The Upside-Down Value of REITs

Contrary to popular investor assumptions, Top REIT performers tend to have:

- *Lower dividend yields*
- *Lower leverage*
- *Lower capitalisation rates*

Of the primary impacting factors that impact value it is Mean Reversion that generates the highest returns in the REIT environment.

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The commonly held beliefs of which factors contribute to generating returns from REITs have typically been attributed to High Yields, Medium levels of Leverage, and Mid – to High Cap Rates.

In our current environment, the changing demographics brought on by an aging population has heightened the focus on post retirement income generation. However, a decline in capital generation is a by-product of a fixation on yield and ultimately a deterioration in the ability to generate income of any consequence.

Investors scouring the REIT universe for yield typically behave to a large degree like Value Investors. This however is the wrong approach, as highlighted by Green Street Advisors where their research clearly demonstrates that REITs with value characteristics *tend* to **underperform** their sector peers. Nevertheless, this observation and evidence should in no way be construed as a contention that Value Investing is inappropriate for other sectors, but that REITs demand a specialised sector specific approach to finding value and delivering Alpha.

What is value investing?

It is an investment style that places an emphasis on Stocks and REITs with *lower-than-average* price to book ratios and higher dividend yields.

Investopedia defines **"Value Investing"** as an investment strategy where stocks are selected that trade for less than their intrinsic values, so they actively seek stocks they believe the market has undervalued. The strategy is built on the belief that the market overreacts to good and bad news, resulting in stock price movements that do not correspond with a company's long-term fundamentals.

The strategy to invest in these undervalued stocks originates from investor irrationality and the objective is to profit from holdings in stocks with *lower-than-average:*

- **price-to-book ratios**
- **price-to-earnings ratios** and/or *higher* **dividend yields**.

However, calculating the intrinsic value of a stock is challenging with investors deriving differing valuations despite acting on the same information. For this reason, another central concept of value investing is that of "margin of safety."

Benjamin Graham, who is seen as the father of value investing, in his 1949 book *The Intelligent Investor* wrote that: "The function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future."[1]

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[1] Graham, Benjamin. "The Intelligent Investor." HarperBusiness, 1949.

Renowned value investor Seth Klarman, in his book *Margin of Safety*, states that: "a margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world."[2]

Klarman further stated that: "The disciplined pursuit of bargains makes value investing very much a risk-averse approach. The greatest challenge for value investors is maintaining the required discipline. Being a value investor usually means standing apart from the crowd, challenging conventional wisdom, and opposing the prevailing investment winds."

This statement seems even more true for REITs, where the generally accepted investment principles of equities seem to reverse.

REITs with value characteristics *TEND* to underperform their sector peers

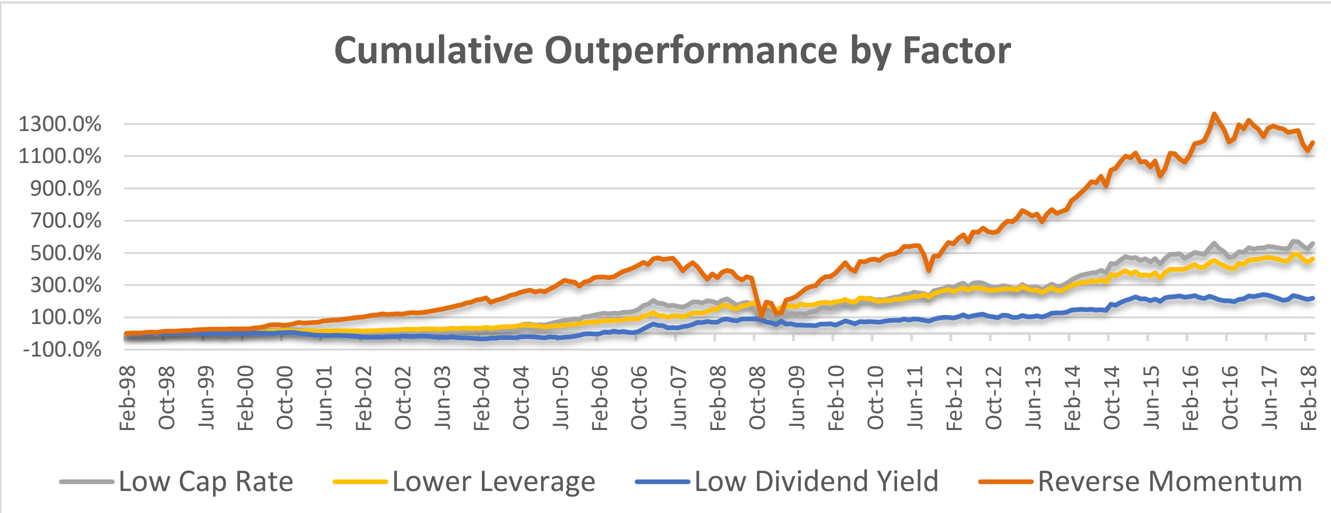
Research by Greenstreet Advisors demonstrates that contrary to conventional wisdom, it is REITS with lower:

- dividend yields,
- leverage and
- capitalisation rates

who are the top performers.

However, the mean reverting nature of REITs needs to be exploited to achieve the greatest level of outperformance.

2 Klarman, Seth. "Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor." HarperCollins, 1991.



Those factors with the greatest connection to excess returns in the broader market such as momentum, value (i.e. low P/E) and small size does not work in the REIT space. Some of these factors such as value and momentum, even tend to work in the opposite direction.

Low cap rates (Quality property with excellent location)

Firstly, the capitalization rate (or just cap rate) is the rate that an investment property will generate based on its current market value. It is calculated by dividing its expected annual net profit by the current market value of the company. Lower cap rates mean the property is most probably of higher quality, which increases its market value and thus decreases the cap rate. Greater quality properties come from better management teams and superior locations of the properties.

Lower leverage (Balance sheet quality)

Having lower leverage in REIT investments is a yield-suppressing trait. REITs with lower leverage tend to generate superior results, which is surprising since lower risk should have been accompanied by lower returns. Eugene Fama and Kenneth French, world renowned finance academics, found that most investors tend to shy away from cheaper, high-yielding stocks but that the REIT sector was a place where investors had a habit of overpaying for yield.

Low dividend yields (Inverse value)

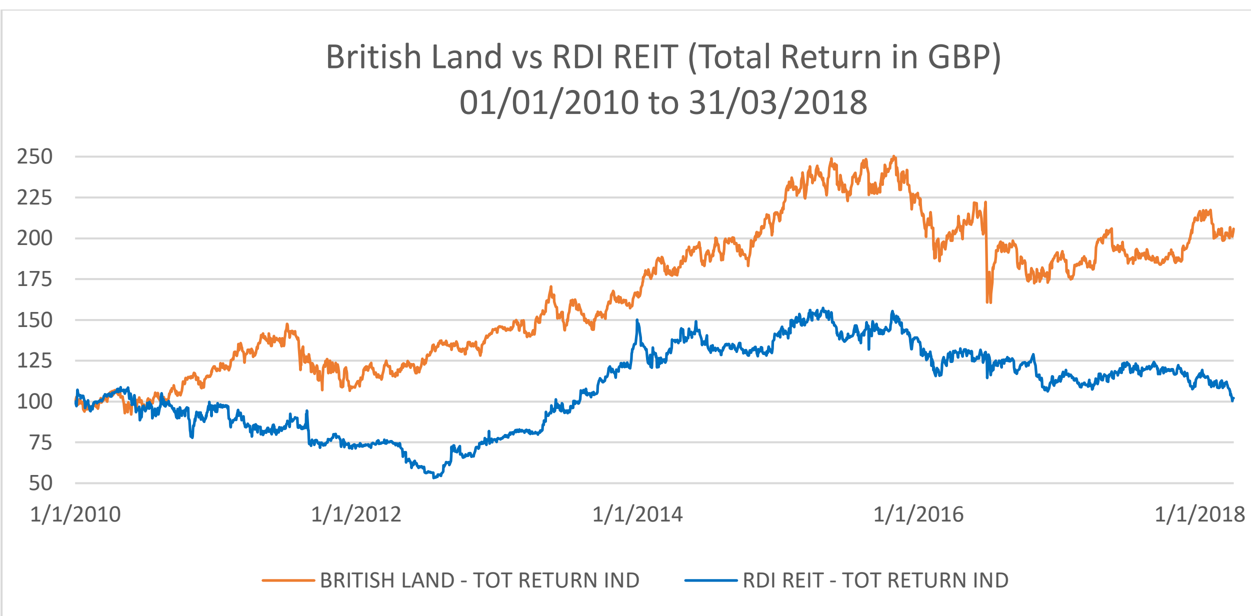
REITs with **low dividend yields** have prevailed over the period under consideration in the Cumulative Outperformance by Factor chart above. It is thus also no surprise that REITs with **high earnings growth** outperformed those with low earnings growth. REITs with high yield rates are more rate sensitive and they will underperform in a rising rate environment.

Reverse momentum (Sell winners)

The effect of momentum on REITs is upside-down to that of the general market, thus "Reverse Momentum." There is a tendency in the broader market where high/low performing stocks continue to out/underperform. This does however not hold for REITs, which tend to revert back to the mean and cause hot stocks to become cold and vice versa. The inevitable outcome is a higher portfolio turnover ratio, where REITs are sold when they are expensive and bought when they are cheap.

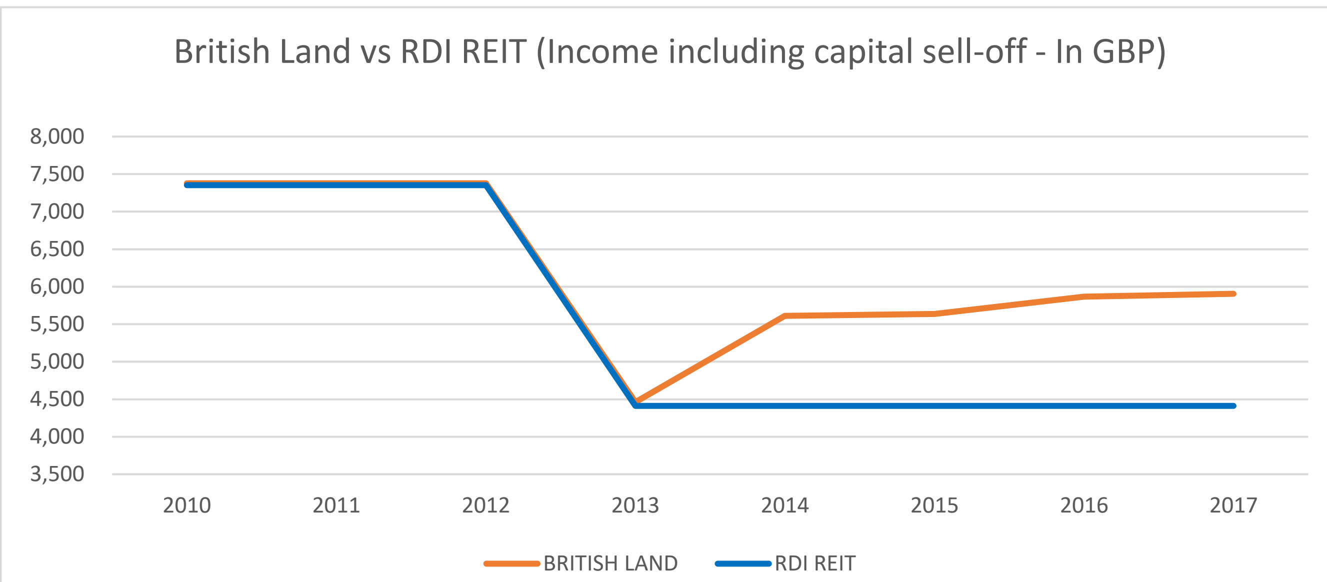
Specific example of valueless value REITs

We took two REITs on the opposing ends of the spectrum to compare the effect of value investing (RDI REIT) and that of investing in REITs with growth characteristics (British Land). Both provide the total return in GBP from 01/01/2010 to 31/03/2018.



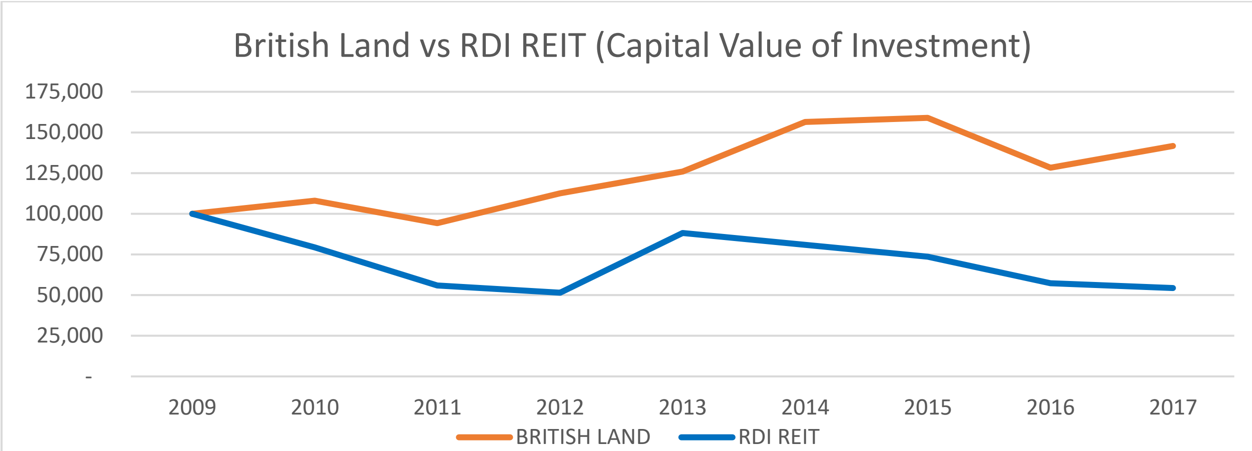
From the above it is clear that the higher yielding value REIT (RDI REIT) provided far less total returns over the period due to the wealth created from capital growth in British Land compared to RDI REIT. The **average dividend yield** over the period considered was **3.93%** for ***British Land*** and **6.94%** for ***RDI REIT***. ***British Land*** provided a total return of **102.27%** and ***RDI REIT*** **1.96%** for the period under consideration.

We then went further to analyse how long it would take for the returns from the lower yielding British Land to exceed that of the higher yielding RDI REIT after selling off capital in British Land to cover the shortfall in income from that of RDI REIT and the results speak for themselves, please see below.



The above is based on initial investments in both REITs of GBP 100,000. Although there might be those that prefer not to sell any capital in principle, it is clear from the above that even with the selling of the capital to cover shortfalls in income, the income from the lower yielding investment with greater growth starts exceeding the income earned from the higher yielding option after just 3 years (Without have to sell any capital after 3 years).

We then had to look at the impact of selling off capital to fund the deficit in income earned:



If we look at the change in capital value of the initial investments (GBP 100,000) based on price movements for this specific example even after selling capital to fund the deficit in income it is evident that growth in the price is a big consideration for choosing which option to invest in. ***British Land*** provided an **increase** in the initial capital amount of **42%** while ***RDI REIT's initial*** capital amount **decreased** by **46%.**

Conclusion

We at Reitway have a philosophy of benchmark agnosticism which we believe allows us the opportunity to select REITs with greater opportunity to outperform based on sound fundamentals.

Our style is **G**rowth **A**t a **R**easonable **P**rice (GARP), in which we look for companies that are showing consistent earnings growth above broad market levels (a tenet of growth investing) while excluding companies that have very high valuations (central principle value investing). We also actively seek to deliver returns with a reasonable Margin of Safety.

We apply Reverse Momentum, as shown in the *Cumulative Outperformance by Factor* graph, to our investment considerations and, as can be seen in the graph, it is a significant contributor to outperformance.

The overarching goal is to avoid the extremes of either growth or value investing; as this typically leads GARP investors to growth-oriented stocks with relatively low price/earnings (P/E) multiples in normal market conditions.

We believe that our approach provides the best-balanced investment approach, specifically tailored to the unique sectoral realities of global REITs, in order to deliver superior investment returns to our investors.

References:

- Investopedia
- Kirby, Mike and Rothemund, Peter. "The Factor Tracker." Greenstreet Advisors – Heard on the Beach Series. 2018-01-11.
- Graham, Benjamin. "The Intelligent Investor." HarperBusiness, 1949.
- Klarman, Seth. "Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor." HarperCollins, 1991.

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