REITs – superior and growing dividends, even as rates rise

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Death, taxes and…

With the odd exception such as Greece where tax evasion is deemed by some to be a national sport, there are only two things in life which are certain – death and taxes. Perhaps we should add a third item to that list – US interest rates are going up.

Speculation about the timing and the magnitude is not the purpose of this document. Rather, what matters is that we are likely at or near a structural low in terms of US interest rates.

The yield on the US 10-year Treasury increased from an intra-day low of 1.65% in January 2015 to 2.42% at the time of writing. The increase has largely been due to communication from the US Federal Reserve that they are poised to increase the Federal Funds (overnight) rate by the end of 2015, after lowering and keeping it at 0.25% since 2008. The Fed wishes to move at least somewhat closer to normalised monetary conditions, as it attempts to ween the US (and global) economy and financial markets off ultra-low interest rates which were implemented during the Great Recession.

Source: Thomson Reuters Datastream

Even before any analysis is done, it is apparent that rates are near multi-decade lows. Given the Fed's abovementioned policy stance, it is likely that rates have bottomed.

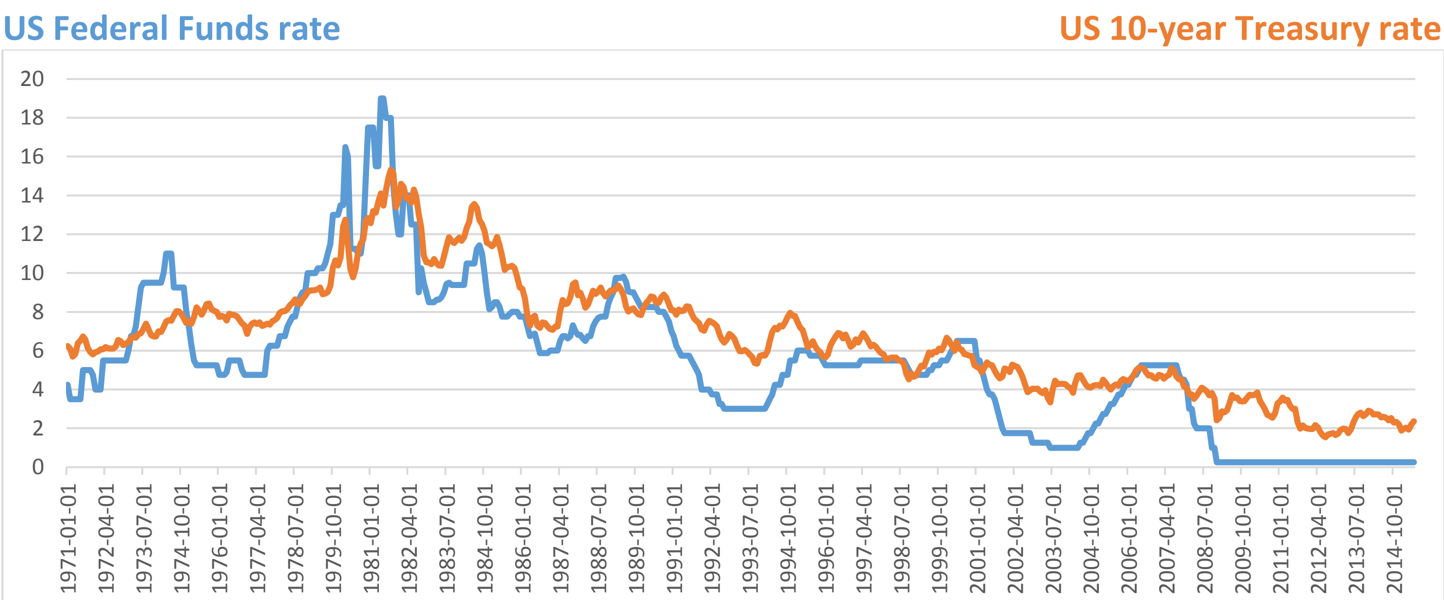
Rates are on the way up – so what?

The dynamic of potentially persistent rising rates is important because it would represent a secular change. Notwithstanding intra-cyclical increases and decreases, rates have been in long-term decline since 1981. In fact, some younger investors have never experienced consistently increasing rates! With the Federal Funds overnight policy rate currently at 0.25% (and assuming that the Federal Reserve doesn't unexpectedly implement a zero/negative policy rate) there is only one way rates can go, and that is up.

Besides the relative unfamiliarity with consistently rising rates, the importance of rates being at or near a structural low is the impact of rate escalations on the valuations and pricing of various financial assets. Easy monetary policy has supported the prices of financial or "interest-rate-sensitive" assets. Some investors fear that a new era of rate increases could shock the economy and financial markets. There is even a tinge of paranoia in certain quarters that it could have disastrous, unforeseen consequences.

Rate hikes are going to be gradual

Due in part to the abovementioned fears and uncertainty, the Fed is likely to hike rates very slowly. The chart below illustrates the path of the US Fed Funds rate and 10-year Treasury rate over a number of decades:



Source: Thomson Reuters Datastream

Over the last 25 years, the average pace of rate increases during hiking cycles has been 0.315% (31.5bps) per month. That pace is far from what the Fed is targeting this time around. In fact, the Fed has repeatedly gone out of its way to de-emphasise the exact timing of the start of the hiking cycle. Instead, they have reiterated that the trajectory of rate increases will be extremely shallow. Some commentators have even stated that the looming hikes are more symbolic than out of any need to cool potential inflation pressures.

These remarks seem viable when one considers that core inflation in the US is around 1.7%, below the Fed's target of 2%. Also, even though US unemployment is at the lowest level since 2008 (5.3%), some postulate that this is not due to overwhelming net employment gains. Rather, it is cited that the declining unemployment rate is because of the decreasing labour force participation rate. This means that workers who were previously jobless are no longer counted as unemployed, because they have simply stopped looking for work. In addition, there appears to be the tendency for people to (re)enter the work force in jobs that pay less than those they may have previously had.

The factors above, combined with tepid global commodity economic growth, render the inflation outlook as low to moderate in the short to medium term. This supports the case for the Fed to hike slowly.

The implications of rising rates for yield-seeking investors

At Reitway we believe that cash, bills and bonds have always been a key component of long-term multi-asset-class (MAC) portfolios. Their capital preservation qualities assist in mitigating portfolio risk. These attributes are of course most valuable during times of economic and financial distress. The cost of the abovementioned capital preservation qualities, though, is low yield.

The capital value of long-bonds increases when rates decline. It decreases when rates go up. The long-term declining rate environment has provided an underpin to the price return that long-bond investors have experienced. It has also meant that new money put to work in bonds over the years has yielded consistently less income. Rates rising (albeit slowly) would be a negative for the price/capital return of bonds.

In a rising rate environment, investors can increase investment income by rotating into shorter duration or floating-rate paper. Increased demand for shorter term paper, though, is likely to compress yields at the short end. This would nullify some of the yield uplift that otherwise would have been achieved.

Currently, a 1-year CD in the US yields in the region of 1.25% at most. Further out on the maturity curve, 5-year paper can currently earn you up to 2.25%. In South Africa, 1-year paper currently earns you a yield of 6-7%, with 5-year paper currently providing a yield of about 8%. Official SA CPI has ranged mainly between 4.5-7% over the last 5 years. Anecdotal evidence is that practical or "real-world" inflation is significantly higher than that. Therefore, these income yields are not very attractive in inflation-adjusted terms.

A slower hiking cycle (in the US, SA and other places such as the UK) would mean lower capital losses for long-bond investors. It would also mean a very gradual increase in their rolling income returns on shorter term paper. Gradually rising rates, therefore, do not represent an exceptionally exciting opportunity for increases in inflation-adjusted bond income.

Alternatives to bonds?

As with bonds, conventional wisdom states that the price return on REITs exhibits a negative correlation with interest rates. This seems logical if we assume fairly stable REIT cash flows. However:

- Some REITs are a lot more equity-like than others in terms of their operating cash flows, therefore their earnings and distributions grow over time, sometimes significantly. Recently in the US, for example, LasSalle Hotel Properties REIT increased their dividend by 20%.
- Property supply in certain REIT sectors is largely limited. In a rising rate environment underpinned by economic growth, property demand increases. This demand/supply imbalance creates the opportunity for significant and regular rental income and dividend increases.

Reitway Global Property Funds, for example, exhibit a yield of about 5%, in USD. This yield is far superior to what could be achieved on the cash/bond market (unless you lock your cash away for decades, in which case the extended duration would significantly destroy capital as rates rise). This supports the notion that an increase in allocation to REITs is warranted for investors seeking superior yield and growing dividends.

Nominally speaking, the abovementioned yield of 5% may seem moderate compared to what is available in the SA REIT and bond markets. However, this 5% yield in ***USD*** income allows South Africans to invest in a Rand Hedge portfolio while buying into some of the most well managed REITs in the world. In addition, there is the abovementioned capital growth over time.

REITs versus equities

Although it is hypothesized that REITs underperform equities during rising interest rate cycles, research by Gerstein Fisher shows that REITs have outperformed equities during periods of rising rates:

Exhibit 1: REITs and Interest Rate Cycles, Jan. 1, 1978 to Dec. 31, 2014

Period	Rising or Falling Rates	Fed Rate Change	Annualized Return – US REITs*
1/1978 to 5/1981	Rising	5% to 20%	28.56%
5/1981 to 3/1983	Falling	20% to 8.5%	22.70%
3/1983 to 4/1984	Rising	8.5% to 11.63%	26.67%
4/1984 to 2/1987	Falling	11.63% to 5.88%	18.54%
2/1987 to 4/1989	Rising	5.88% to 9.75%	3.48%
7/1989 to 12/1993	Falling	9.75% to 3.00%	5.86%
12/1993 to 12/2000	Rising	3.00% to 6.5%	10.30%
12/2000 to 5/2004	Falling	6.5% to 1%	17.28%
5/2004 to 7/2007	Rising	1% to 5.25%	21.17%
7/2007 to 9/2014	Falling	5.25% to 0.25%	3.73%

Sources: US Federal Reserve, Dow Jones, Gerstein Fisher
*DJ US Select REIT Index

Asset Class	Average Monthly Returns All Rising Rate Periods	Average Monthly Returns All Falling Rate Periods
US REITs	1.28%	1.06%
US Equities	1.21%	0.85%
US Fixed Income	0.47%	0.63%

Sources: US Federal Reserve, Dow Jones, Gerstein Fisher Research
REITs represented by DJ US Select REIT Index, Equities by S&P 500 Index, Fixed Income by Barclays 1-5 Year Treasury Index.

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Global investing is important

A concern for SA REIT investors is exposure exclusively to the stock market of an economy that represents about 0.5% of global GDP. Yes, some SA REITs have offshore exposure. This exposure, though, is not enough to deem a South African REIT portfolio as displaying significant geographic diversification. In addition, being highly exposed to the vagaries of the South African bond market (the SA REIT market is subject to changes in SA bond yields) without diversifying geographically is a dangerous pastime for any investor.

Yes, South Africa is one of the emerging markets that may represent certain exciting investment opportunities. The danger is that some investors demonstrate a bias towards emerging markets that borders on being blindly in love. The trouble with being too concentrated in any particular region is that you may just get your heart broken when you least expect it.

Conclusion

US interest rates are rising. We at Reitway do not advocate for REITs as a replacement for bonds, because REITs may decrease their distributions during exceptionally stressful financial circumstances. However, over time REITs provide superior and growing dividends relative to cash, bills and bonds. We therefore think that REITs warrant a higher portfolio allocation for investors seeking superior income streams along with capital appreciation.

Another vital aspect is to diversify globally, without making the mistake of concentrating too much of one’s portfolio in South Africa or other emerging markets.