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No reason to assume REITs can't thrive when rates rise

Rising rates might hurt REITs initially, but they could benefit from a strengthening economy

By Jeff Benjamin | *July 12, 2015 - 12:01 am EST*

Just because real estate investment trusts have been riding high as an alternative source of income during an extended — and unprecedented — period of low interest rates, there is no reason to assume REITs can't thrive when rates start rising.

“There's a prevailing thinking that REITs don't do well in a rising-rate environment, but that's not a given,” said Kevin DiSano, chief portfolio strategist at IndexIQ.

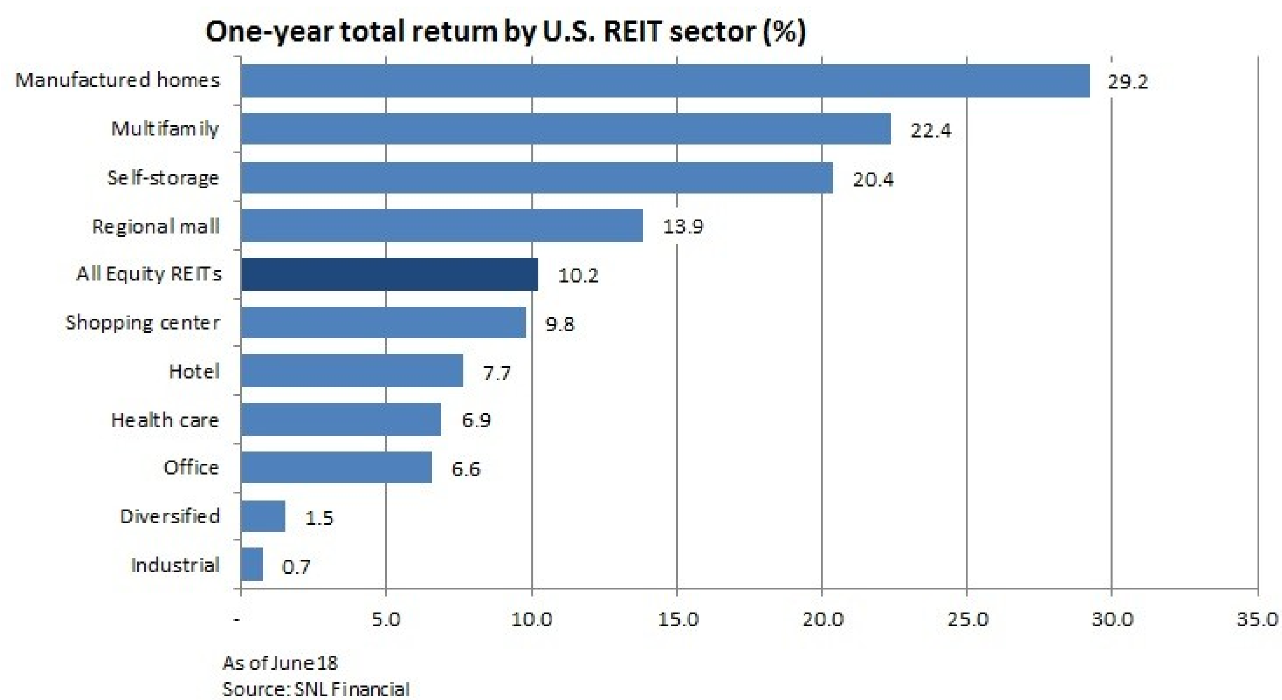
Under historically normal conditions, a rising-rate environment would logically equate to a higher cost of financing for leverage-heavy REITs. “The cost of financing is the key, because that obviously puts pressure on the free cash flow that is paid out in the form of dividend yields,” Mr. DiSano said.

That's the logic that might trigger an initial spike in REIT price volatility. But it is also assumed that the logic, when carried a step further, recognizes that a decision by the Federal Reserve to move short-term interest rates off a floor of near zero will be seen as a sign of a stronger economy.

“Initially, with any discussion of rising rates, REITs should come down with the rest of the market because they get lumped into the fixed-income category, but that's when you have to start thinking of the business structure of a REIT,” said Michael Black, owner of Michael Phillips Black Wealth Management.

A strengthening economy allows many REITs to raise rents, making properties more valuable, he said. “So, I see it as a buying opportunity.”

By various measures, it has not been a great year for REITs, but they've had a good run over the past few years. This year, through June 26, the FTSE NAREIT Index declined by 3.8%, which compares with a gain of 3.1% for the S&P 500, a 0.3% gain for the 10-year Treasury, a 10% decline for the S&P utilities sector, and a 7.3% gain for the Nasdaq Composite Index.



In the same period, open-end U.S. real estate mutual funds declined by 4%, while global real estate mutual funds were up 0.5%. Last year, the NAREIT index gained 27.2%, outpacing all the previously mentioned investment categories with the exception of the utilities sector, which gained 29%.

"You always need to be selective when investing in REITs, but when you're looking at rising rates, you want to invest in areas that have the ability to increase rents and therefore their income," said **Gilbert Armour, a financial adviser with SagePoint Financial.** "As rates rise, competition with other sources of income could make REITs less attractive," he added. "But I think it still makes sense if you're selective, because rising rates probably favor REITs with the ability to raise rents more frequently, such as apartments and hotels."

A key element to investing in REITs in a rising-rate cycle is to recognize the unprecedented context of the Fed's monetary policy over the past six years. "One of the things we need to consider is that we have been through an abnormal period for REITs, because for the past several years, they've been treated as income vehicles, just like utility stocks," said David Spika, global investment strategist at GuideStone Funds.

"REITs haven't really been trading based on the underlying cash flow," he added. "A lot of the valuations did get somewhat excessive because of investor demand for income, but as rates rise, those yield-producing asset classes should underperform. And for REITs to perform well going forward, they need to trade more than they have historically, based on the underlying investment properties."

Todd Rosenbluth, director of mutual fund and ETF research at S&P Capital IQ, acknowledged the abnormalities that have encompassed the REIT space as a result of Fed monetary policy. But he said the smart play is to expect REITs and REIT investors to normalize as rates start to adjust higher. "Higher rates don't directly benefit the REIT space, but if the Fed is raising rates because the economy is improving, a better economy is a tail wind for REITs," Mr. Rosenbluth said. "We don't think people who are already invested in REITs have to steer away from them when rates go higher."

While Mr. Rosenbluth doesn't expect the appetite for REITs to be as strong as it has been over the past few years, when the category became a predictable proxy for bond income, he does subscribe to the case for investors getting back to the basics of REIT value. "We think the economy is going to strengthen, and we think that's good for shopping centers and malls because rents will go higher," he added. "Investors have gravitated toward REITs because of the low yields out there, but we think REITs will continue to stay in focus even as rates move higher."

Calvin Schnure, an economist with the National Association of Real Estate Investment Trusts Inc., said the benefits to REITs of rising interest rates are well-documented, even if sometimes overlooked by investors. "We've seen concern and lots of confusion, but interest rates are important for the REIT market," he said. "Right now, the market is paying more attention to the interest rate issue than to the solid fundamentals underpinning REITs. It's true that some investors have become attracted to REITs for the income, but going forward with rising occupancy rates, rents and property values, REITs will continue to provide income."

He cited 16 periods since 1995 during which interest rates rose significantly, noting that REITs were positive for 12 of those periods. Mr. DiSano also studied the performance of REITs during recent periods of rising rates and found that REITs have held up quite well. "If rates are rising because the economy is improving, that's different than if you're Greece and rates are rising because nobody wants to lend you money," he said. Like Mr. Schnure, Mr. DiSano pointed out that the market might have an initial reaction to a Fed hike of short-term rates, but it is the rising yields of longer-term bonds that tend to affect REITs.

With that in mind, Mr. DiSano measured large-cap and small-cap REIT category returns against the six most recent periods that saw the yield on the 10-year Treasury bond gain 100 basis points or more. The most recent period, from June 11, 2012 through Sept. 6, 2013, during which the 10-year Treasury yield gained 135 basis points, large-cap REITs, as measured by the Vanguard REIT ETF (VNQ) gained 4.9%. Over that same period, small-cap REITs, represented by IQ US Small Cap Real Estate ETF (ROOF), gained 23.9%.

During the period of Dec. 18, 2008 through June 10, 2009 when the 10-year yield jumped 187 basis points, the large-cap REITs fell by 17.2%, while the small-cap counterpart gained 33.6%. But during the period of June 7, 2005 through June 28, 2006 when the 10-year yield gained 135 basis points large-cap REITs gained 12.4%, and small-cap REITs lost 2.6%.

"I think the message here is that you want to stay diversified when it comes to REITs," said Mr. DiSano. "There will be some volatility associated with a rate hike, but the point is, there seems to be some prevailing misperception that REITs don't do well in a rising-rate environment."

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