REITs' mean reversion presents trading opportunities

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Back in the heyday of Messrs Graham and Dodd, information used to be a scarce enough resource that incremental titbits could provide big alpha-generating advantages. However, the daily news flow emanating from business channels and the internet has become so ambiguous in the modern investment era that it could even be regarded as a performance detractor. Suffice it to say that this "noise" has made it difficult for most modern investment professionals to focus on the issues that truly matter.

This is not a discussion on the merits of active management. It is simply an explanation of how our opportunistic investment process at Reitway allows us to take advantage of "market noise", despite the fact that it increases the turnover of our portfolio.

Mean reversion in the REIT-world

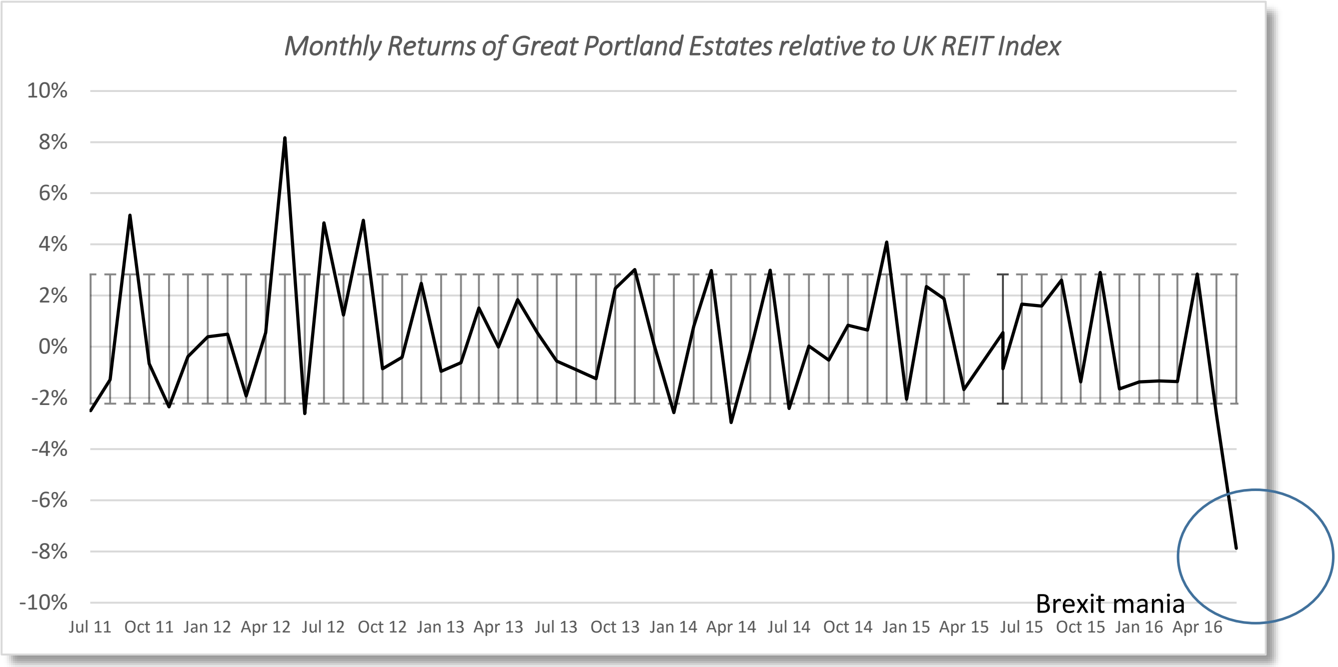
REITs behave differently from other stocks by exhibiting a higher tendency to revert-to-the-mean. ***This means that REITs that have delivered outsized returns relative to peers during one month, tend to lag in the following month.***

The main reason for this behaviour is that REITs, for the most part, do not change much over monthly or quarterly periods. **Rental contracts of property assets provide a higher degree of visibility than can generally be found in other sectors of the equity market.** Despite the fact that REIT fundamentals and fair values change more slowly over time, their market prices oscillate wildly on stock markets due to trading noise.

BREXIT: Real-world example of our actions

UK REITs experienced a violent sell-off on Friday 24 June after the UK public voted to leave the European Union. Going into Brexit we opted for low exposure to the UK REIT market. However, on the day, we saw a disproportionate 25% sell-off in Great Portland Estates. After some quick thinking, we garnered enough courage to enter a position in the stock at the end of the trading day.

The chart below shows how Great Portland Estates' relative performance consistently reverts to a mean and how it strayed from historic norms on 24 June.



Conclusion

The existence of excessive price instability provides us as an active manager with opportunities that more docile markets wouldn't, given that we are willing to stomach these sharp movements and be opportunistic. While the preponderance of our efforts revolve around identifying only the best longer-term opportunities, our real time relative valuation screens enable us to spot potential short-term trading opportunities in a noisy market.

We emphatically recognise the increasingly temperamental nature of the current market environment, and are fully embracing the fact that we can use this to our advantage. We therefore accept that this may influence our levels of portfolio turnover, as long as there is strong conviction that our actions will be alpha generative. ***The gauge of its effectiveness is ultimately represented by our longer-term performance.***

Sources: Reitway models, Green Street Advisors, Thomson Reuters