What History Tells Us About
REITs and Rising Rates

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Edited by Parke Miller Johnson

The U.S. continues to show signs of economic improvement, which are most visible in the upward march of monthly employment data, improving consumer confidence and accelerating loan growth. These trends have led to the continued withdrawal of quantitative easing QE by the Federal Reserve (the Fed), which will eventually bring the era of near-zero interest rates to an end.

Real estate investment trusts, or REITs, have benefited from the recent era of record low interest rates, which have served to reduce borrowing costs and strengthen balance sheets. In many markets, the balance of supply and demand for space is favorable, and U.S. REIT fundamentals are strong across property types. In our view, this fundamental strength will go a long way to buoy the asset class as the economy continues to expand and interest rates move back towards historical norms, just as they have under similar conditions in the past. REITs have also proven to be an effective hedge against rising inflation, which is often associated with these periods.
Executive Summary

In all likelihood, interest rates will move higher as the global economy accelerates and the era of quantitative easing comes to an end. Historically, such periods of economic expansion have also ushered in higher inflation. In this Viewpoint, we tackle frequently asked questions about REITs and explore the historical relationships among REITs, rising rates and inflation. Our key takeaways are as follows:

1. **History shows that REITs can generate attractive returns in the face of rising interest rates.**
   REITs have generated an average annual return of 11.4% over the six monetary tightening cycles that have occurred since 1979. Over the seven periods in this time frame when U.S. Treasury yields were rising, REITs generated an average annual return of 14.9%.\(^{(1)}\)

2. **Capitalization Rates (or cap rates), a common valuation metric for REITs, can be impacted more by economic growth than by monetary policy and rising U.S. Treasury yields.**\(^{(2)}\)
   While there is some long-term linkage between real estate cap rates and U.S. Treasury yields, we believe that cap rates and real estate values are far more tied to economic growth expectations and credit spreads relative to U.S. corporate bonds.

3. **U.S. REITs can be effective as a hedge against inflation.**
   Businesses that do well in periods of rising inflation tend to be those with the pricing power to pass along rising costs to their customers. These characteristics are found among many types of U.S. REITs, which tend to generate cash flow and dividend growth that significantly exceed the rate of inflation.

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\(^{(1)}\) Returns, which were obtained from Bloomberg as of March 31, 2014, were time-weighted.

\(^{(2)}\) A capitalization rate, also referred to as a “cap rate,” is a valuation metric for commercial real estate, which represents the unleveraged initial return that a buyer of commercial property expects, expressed as a percentage of the purchase price.
History shows that REITs can generate attractive returns in the face of rising interest rates.

Volatility can rise sharply when the expectations for interest rates change unexpectedly. This is what occurred in mid-2013 when a Fed spokesperson suggested that the QE “taper” could begin somewhat earlier than anticipated. But markets calmed over the course of the year as the path of economic growth warranted a more gradual reduction in the Fed’s monthly bond purchase program, and investors focused more on the fundamental benefits from an improving economy.

Historically, U.S. REITs have held their own when interest rates have moved higher over a full cycle of economic expansion. As shown in Exhibit 1, this was the case over the past 20 years when REITs outperformed both stocks and bonds in periods when the Fed was increasing the federal funds rate. The data in Exhibits 2A and 2B show that REITs generated positive returns in 85% of periods when the U.S. 10-Year Treasury moved higher, and 84% in chart below of periods when global GDP growth accelerated.

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The Real Assets Pricing Power of Commercial Real Estate

As with other real asset categories, commercial real estate tends to have the pricing power to pass along rising costs by raising rents in periods when interest rates are rising or inflation is moving higher. Moreover, the values of tangible assets like land and buildings tend to rise over time due to the linkages among inflation, replacement costs and rents. In our view, these factors point to the attractive performance potential of REITs in periods of accelerating economic growth, which is often accompanied by rising inflation. Such a period occurred during the most recent Fed tightening cycle between 2004 and 2006.

June 2004–June 2006:
- Federal Funds Rate: 1.00% to 5.00%
- 10-Year Treasury Yield: 4.7% to 5.1%
- U.S. GDP: $11.5T to $13.4T


The most recent period of monetary tightening spanned the period from June 2004 through June 2006. REITs performed especially well during this period, relative to stocks and bonds. The federal funds rate was hiked 17 times over the two-year period, from the post-recession lows of 1.00% to 5.00%. The cumulative return of REITs in this period was 57.9%, compared with just 15.5% for stocks and a 6.5% return for bonds.

These results are consistent with our view that real estate fundamentals and the overall strength of the economy have a greater impact on the performance of REITs than the trajectory of interest rates. While the Fed was aggressively tightening monetary policy in an effort to quell inflation, 2004–2006 was also a period of steady economic growth, moderate real estate demand and low levels of new supply.

Exhibit A: REITs Outperformed Stocks During the Last Monetary Tightening Period
Cumulative Total Returns, June 2004–June 2006

<table>
<thead>
<tr>
<th>Date</th>
<th>Federal Funds Rate</th>
<th>Stocks</th>
<th>Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2004</td>
<td>1.00% to 5.00%</td>
<td>4.7%</td>
<td>1.0%</td>
</tr>
<tr>
<td>June 2006</td>
<td>5.00%</td>
<td>5.1%</td>
<td>6.5%</td>
</tr>
</tbody>
</table>

Source: Bloomberg and Cohen & Steers.

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

(a) Federal funds are the interest rates depository institutions charge to other depository institutions. (b) REITs are represented by the FTSE NAREIT Equity REIT Index. (c) Stocks are represented by the S&P 500 Index. (d) Bonds are represented by the Barclays Capital U.S. Aggregate Bond Index. See index definitions on page 10.
Cap rates declined in the past four cycles of monetary tightening and periods of rising Treasury yields.

Cap rates are driven more by economic growth than monetary policy and rising U.S. Treasury yields.

The valuation of commercial real estate is often expressed using cap rates—the unleveraged initial return that a buyer of commercial property expects, expressed as a percentage of the purchase price. For example, paying $1 million for a property with a 6.0% cap rate should produce cash flow of $60,000 over the first full year of operations.

Analyzing the historical movements of cap rates in periods of rising interest rates can provide insight into the economic sensitivity of real estate performance. Rising U.S. Treasury yields and tighter monetary policy typically reflect a recovering economy and a rebound in inflation expectations. History shows that cap rates have declined and real estate values have risen in these periods. We attribute this performance to the market’s perception that these conditions will drive cash-flow growth realized from rising occupancies and increasing rents. These historical trends are highlighted in Exhibit 3 below.

Exhibit 3: U.S. Cap Rates Not Linked to Risk-Free Rates

<table>
<thead>
<tr>
<th>Cap rates declined during Fed tightening periods</th>
<th>Fed Funds Rate</th>
<th>Capitalization Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/4/87–2/28/89</td>
<td>214</td>
<td>-20</td>
</tr>
<tr>
<td>2/4/94–2/1/95</td>
<td>267</td>
<td>-10</td>
</tr>
<tr>
<td>6/30/99–5/16/00</td>
<td>128</td>
<td>0</td>
</tr>
<tr>
<td>6/30/04–6/30/06</td>
<td>373</td>
<td>-140</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cap rates declined during rising yield periods</th>
<th>10-Yr. Treasury Yield</th>
<th>Capitalization Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>8/29/86–10/16/87</td>
<td>193</td>
<td>0</td>
</tr>
<tr>
<td>10/15/93–11/7/94</td>
<td>248</td>
<td>-40</td>
</tr>
<tr>
<td>10/5/98–1/20/00</td>
<td>204</td>
<td>-10</td>
</tr>
<tr>
<td>6/13/03–6/12/07</td>
<td>149</td>
<td>-260</td>
</tr>
<tr>
<td>7/25/12–6/30/14</td>
<td>110</td>
<td>-60</td>
</tr>
</tbody>
</table>


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

(a) Risk-free rates are represented by 10-year U.S. Treasury notes, which are backed by the full faith and credit of the U.S. government. (b) Bps refer to basis points, or 1/100 of 1%. (c) Capitalization rates are represented by the weighted average of the five major property sectors—apartments, industrial, mall, office and strip center. Month-end data were used.

This economic sensitivity can also be observed in credit-sensitive rates, such as Baa corporate bond yields, which reflect credit spreads that move inversely to risk-free rates. Exhibit 4 on the following page highlights the high historical correlation between cap rates and Baa corporate bonds.

If inflation were to rise, it is likely that cap rates would fall below Baa corporate bond yields, as they did in the higher inflation regimes seen prior to the early 1990s. In these periods, real estate investors accepted a lower cap rate on properties with the expectation that inflation would lead to cash flow growth from increasing occupancies and rents.
REITs have demonstrated the ability to perform in periods when inflation is above average.

U.S. REITs can be an effective hedge against inflation.

One reason is that the cash flow and dividends generated by REITs tend to grow at a faster pace than the rate of inflation. These trends are highlighted in Exhibit 5, which tracks cash-flow and dividend growth over the modern era of U.S. REITs, spanning the period from 1992–2013.

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Exhibit 6 below highlights the economic drivers of performance for various commercial real estate sectors. Notably, sectors with shorter lease terms such as hotels and apartments, tend to be more cyclical.

### Exhibit 6: Characteristics of Commercial Real Estate Sectors

<table>
<thead>
<tr>
<th>Property Sector</th>
<th>Economic Drivers</th>
<th>Lease Duration</th>
<th>Construction Cycle (post approval)</th>
<th>Relative Cyclicality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotel</td>
<td>Business and consumer sentiment; corporate profits; fuel prices (higher costs for air travel)</td>
<td>1 day</td>
<td>2 years</td>
<td>Very high</td>
</tr>
<tr>
<td></td>
<td>Hotels are highly cyclical due to their nightly leases, as room rates and occupancies can change swiftly with economic conditions. Low relative operating margins and significant recurring capital expenditures add volatility to the cash flow profile.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Self Storage</td>
<td>Population; employment growth (particularly in urban areas, where space is more limited)</td>
<td>1 month</td>
<td>6 months</td>
<td>High</td>
</tr>
<tr>
<td></td>
<td>Lease terms are relatively short, but self storage companies have strong pricing power, since small businesses and apartment dwellers will typically agree to higher rents rather than discard belongings or move into a larger space.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apartment</td>
<td>Household formation; job growth; home affordability; single-family housing sentiment</td>
<td>1 year</td>
<td>1–1½ years</td>
<td>High to medium</td>
</tr>
<tr>
<td></td>
<td>Apartment REITs are largely cyclical, as profitability is tied to employment rates. However, they tend to be inversely (negatively) correlated to residential housing (tighter mortgage requirements and uncertainty on home prices tend to benefit apartment demand).</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shopping Center</td>
<td>Consumer spending; disposable income; employment</td>
<td>3–5 years</td>
<td>12 months</td>
<td>Low to medium</td>
</tr>
<tr>
<td></td>
<td>Tenants are generally geared toward non-discretionary (grocery, discount retail, pharmacy), offering some defensive qualities. Big box centers generally have stronger-credit tenants, but are also at greater risk from e-commerce penetration. Neighborhood centers typically include more local businesses (nail salons, pizza parlors), which are more dependent on the local economy.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial</td>
<td>Exports; manufacturing activity; inventories; shipping volumes; business sentiment</td>
<td>3–6 years</td>
<td>6 months</td>
<td>Medium</td>
</tr>
<tr>
<td></td>
<td>Despite long lease durations, industrial properties have short construction times due to less-complex building requirements, so supply tends to closely track demand. A shorter property cycle results in greater sensitivity to domestic and global economic growth.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regional Mall</td>
<td>Discretionary spending; consumer sentiment; employment</td>
<td>5–10+ years</td>
<td>1½–2 years</td>
<td>Low</td>
</tr>
<tr>
<td></td>
<td>Tenants tend to be discretionary-focused (department stores, boutique retail). Leases typically include rent step-ups, providing some support in the event of a downturn in the economy.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Office</td>
<td>Corporate profits; employment growth; business outlook</td>
<td>5–10+ years</td>
<td>1½–2 years</td>
<td>Low to medium</td>
</tr>
<tr>
<td></td>
<td>Lengthy lease durations (10 years or more for urban offices) provide long-term cash flow visibility. Offices in central business districts often see near-constant low supply conditions.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health Care</td>
<td>Government reimbursement rates (i.e., Medicare and Medicaid); population aging; home sales</td>
<td>8–10 years</td>
<td>1–1½ years</td>
<td>Very low to medium</td>
</tr>
<tr>
<td></td>
<td>Long-term tenants such as hospitals and medical office buildings provide generally stable, bond-like income payments, resulting in a defensive investment profile.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: NAREIT and Cohen & Steers.

There is no guarantee that any market forecast set forth in this commentary will be realized. The views and opinions are as of the date of publication and are subject to change without notice.
What History Tells Us About REITs and Rising Rates

Overall, REITs have demonstrated the potential to outperform stocks and bonds in periods when inflation is above average. Over the past 20 years, the time-weighted annual returns for REITs over periods of above-average inflation were 13.8%, compared with 13.2% for stocks and 6.0% for bonds. These trends are summarized in Exhibit 7 below.

Exhibit 7: Asset Class Performance in Periods of Above-Average Inflation
March 1994 Through June 2014

<table>
<thead>
<tr>
<th></th>
<th>U.S. REITs®</th>
<th>Stocks®</th>
<th>Bonds®</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Periods</td>
<td>13.6</td>
<td>11.7</td>
<td>7.2</td>
</tr>
<tr>
<td>Above-Average Inflation</td>
<td>13.8</td>
<td>13.2</td>
<td>6.0</td>
</tr>
</tbody>
</table>


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(a) U.S. REITs are represented by the FTSE NAREIT Equity REIT Index. (b) Stocks are represented by the S&P 500 Index. (c) Bonds are represented by the Barclays Capital U.S. Aggregate Bond Index. See page 10 for index definitions.

Employment growth is a key driver of real estate demand.

We believe that employment growth is and will continue to be a significant driver of REIT performance as the economy continues to expand. In closing, Exhibits 8 and 9 on the following page put these trends in perspective. Job growth over the past four years has led to the recovery of the 8.7 million jobs that were lost in the two years of the financial crisis, and wage growth has been climbing since 2012. In particular, these trends benefit sectors for which profitability is tied to employment trends, such as apartments and self storage.
Throughout this Viewpoint, we have highlighted the ability of REITs to perform in a rising interest rate environment, which is often accompanied by rising inflation. In part, we attribute these results to the close ties in the performance of this asset class to economic improvement, which can favorably affect real estate fundamentals. We see these trends today in the relative attractiveness of more economically sensitive sectors, such as hotels, apartments and self storage. However, the fundamentals of U.S. REITs continue to be strong across property types, based on subdued overall supply growth and rising demand from an expanding U.S. economy. With varying degrees of cyclicality across property sectors, and a long history of cash flow and dividend growth rising at a pace faster than the rate of inflation, we also believe that REITs can provide an effective hedge against inflation. In our view, these trends will hold true as the next cycle takes shape.

Job growth has returned to pre-financial crisis levels and wage growth has been rising since 2012.

**Conclusion**

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Index Definitions
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The Barclays Capital U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Consumer Price Indexes produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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 and infrastructure.

The S&P 500 Index is an unmanaged index of 500 large-capitalization, publicly traded U.S. stocks representing a variety of industries.

The methodology for presenting cash flow and dividend information on Exhibit 5 is as follows: Cash flow data reflects actual results through 2014 and Cohen & Steers estimates for 2014 and 2015. Dividend growth reflects actual results through 2007, Cohen & Steers calculated results from 2008–2013 and Cohen & Steers estimates for 2014. The 2014E and 2015E cash flow growth projection was compiled by Cohen & Steers based on a statistical model using historical data for each company’s net income, real estate gains and losses as well as expected depreciation and or amortization of assets. The projection of equity REITs was then derived by averaging the model’s projected cash flow growth rates for 2014 and 2015. The 2014E and 2015E dividend growth projection was compiled by Cohen & Steers, based on a statistical model using historical dividend payout ratios and cash earnings growth as inputs. The projection of equity REITs was then derived by averaging the model’s projected dividend growth rates for 2014. Note: Actual annual dividend growth through 2007 was compiled using the methodology of and data provided by NAREIT. Annual growth rates represent a market-capitalization-weighted average on the year-over-year percent change in cash-only income distributions for the constituent companies in the FTSE NAREIT Equity REIT Index. It includes all REITs that are listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ National Market List. Accordingly, any stock dividends paid by index constituents are not included. This methodology overstates the importance of large percentage changes in dividends by the largest index constituents. Therefore, Cohen & Steers estimates of dividend growth rates from 2008 through 2013 were calculated based on actual dividend yields and price values for the FTSE NAREIT Equity REIT Index.

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Risks of Investing in Real Estate Securities
Risks of investing in real estate securities include falling property values 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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