REIT Correlations Have Returned to Historical Norms

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Investors are paying closer attention to the fundamental drivers of REIT cash flows, and the asset class is once again reflecting traditional diversification attributes.

REITs have historically been excellent diversifiers, providing returns that are not correlated with stocks or bonds. However, during the global recession and credit crisis, return patterns for REITs and other stocks converged, as the strains affecting financial markets affected many industries and asset classes in similar ways. REITs continued to trade closely with the stock market until 2012, when correlations across a wide range of sectors and asset classes began to trend lower. Today, correlations for both the U.S. and global real estate securities markets have settled back to levels more typical of their historical behavior.

Correlation of REITs and the Stock Market


Performance data quoted represents past performance. Past performance is no guarantee of future results.

Correlation is a statistical measure of how two data series move in relation to each other. U.S. correlations based on the FTSE NAREIT Equity REIT Index and the S&P 500 Index; global correlations based on the FTSE EPRA/NAREIT Developed Real Estate Index and the MSCI World Index. See index definitions and additional disclosure on the reverse side.

We believe the decline in correlations reflects the normalization of global financial markets post-crisis and the recovery in economic growth. As credit markets have stabilized and tenant demand has rebounded, REITs are benefiting from more predictable cash flows and cash-flow growth. To this point, U.S. REITs have broadly outperformed U.S. stocks year to date after widely lagging in 2013, benefiting from strengthening tenant demand, job growth and limited new supply for most property types.
The Four Pillars of REIT Investing

Low correlations are just one of four characteristics that have helped real estate securities add value to a financial asset portfolio of stocks and bonds. These “Four Pillars” of REIT investing have been remarkably reliable over time, grounded in the underlying strengths of the asset class. Below we provide some highlights based on U.S. REIT performance.\(^1\)

1. **Competitive total returns** appear to be linked to economic growth and the inflation-hedging characteristics of real assets. Since the end of 1992, which roughly marks the beginning of the modern era for U.S. REITs, total returns have averaged 10.9% per year.

2. **Potential for attractive and growing dividend income** resulting from REITs’ high minimum distribution requirements and strong cash-flow growth. Since the end of 1992, the annual cash-flow and dividend growth of U.S. REITs have averaged 9.0% and 5.9%, respectively.

3. **Moderate volatility** due to business models focused on owning long-lived assets that produce predictable cash flows tied to leases. After peaking in 2009, the volatility of REITs has reached record lows of about 10%, as measured by standard deviation.

4. **Low correlations with stocks and bonds**, driven by the underlying qualities of commercial real estate cash flows, cash-flow growth and risk premiums. The correlations of U.S. REITs have returned to their long-term average of 0.57, after falling from about 0.83, on average, during the years of the financial crisis.

Shifting Market Dynamics Point to the Importance of Active Management

The decline in correlations is occurring at a time when global economic trends are diverging and monetary policies are heading in separate directions. In this environment, some types of real estate securities are likely to perform much differently than others based on their relative sensitivity to economic cycles.

For instance, REITs that own properties with short lease durations such as hotels and self storage may perform better than others when economic conditions are getting stronger. These companies are able to adjust rents quickly to capture changes in demand, resulting in stronger cash-flow growth. Companies with more bond-like cash flows may exhibit more defensive qualities, potentially outperforming in periods of uncertainty. Active managers have the ability to dynamically adjust a portfolio’s assets based on their economic outlook, focusing on companies and property markets that they believe are best-positioned for a particular environment.

How Much Should Investors Allocate to REITs?

UBS conducts an annual survey of investors, which, among other things, asks their views on an appropriate allocation to real estate securities. In the April 2014 survey, 50% of respondents recommended an allocation of 5–10%, while 43% recommended an 11–15% allocation.\(^2\) Investors should consider allocations to real estate securities within the context of their investment objectives and risk tolerance, taking into account the asset class’s historical diversification benefits and the potential to enhance total returns over time.

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\(^1\) All data supporting “The Four Pillars” based on U.S. REITs, represented by the FTSE NAREIT Equity REIT Index. Standard deviation is a commonly used measure of volatility.

\(^2\) Source: UBS. Survey results represent 49 respondents, each with more than $340 billion in assets under management. Full results: 0–4% allocation (3% of respondents); 5–10% (50%); 11–15% (43%); 16–20% (3%); 20%+ (1%).

**Index Definitions**

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

The FTSE EPRA/NAREIT Developed Real Estate Index (net) is an unmanaged market-weighted total return index which consists of companies from developed markets that derive more than half of their revenue from property-related activities. The FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded U.S. REITs that invest predominantly in the equity ownership of real estate, not including timber or infrastructure. The MSCI World Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets. The S&P 500 Index is an unmanaged index of 500 large-capitalization, publicly traded stocks representing a variety of industries.

Performance data quoted represents past performance. Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above.

**Risks of Investing in Real Estate Securities**

Property values may fall due to increasing vacancies, declining rents resulting from economic, legal, tax, political or technological developments, lack of liquidity, limited diversification and sensitivity to certain economic factors such as interest rate changes and market recessions. The risks of investing in REITs are similar to those associated with direct investments in real estate securities. Foreign securities involve special risks, including currency fluctuations, lower liquidity, political and economic uncertainties, and differences in accounting standards. Some international securities may represent small- and medium-sized companies, which may be more susceptible to price volatility and less liquidity than larger companies.

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