

Exhibit 2A: CBI As-Reported Private Real Estate Fund Performance

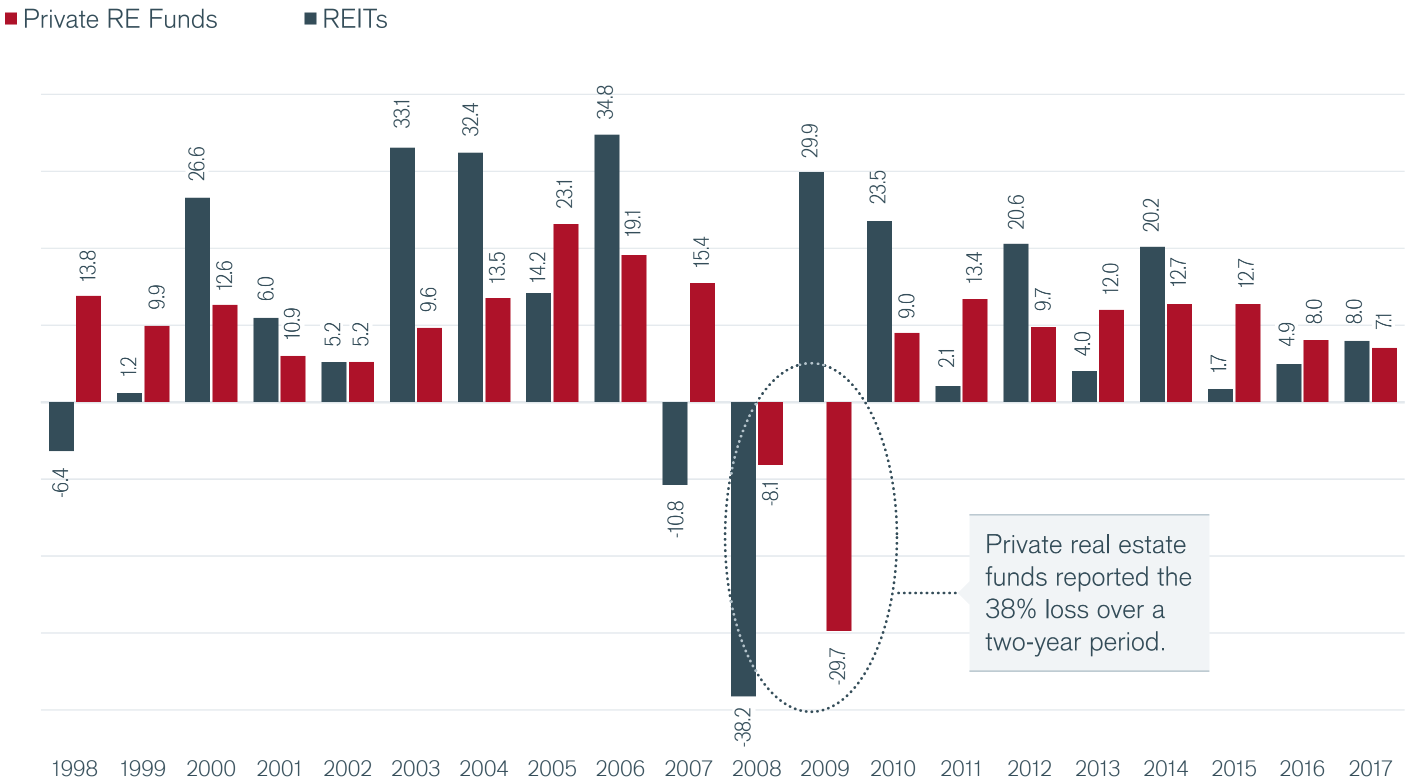
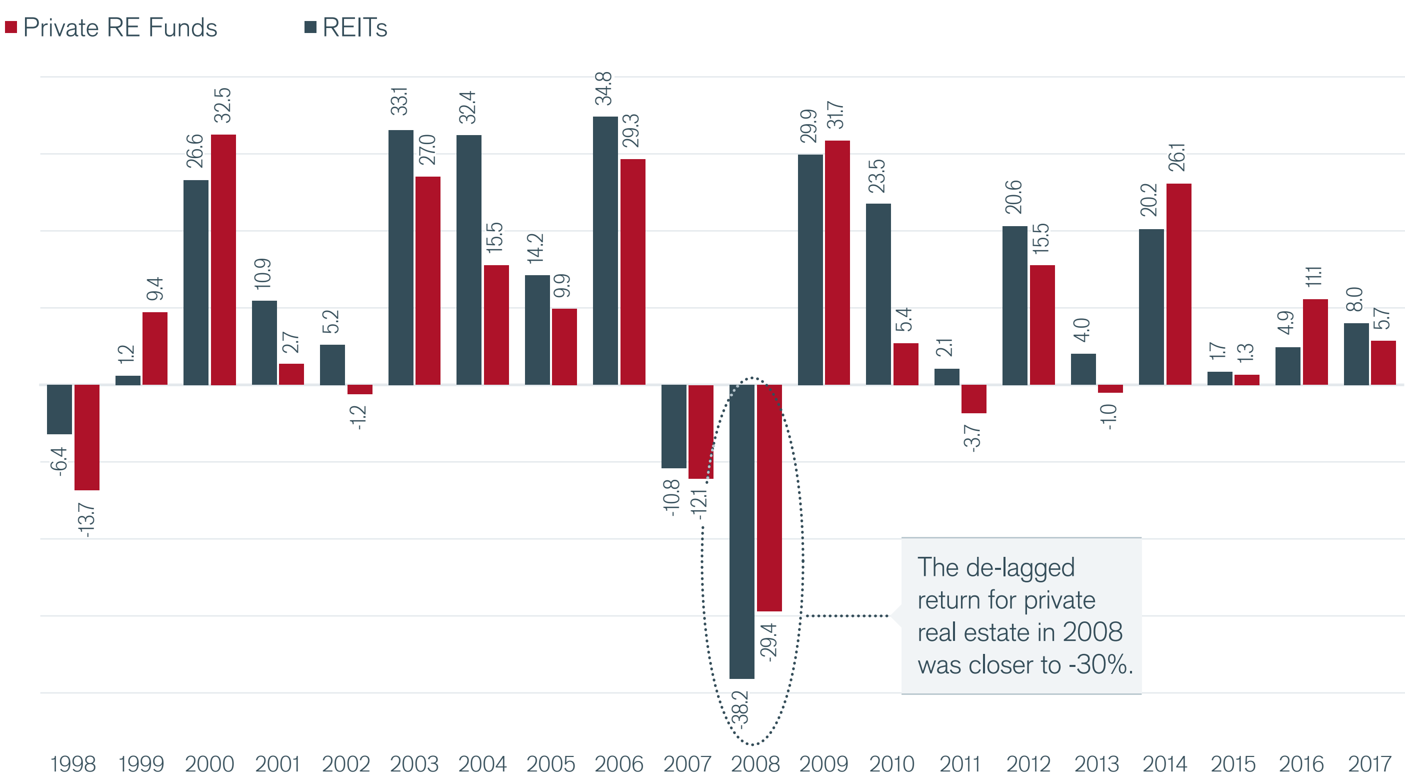


Exhibit 2B: CBI Standardized Private Real Estate Fund Performance



Source: Alexander D. Beath, Ph.D. & Chris Flynn, CFA, "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States, 1998 – 2017" (October 2019).

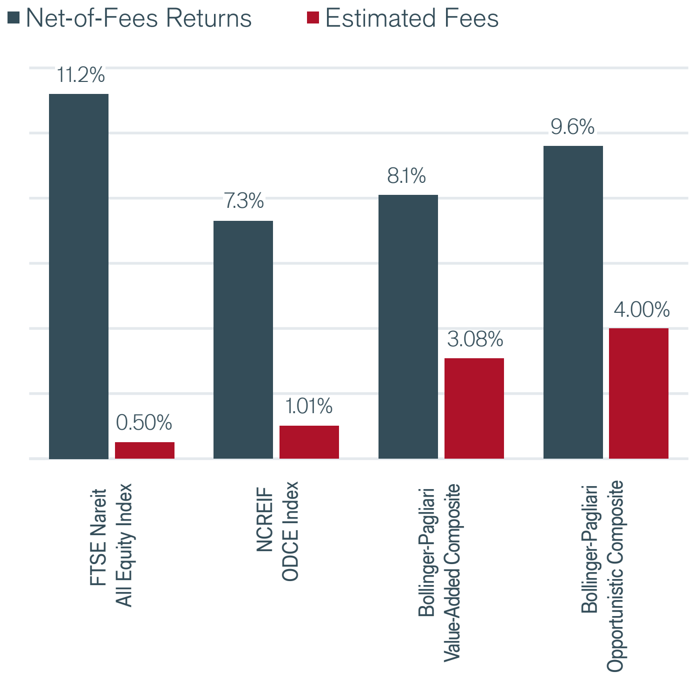
CBI's bottom-up, plan level analysis indicated private real estate funds systematically exhibit reporting lags averaging one year. Therefore, CBI standardized private real estate fund returns by de-lagging reported historical returns adjusted for comparable leverage.

Once private real estate funds' as-reported returns have been standardized, they exhibit a much higher correlation of 0.9 with REITs, as shown in Exhibit 2B. This result should not come as a surprise to anyone since both REITs and private real estate funds invest in commercial real estate properties. Just as equities are equities, whether listed or private, real estate is real estate whether accessed through REITs or through private real estate funds.

Net of Fees, REITs have Outperformed Private Core, Value-Added and Opportunistic Funds

Previously, we remarked, "... the Nareit Index has handily outpaced the NCREIF ODCE Index by 2.3% per year (on a gross basis) and by 0.7% per year (on an unlevered basis) for the past 20 years ended 30 June 2019." What is more noteworthy is that, as shown in Exhibit 3A, REITs have outperformed all private real estate strategies on a net-of-fee basis.

Exhibit 3A: Net of Fees, REITs Outperform All Private Real Estate Funds



Source: Bollinger, Mitchell A. and Joseph L. Pagliari, Jr. "Another Look at Private Real Estate Returns by Strategy." The Journal of Portfolio Management Special Real Estate Issue 2019: 95-112.

* Note: A passive allocation to the FTSE Nareit All Equity Index would not include an active management fee; however, for net-of-fee comparison purposes, we deducted 50 bps of average active management fee from the FTSE Nareit All Equity Index returns.

Exhibit 3B: Comparative Statistics (Bollinger-Pagliari, Jr. Study Period, 2000 – 2017)

	Estimated		Returns				
Description	Debt-to-Assets	Fees	Gross Levered	Net of Fees Levered	Gross Unlevered	Standard Deviation	Sharpe Ratio
	[A]	[B]	[C]	[D]	[E]		
FTSE NAREIT All Equity Index	36.6%	0.50%	11.7%	11.2%	7.8%	20.9%	0.35
NCREIF ODCE Index	22.0%	1.01%	8.3%	7.3%	6.5%	11.8%	0.51
Bollinger-Pagliari Value-Added Composite	29.3%	3.08%	11.1%	8.1%	7.9%	17.4%	0.42
Bollinger-Pagliari Opportunistic Composite	36.6%	4.00%	13.6%	9.6%	8.6%	19.0%	0.43
US 3-MO Tbill					0.5%		
FTSE NAREIT Outperformance Over ODCE (2000 - 2017)			3.3%		1.3%		
FTSE NAREIT Outperformance Over ODCE - 20 Years Ended on 06/30/19			2.3%		0.7%		
FTSE NAREIT Outperformance Over ODCE - 10 Years Ended on 06/30/19			6.2%		2.6%		

Source: Bollinger, Mitchell A. and Joseph L. Pagliari, Jr. "Another Look at Private Real Estate Returns by Strategy." The Journal of Portfolio Management Special Real Estate Issue 2019: 95-112.

For the Bollinger-Pagliari examination period from 2000 – 2017, after deducting estimated investment management fees, REITs outpaced the NCREIF ODCE Index by 3.9%, the Value-Added Composite by 3.1% and the Opportunistic Composite by 1.6% per year. A word of caution about comparative returns is in order: due to the varying debt-to-asset leverage ratios across these four indices, the net-of-fees returns are not fully comparable across different investment strategies, and for that reason, estimated leverage ratios, fees and gross unlevered returns are shown in Exhibit 3B columns [A], [B], and [E], respectively.

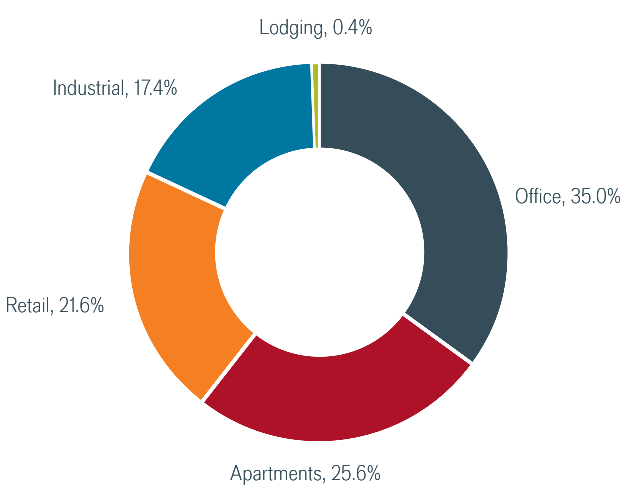
At first glance, it may appear that historical returns for REITs have been higher than the ODCE Index simply due to higher volatility levels; that is, REITs generated higher returns because they represented a riskier investment strategy. Seasoned investors recognize that comparing risk estimates across daily-marked listed securities and quarterly-estimated private securities is fraught with estimation errors due to differences in valuation methodology, mark-to-market or valuation frequency and a lag in performance reporting by private real estate strategies. By simply smoothing the monthly returns on a rolling three-month basis, the volatility estimate for REITs drops from 20% to 11%[5], making it comparable to that of the ODCE Index. Therefore, we advise against drawing any return per unit-of-risk conclusions based on highly questionable risk estimates for private real estate strategies.

The Growth of Specialty Property Sectors – an Important Driver of Returns for REITs

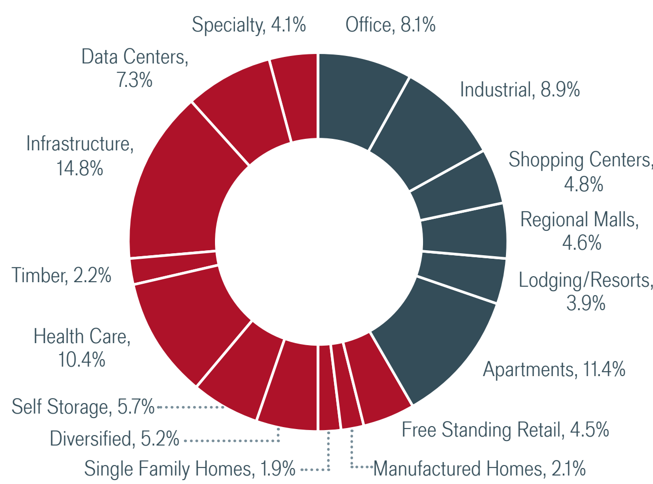
The listed real estate market's early embrace of specialty property sectors has been an important driver of the return differential between REITs and private ODCE funds. As shown in Exhibit 4A, as of 30 September 2019, non-core property sectors were noticeably absent from the NCREIF Property Index (NPI), whereas, they accounted for 58% of the Nareit Index. And as shown in Exhibit 4B on page 6, non-core sectors have grown from 26% in October 1999 to 58% in September 2019 of the Nareit index.

Exhibit 4A: Comparative Sector Allocation - Nareit Index vs. NPI

NPI Sector Allocation
(as of 9/30/2019)



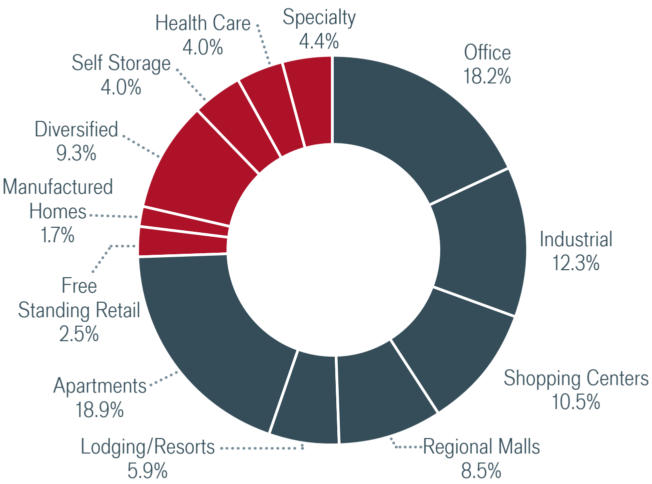
Nareit Index Sector Allocation
(as of 9/30/2019)



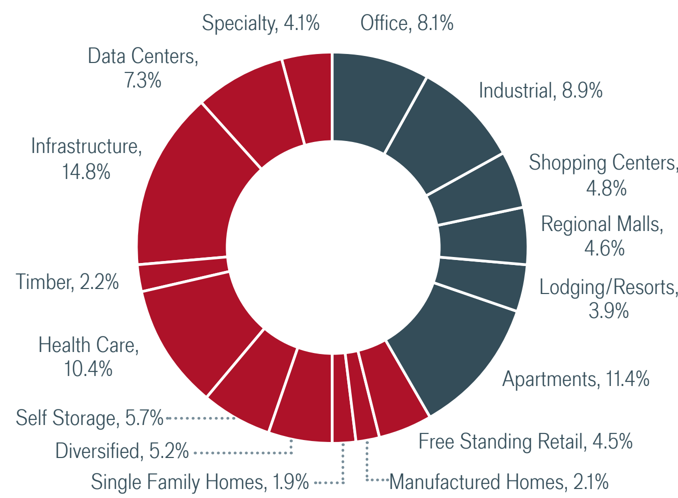
As of 9/30/2019. Source: NCREIF, FTSE.

Exhibit 4B: Nareit Index Sector Allocation - October 1999 vs. September 2019

As of 10/31/1999



As of 9/30/2019



Source: FTSE

Due to their differentiated operating platforms and the granularity of their individual property holdings, in our opinion, specialty property types including single tenant net lease, manufactured housing, self storage, cell towers, and data centers, among others, are more commonly found in, and better suited to, the listed market. And that explains the divergence of sector allocation between the Nareit Index and the NCREIF Property Index. By their very nature, investments in specialty property types tend not to be compatible with the structure and cadence of private equity capital raising, investment, and distribution of capital. Individual properties in sectors like self storage and single tenant retail often have property values between $1 million and $10 million. Even industrial properties – a core real estate property type – averaged $15 million in transactional value in 2018. In comparison, average transactional values for office, retail, or apartment properties ranged from $20 to $35 million in 2018. The fact that for every property acquired, many more are underwritten and rejected, demonstrates why private real estate managers find it easier to expediently deploy capital in retail, office, and apartments – fewer but larger transactional value property types.

By contrast, REITs represent infinite-lived vehicles that can continuously raise and deploy capital on an opportunistic basis. This permanent capital structure is much more conducive to assembling a portfolio of smaller transactional value assets, which can take years or decades to reach a critical mass. While it is relatively straightforward for a private real estate manager to underwrite the next seven years of cash flows for an office building, it is generally more difficult to find highly qualified underwriters and capital allocators with specialized knowledge of manufactured housing, data centers, or cell towers. In our opinion, specialty managers in sectors like these are more often found in REITs, not in private real estate managers who tend to be more financial, rather than operational in focus.

Reasons for Continued Optimism in Specialty Property Sectors

We expect non-core specialty sectors to continue to outpace core sectors due to higher initial unlevered yields, demand-driven higher secular growth leading to landlord pricing power, and generally lower recurring capital expenditures supportive of higher free cash flow growth. For indicative purposes, in Exhibit 5, we set forth long-term returns projections for all major sectors of the Nareit Index, excluding mortgage REITs.

Exhibit 5: Long-Term Growth Projections for Core and Non-Core Nareit Sectors

Description	Type	Levered Growth	Dividend Yield	Dividend Payout Ratio	Total Return	NCREIF Weight	NAREIT Weight
Technology Infrastructure	Non-Core	10.1%	2.0%	46.1%	12.1%		14.8%
Specialty	Non-Core	5.5%	5.0%	76.7%	10.5%		4.1%
Free Standing Retail	Non-Core	6.3%	4.0%	75.4%	10.3%		4.5%
Industrial	Core	6.9%	2.6%	71.6%	9.5%	17.0%	8.9%
Data Centers	Non-Core	7.3%	2.2%	41.6%	9.4%		7.3%
Regional Malls	Core	2.8%	6.1%	87.5%	8.9%	11.0%	4.6%
Health Care	Non-Core	3.5%	5.3%	85.5%	8.8%		10.4%
Diversified	Non-Core	4.4%	4.2%	84.1%	8.6%		5.2%
Manufactured Homes	Non-Core	6.8%	1.8%	61.4%	8.6%		2.1%
Shopping Centers	Core	3.5%	5.1%	90.6%	8.5%	11.0%	4.8%
Office	Core	4.9%	3.2%	79.1%	8.1%	35.0%	8.1%
Single Family Rental Homes	Non-Core	6.7%	1.3%	32.5%	8.0%		1.9%
Self Storage	Non-Core	4.1%	3.8%	78.9%	7.9%		5.7%
Apartments	Core	4.0%	3.2%	70.2%	7.2%	25.0%	11.4%
Lodging/Resorts	Core	0.1%	6.4%	68.1%	6.5%	1.0%	3.9%
Timber	Non-Core	7.6%	3.9%	102.5%	11.5%		2.2%
Overall Average		5.3%	3.8%	72.0%	9.0%		
Core Average		3.7%	4.4%	77.9%	8.1%		
Non-Core Average		6.2%	3.4%	68.5%	9.6%		
Core % in NAREIT Index							41.71%
Non-Core % in NAREIT Index							58.29%

As of 9/30/2019.

Sources: BMO Capital Markets for Data Centers, Manufactured Homes, Industrial, Self Storage, Apartments, Diversified, Office, Shopping Centers, Health Care, Lodging/Resorts and Regional Malls; RBC Capital Markets for Technology Infrastructure and Timber; Robert W. Baird & Co.for Single Family Rental, Free Standing Retail and Specialty.

As remarked previously, because private real estate managers find it more difficult to expediently deploy capital in specialty property types, and the latter, oftentimes, requires differentiated property management capabilities and is generally incompatible with private fund structures, institutional investors have historically been under-invested in these specialty sectors, resulting in relatively higher initial unlevered yields compared with core property types.

In addition, specialty sectors have disproportionately benefited from secular demand that has driven rental rate and occupancy growth ahead of those experienced by core sectors. For example, the age-restricted manufactured housing REITs are capitalizing on younger retirees' appetite for affordable active adult residential accommodations, while cell tower landlords endeavor to meet the ever increasing mobile data demands of today's consumers and businesses. Both property types face minimal oncoming supply due to onerous zoning and entitlement processes for developments while demand continues to steadily grow, largely independent of business cycles.

Finally, specialty properties generally require lower levels of maintenance capital expenditure – defensive capital projects that maintain competitive relevance of real estate properties. Office and retail properties, which comprised 57% of the NCREIF Property Index as of September 2019, currently require maintenance capital spending upwards of 30%[6] of annual operating cash flow. In contrast, specialty sub-sectors, such as self-storage and single-tenant net lease, require maintenance capital expenditures of less than 5%[6] of annual operating cash flow. In our opinion, real estate investors have consistently underappreciated the magnitude and impact of annual capital expenditure requirements on investment net returns.

The key drivers of specialty real estate's differentiated return profile – higher initial unlevered yields, greater cash flow growth driven by landlord pricing power, and lower maintenance capital expenditures – are all expected to continue into the future. In fact, these factors may be even more of a differentiator going forward as consumer preferences for services like online shopping and co-working space may materially impact retail and office landlords who are just beginning to get a small taste of what is yet to come.

Flexibility Afforded by Daily Liquidity

Daily liquidity of REITs is an important asset allocation and risk management tool generally not available to private real estate managers. Evolving property market fundamentals are visible to both private and listed real estate market investors; however, only listed real estate managers can adapt their sector allocations over the course of days or weeks – at a minimal transaction cost – to take advantage of emerging secular growth trends or to limit exposures to sectors facing increasing secular headwinds. The weakening position of retail landlords and the strengthening position of their logistics warehouse brethren have been evident for several years. Real estate managers would have done well to dramatically reduce their exposures to the retail sector while increasing exposure to the industrial sector to position the portfolio to changing industry fundamentals, as well as to anticipated changes in asset prices. Compared to private real estate managers, REIT managers have the potential to be much more dynamic and adaptive in sector allocations and portfolio risk management.

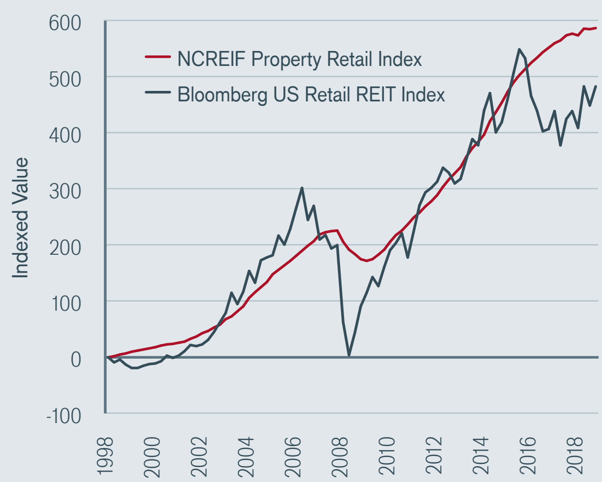
As listed securities, REITs experience short-term pricing fluctuations whereby portfolios can occasionally trade below their net asset value (NAV) – a proxy for private market liquidation value. Active REIT managers can tactically reposition portfolio holdings during periods of such volatility to take advantage of opportunistic pricing and therefore acquire real estate assets at a discount to private market value. Since private real estate sales are lengthy negotiated transactions and reported values rarely decline, this type of tactical trade is less likely to be available in the private world. By taking advantage of short-term price volatility and the inherent liquidity in the listed REIT market, active REIT managers can augment returns in a way private real estate managers cannot.

Conclusion

REITs have delivered low double digit net-of-fee returns since the turn of the century, as the asset class has grown and matured. Within the Nareit Index, the majority of real estate companies reside outside traditional core real estate sectors. Given the attractive traits such as expected supply constraints, durable demand and higher initial unlevered yields, long-term growth prospects for specialty sectors remain strong moving forward. A comparison of estimated long-term forward returns indicates that specialty property is poised to deliver faster cash flow growth and greater total return relative to traditional core real estate sectors. Moreover, secular headwinds facing core sectors such as retail and office strongly suggest more private property write-downs are waiting in the wings, which may lead to a wider performance divergence between core and non-core sectors of the real estate market.

Listed Retail REITs versus Private Market Retail Real Estate

Record levels of store closures emanating from tenant bankruptcies, shifting buying patterns of consumers from physical stores to online shopping, and the significant capital requirements associated with finding new tenants or repurposing of vacated shops have prompted material declines of retail REIT properties. Notably, reported valuations of private real estate funds have yet to reflect write-downs of retail properties suffering from the same headwinds.



This lack of write-downs in private markets stems, in part, from a dearth of transactions as the bid-ask spread between buyers and sellers have widened significantly over the past three years. As more and more malls and shopping centers become distressed, the owners of these distressed assets will be forced to lower property values, which will exert downward pressure on the returns reported by private real estate funds and the NCREIF Property Index as a broad barometer of the private real estate market.

Despite a steadily growing market, REITs have been a forgotten asset class among institutional investors. In the not so distant future, the REIT market is likely to further expand its breadth of specialty sectors, as recently introduced assets in cold-storage, marinas, and affordable housing continue to grow. If the past 20 years of listed real estate experience is any guide, it behooves institutional investors to reassess REITs as a strategic return-enhancing asset class deserving of their attention. Our advice is not to supplant but rather to supplement a private real estate allocation with a REIT allocation because, in our opinion, the latter will not only offer institutional investors more complete exposure to all real estate sectors, but may improve risk-adjusted returns of the entire real estate structure.

[1] https://www.reit.com/news/reit-magazine/november-december-2013/beginnings-era.

[2] The magnitude of outperformance is even greater for the 10 years ended on 30 June 2019: 6.2% on a gross levered basis and 2.6% on a gross unlevered basis.

[3] Alexander D. Beath, Ph.D. & Chris Flynn, CFA. "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States, 1998- 2017." October 2019: Page 4.

[4] Alexander D. Beath, Ph.D. & Chris Flynn, CFA. "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States, 1998- 2017." October 2019: Page 17.

[5] Estimated by Janus Henderson Investors based on the FTSE Nareit All Equity REITs Total Return Index monthly returns as provided by Bloomberg.

[6] Green Street Advisors, Sector Allocation Special Report, August 2019.

For more information, please visit **janushenderson.com.**

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