

## What History Tells Us About REITs, Inflation and Rising Rates

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Should investors be worried about rising inflation? A look at core inflation,<sup>(1)</sup> as measured by the Consumer Price Index, suggests not, at least in the very near term. However, this benchmark ignores the cost of food and energy, which are essential and significant expenditures of the everyday U.S. consumer. According to the International Monetary Fund (IMF), these costs rose significantly over the past year,<sup>(2)</sup> with food +33% and energy +40%. Further, the inflation of these so-called non-core items usually finds its way into core inflation eventually. We have seen this occur in the past, coupled with the Federal Reserve's expansion of the monetary base—most of the time, it has gone hand-in-hand with rising inflation.

Inflationary pressures have been more visible in emerging economies, where food and energy tend to comprise a higher percentage of the consumer basket. In fact, the larger BRIC<sup>(3)</sup> nations have already begun to take action by tightening monetary policy. But in the developed world, where economic recovery is still fragile and unemployment remains high, central banks have been more tentative.

At this inflection point, we think it's important to acknowledge that inflation and higher rates will be a byproduct of the next growth cycle. In our view, investors should prepare for this likelihood by allocating a portion of their assets to real asset strategies. REITs offer one such choice, given their historical ability to perform in both rising-rate and inflationary environments. In this *Viewpoint*, we tackle common misconceptions about REITs and explore the historical relationships among REITs, rising rates and inflation. Our key takeaways are as follows:

- **U.S. REITs have the potential to outperform in periods of rising rates.** Contrary to a common misconception, higher interest rates and poor U.S. REIT performance are not synonymous. In stark contrast, U.S. REITs have outperformed stocks in two-thirds of the periods when the Federal Reserve was increasing rates systematically.
- **Capitalization rates are not linked to risk-free rates.** Real estate capitalization rates (cap rates)<sup>(4)</sup> show little historical linkage to increases in the federal funds rate and Treasury yields. Instead, we conclude that cap rates and real estate values are more tied to economic growth expectations and credit spreads.
- **U.S. REITs can be effective as a hedge against inflation.** U.S. REITs have outperformed stocks and bonds in periods of both rising and moderating inflation. With varying degrees of cyclicity across property sectors—and a long history of dividend growth at a pace faster than that of inflation—U.S. REITs have proven to be, and should continue to be viewed as, an effective inflation hedge.

(1) Based on the Consumer Price Index (CPI), a measure of U.S. consumer price inflation for goods and services.

(2) As of May 31, 2011.

(3) Brazil, Russia, India and China.

(4) See Page 4 for a definition and more detailed discussion of cap rates.

**U.S. REITs Have Outperformed in Periods of Rising Rates**

Given the absolute level of current interest rates and the potential for rising inflation, investors are rightfully examining their positioning in a rising interest rate environment. As we noted above, misconceptions about what rising rates mean for real estate values remain, and we find the same misconceptions about REIT performance.

Contrary to conventional wisdom, REITs have historically delivered solid returns in periods when Treasury yields were rising.

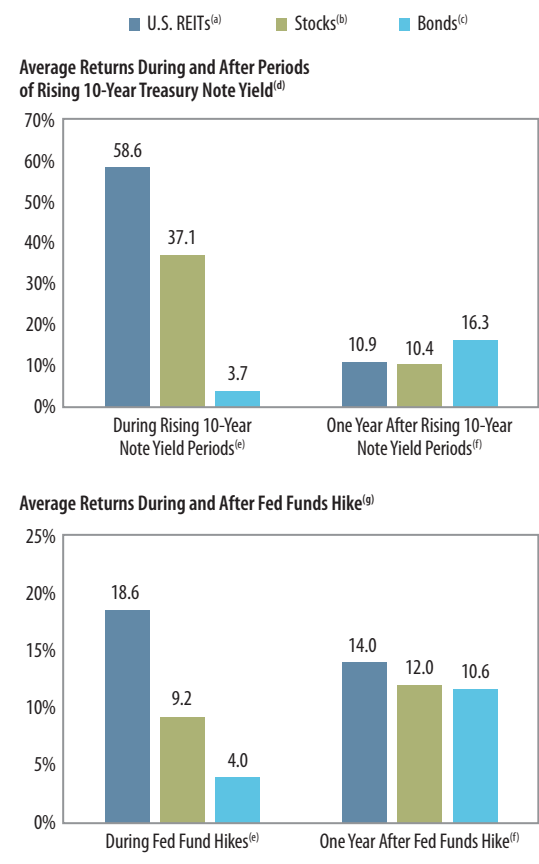
- Over the past six episodes of increasing Treasury yields, REITs delivered average returns of 58.6% and outperformed stocks half of the time.
- Once the rate hikes concluded, REITs delivered average returns of 10.9% and again outperformed stocks half of the time.

REITs have also delivered solid returns in periods when the Federal Reserve has increased short-term interest rates.

- Over the past six rounds of monetary tightening, REITs delivered average returns of 18.6% and outperformed stocks two-thirds of the time.
- Once the rate hikes concluded, REITs delivered average returns of 14.0% and again outperformed stocks two-thirds of the time.

Exhibit 1 summarizes the historical performance of REITs, stocks, and bonds during these periods.

EXHIBIT 1. REIT PERFORMANCE HAS BEEN STRONG DURING AND AFTER RATES/YIELD RISE



Source: Ned Davis Research, Inc. Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. An investor cannot invest directly in an index.

(a) U.S. REITs: The FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded REITs that invest predominantly in the equity ownership of real estate. The index is designed to reflect the performance of all publicly traded equity REITs as a whole.

(b) Stocks: The Standard & Poor's 500 Index (S&P 500) is an unmanaged index of 500 large-capitalization, publicly traded stocks representing a variety of industries.

(c) Bonds: The Barclays Capital U.S. Aggregate Bond Index is a market capitalization-weighted index representing most U.S. traded investment-grade bonds. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the U.S.

(d) Rising 10-Year Treasury Note yield periods include: 7/2/79–9/30/81; 5/4/83–5/30/84; 8/29/86–10/16/87; 10/15/93–11/7/94; 10/5/98–1/20/00; 6/13/03–6/12/07.

(e) Time-weighted average.

(f) Simple average.

(g) Fed funds hike periods include: 1/2/79–2/15/80; 9/26/80–5/5/81; 9/4/87–2/29/89; 2/4/94–2/1/95; 6/30/99–5/16/00; 6/30/04–6/30/06.

June 2004–June 2006  
*(the last monetary tightening cycle)*

Fed Funds:  
**1.00% to 5.00%**

10-Year Treasury Yield:  
**4.7% to 5.1%**

U.S. GDP:  
**\$11.5T to \$13.4T**

Unemployment:  
**5.6% to 4.6%**

Although the last monetary tightening cycle (2004–2006) was unique in many respects, we believe it would be ill-advised to dismiss the fact that REITs outperformed stocks throughout the entire period, as shown in Exhibit 2. Spanning a period of 17 consecutive rate hikes, REITs generated cumulative returns of 57.9% compared to 15.5% for stocks.

It is our view that interest rates alone do not determine REIT performance; real estate fundamentals and the trajectory of the economy have an equally important effect. The last monetary tightening cycle served as a perfect example, as it was a period of steady economic growth, moderate real estate demand and low supply.

As we look forward, we believe the same fundamentals will buoy REITs in the next

tightening cycle. The primary drivers are likely to be narrowing credit spreads and limited new supply.

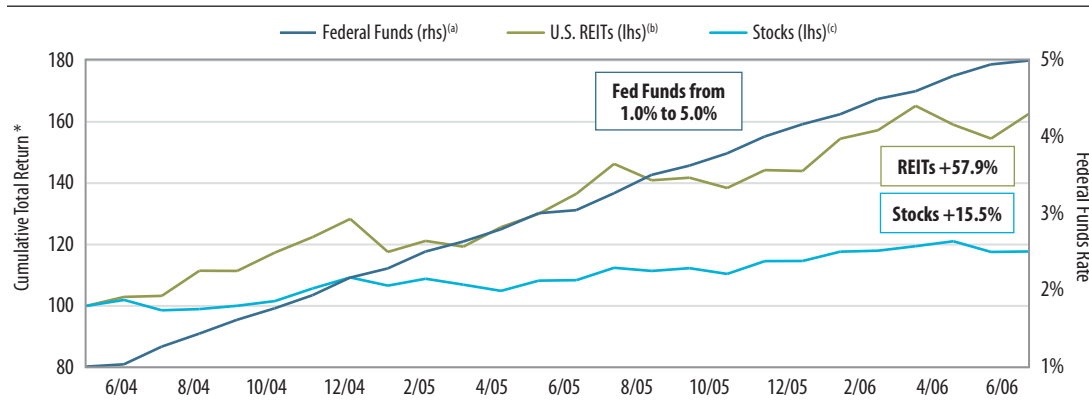
*There is limited new supply on the horizon.*

Another positive for U.S. REITs is a stark lack of new supply. In past recoveries, dramatic overbuilding restricted the commercial real estate market for extended periods beyond the onset of economic growth. However, due to the credit contraction that began before the Great Recession, financing for construction became unattainable. As a result, the early stages of the current demand recovery are being met with limited new supply on the horizon.

Above all else, this combination of narrowing spreads and low supply could be the primary driver for U.S. REITs to move higher over the next interest rate cycle.

#### EXHIBIT 2. REITs OUTPERFORMED STOCKS DURING LAST MONETARY TIGHTENING PERIOD

Cumulative Total Return, June 2004–June 2006



Source: Ned Davis Research, Inc.

\* 6/04 = 100

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(a) Federal Funds are the interest rates depository institutions charge to other depository institutions.

(b) REITs: the FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded REITs that invest predominantly in the equity ownership of real estate. The index is designed to reflect the performance of all publicly traded equity REITs as a whole.

(c) Stocks: The Standard & Poor's 500 Index (S&P 500) is an unmanaged index of 500 large-capitalization, publicly traded stocks representing a variety of industries.

REIT performance is tied to improving economic conditions and real estate fundamentals.

Cap rates declined in the past four cycles of monetary tightening and periods of rising Treasury yields.

**Cap Rates Are Not Linked to Risk-Free Rates**

The valuation of commercial real estate is often expressed via capitalization rates (or cap rates)—the unleveraged initial return that a buyer of commercial property expects, expressed as a percentage of the purchase price, akin to the dividend yield of a stock. For example, paying \$1 million for a property with a 6.0% cap rate should produce an unleveraged return on the investment of \$60,000 for the first year. We underscore that one should not blindly compare cap rates to corporate bond yields. This is because an owner of real estate not only enjoys the initial yield but also the growth in that yield over time as rents rise or occupancies grow.

Until the early 1990s, cap rates consistently traded below most corporate bond yields. The rationale for this seeming inversion was that the real estate owner accepted a lower yield because they enjoyed the growth in that yield during what was a period of higher inflation. Then, a major shift from higher inflation to disinflation caused this relationship to change.

Interestingly, Exhibit 3 shows that cap rates have generally declined during the past four Fed tightening periods and past four periods of rising Treasury yields.

**EXHIBIT 3. U.S. CAP RATES NOT LINKED TO RISK-FREE RATES**

*Cap Rates Declined During Fed Tightening Periods*

Rising Rate Hike Periods	Cumulative Changes (bps)	
	Fed Funds Rate	Capitalization Rate
9/4/87–2/24/89	214	-22
2/4/94–2/1/95	267	-12
6/30/99–5/16/00	128	0
6/30/04–6/29/06	373	-142

*Cap Rates Declined During Rising Yield Periods*

Rising Yield Periods	Cumulative Changes (bps)	
	10-Year Treasury Note Yield	Capitalization Rate
8/29/86–10/16/87	193	-2
10/15/93–11/7/94	248	-35
10/5/98–1/20/00	204	-8
6/13/03–6/12/07	149	-255

As of March 31, 2011.  
 Source: Ned Davis Research, Inc., Green Street Advisors. Monthly data.  
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The rationale behind these trends is that rising Treasury yields and tighter monetary policy typically reflect a recovering economy and a rebound in inflation expectations. Thus, cap rates decline and real estate values rise in anticipation of being able to benefit from higher growth in cash flows via increasing rents and rising occupancies. 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. Although, if inflation were to rise, an inversion would likely occur between cap rates and Baa corporate bond yields.

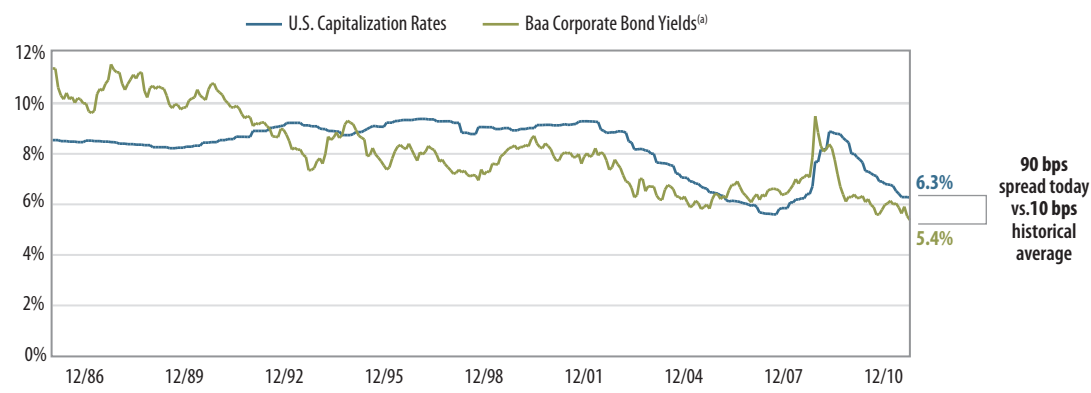
From a U.S. REIT valuation perspective, the current 90-basis-point spread between cap rates (at 6.3%) and Baa corporate bond yields (at 5.4%) is above the long-term average of +10 basis points, as shown in Exhibit 4. This relationship suggests that U.S. REIT returns are

close to historical expectations relative to the corporate bond market.

### U.S. REITs Can Be an Effective Hedge Against Inflation

With respect to inflation, the historical returns from commercial real estate properties have been highly correlated with changes in the Consumer Price Index. This has been especially true when the CPI is unusually elevated. Exhibit 5 tracks this relationship, pairing the one-year returns of the NCREIF Index<sup>(1)</sup> with year-over-year changes in the CPI from 1979–2010.

EXHIBIT 4. U.S. CAPITALIZATION RATES VS. CORPORATE BOND YIELDS



As of August 31, 2011.

Source: Green Street Advisors.

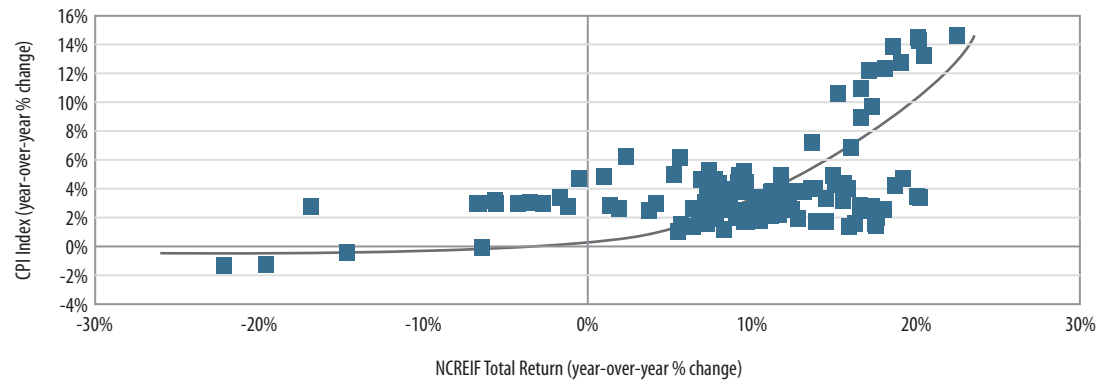
Past performance is no guarantee of future results. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin.

(a) Moody's Baa Corporate Bond Yields (yield to maturity).

(1) The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

Commercial real estate returns are highly correlated with changes in the CPI, especially when this measure is elevated.

EXHIBIT 5. COMMERCIAL REAL ESTATE TOTAL RETURNS VS. INFLATION 1979–2010



Source: ISI Group, NCREIF, U.S. Dept. of Labor (Consumer Price Index); quarterly data 1/1/79–12/31/2010. See last page for index definitions. There is no guarantee that any historical trend will be repeated in the future, and no way to predict precisely when such a trend will begin.

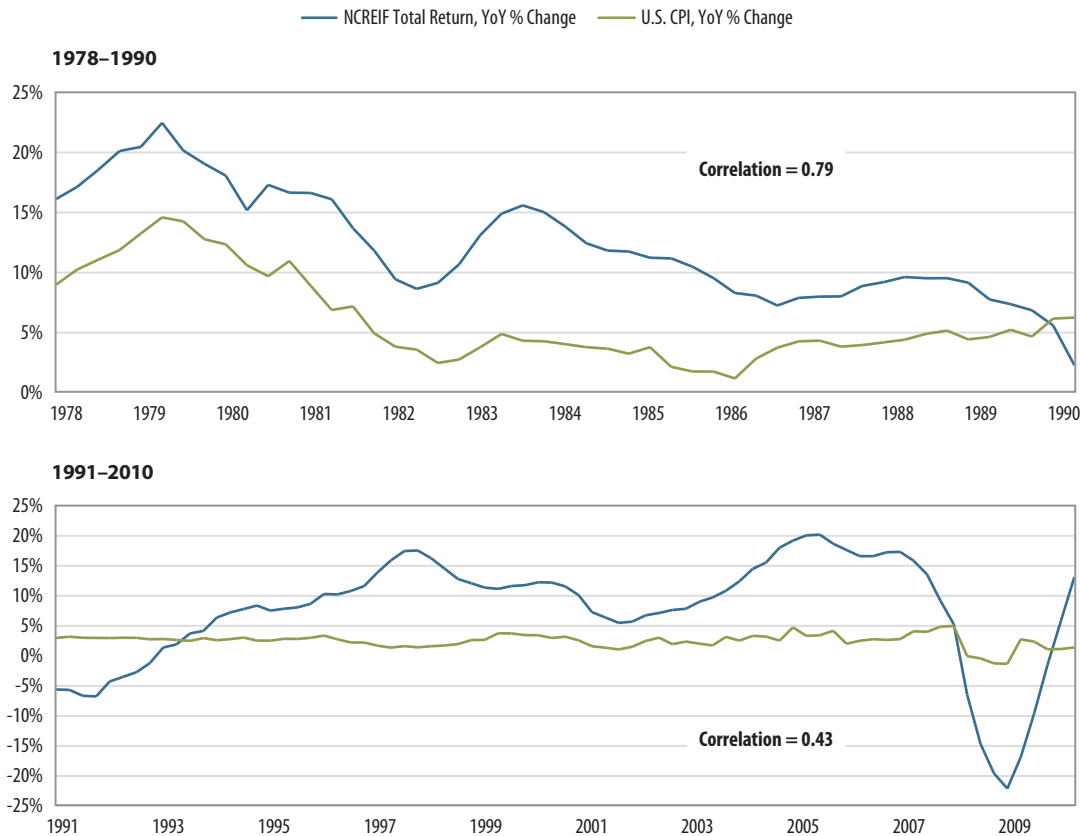
*The higher the inflation rate, the higher the correlation with real estate returns.* Exhibit 6 separates these observations into two broad periods, highlighting further how correlations tend to rise during periods of higher inflation. Note that the correlation between real estate and inflation was much higher in the 1970s and 1980s, when year-over-year inflation was rising on average by 6.2%. However, this relationship waned considerably in the 1990s, as inflation decreased to 2.7%, on average.

Recently, Cohen & Steers conducted an in-depth analysis of the long-term performance of REITs and other asset classes in various inflationary regimes. From this analysis, which spanned inflationary cycles from 1974 through March 2011, we drew the following conclusions:

- As a group, REITs outperformed stocks and bonds in both rising and falling inflationary environments.

EXHIBIT 6. U.S. REAL ESTATE RETURNS AND INFLATION

Relationship Stronger in Inflationary Environment... Not so Much in a Less Inflationary Period



Real estate and inflation were more correlated from 1978–1990 when inflation increased 6.2% on average.

Real estate and inflation have been less correlated since 1991, with inflation at 2.7% on average.

As of December 31, 2010.

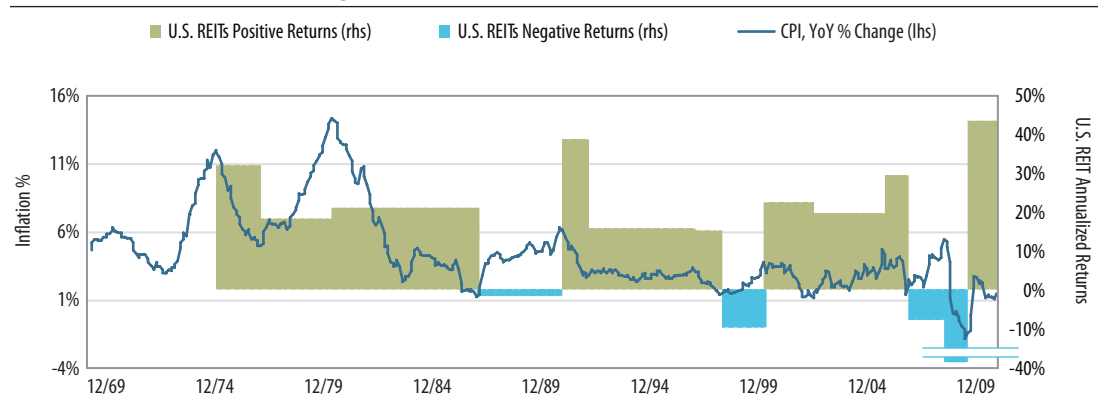
Source: NCREIF, Bloomberg, ISI Group. Quarterly data. Correlation computed on a year-over-year basis.

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- Between 1974 and the first quarter of 2011, REITs had positive total returns in 10 out of the 14 inflationary periods within that span. (See Exhibit 7.)
- During the six periods when inflation rose, REITs had an average annualized return of 10.7%, compared with 9.8% for stocks and 4.6% for bonds.
- Within the seven regimes defined by moderating inflation, REIT returns averaged 17.6%, compared with 14.0% for stocks and 10.8% for bonds. (There was one additional period in which inflation was range-bound.)

EXHIBIT 7A. REIT PERFORMANCE HAS BEEN STRONG IN DIFFERENT INFLATION REGIMES

Positive Returns in 10 of 14 Inflation Regimes<sup>(a)</sup>

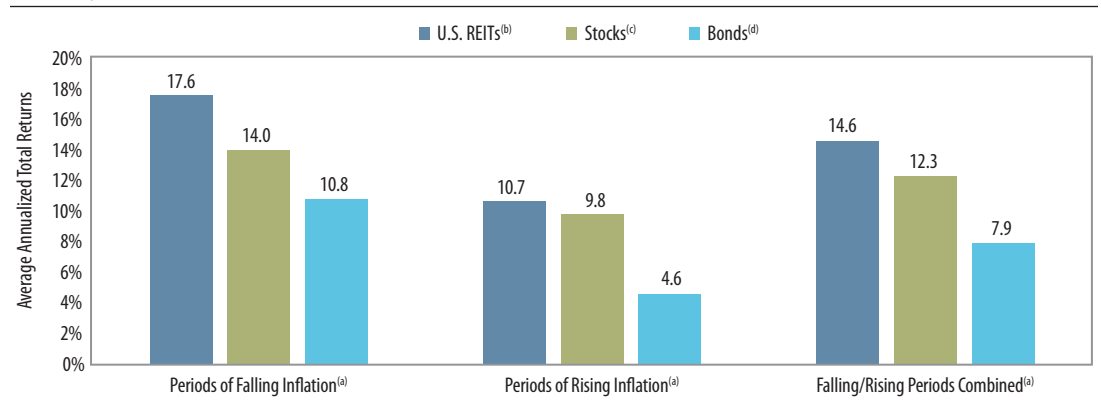


Source: Bloomberg.

(a) Inflation regimes are based on year over year CPI change in percentage. Prior to 12/1982, regimes are defined by absolute levels of 2%, 4%, and 6%. From 01/1983 to 12/1997 and 1/1998 to 12/2010 regimes are defined by standard deviation from period mean.  
 (b) U.S. REITs: The FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded REITs that invest predominantly in the equity ownership of real estate. The index is designed to reflect the performance of all publicly traded equity REITs as a whole.  
 (c) The Consumer Price Index (CPI) measures changes in the price level of consumer goods and services purchased by households. The CPI is defined by the United States Bureau of Labor Statistics as “a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.”

EXHIBIT 7B. REIT PERFORMANCE HAS BEEN STRONG IN DIFFERENT INFLATION REGIMES<sup>(a)</sup>

REITs Outperform Stocks and Bonds



Source: Bloomberg.

(a) Periods of falling inflation include: 12/74–12/76; 3/80–12/86; 10/90–1/92; 12/96–3/98; 3/00–6/02; 9/05–10/06; 7/08–7/09. Periods of rising inflation include: 12/76–3/80; 12/86–10/90; 3/98–3/00; 6/02–9/05; 10/06–7/08; 7/09–12/10.  
 (b) U.S. REITs: The FTSE NAREIT Equity REIT Index is an unmanaged, market-capitalization-weighted index of all publicly traded REITs that invest predominantly in the equity ownership of real estate. The index is designed to reflect the performance of all publicly traded equity REITs as a whole.  
 (c) Stocks: The Standard & Poor’s 500 Index (S&P 500) is an unmanaged index of 500 large capitalization, publicly traded stocks representing a variety of industries.  
 (d) Bonds: The Barclays Capital U.S. Bond Aggregate Index (formerly the Lehman Brothers U.S. Aggregate Bond Index) is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

Some property sectors are more cyclical than others. History also tells us that U.S. REITs, as a broad group, participate with the economy as it expands. Those with highly cyclical (economically sensitive) assets and shorter lease terms tend to reflect this improvement more quickly. As shown in Exhibit 8, the three sectors with the greatest economic sensitivity are hotels, apartments and storage facilities. These property types also tend to have the shortest lease terms, which means that property cash flow values can be marked to market more frequently and will consequently see values change more quickly. As a result, they more rapidly reflect revenue growth and tend to outperform during periods of economic expansion.

### The Important Role of Dividend Growth

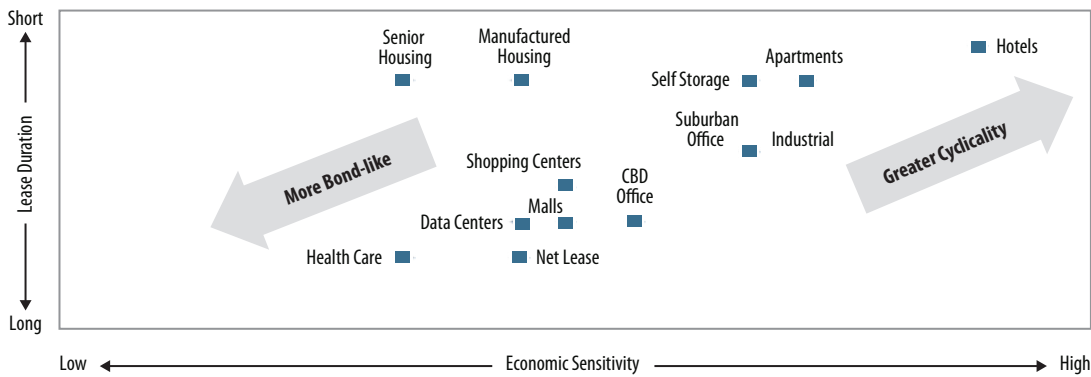
Investors seeking growing dividends as a way to contend with inflation should find U.S. REITs relatively attractive. In fact, the year-over-year growth in dividends from 1987 through 2010 exceeded the rate of inflation in 18 out of 24 years. Over this period, the compound average growth rate of REIT dividends was 5.7%, compared with 3.1% for CPI inflation.<sup>(1)</sup> This above-trend growth has made REITs a good place to invest during periods of rising inflation.

In our view, the near-term outlook for dividend growth is particularly encouraging. As markets continue to normalize after the deep cuts in the financial crisis, we expect that dividend levels

Hotels, apartments and storage facilities are the most economically sensitive property types.

EXHIBIT 8. SHORT-LEASE SECTORS ARE MORE ECONOMICALLY SENSITIVE

Property Types by Economic Sensitivity and Lease Duration



As of August 31, 2011.  
 Source: Cohen & Steers estimates.  
 There is no guarantee that any market forecast set forth in this presentation will be realized.

(1) Returns for REIT dividends and inflation are as of June 30, 2011 and are based on yearly data provided by NAREIT (REIT Dividend Growth) and U.S. Department of Labor (Consumer Price Index).

REIT dividend growth has outpaced the rate of inflation in 18 of the past 24 years.

will also normalize to deliver a multi-year period of dividend growth that exceeds inflation.

#### **Conclusion**

Through this *Viewpoint*, we highlighted the ability of REITs to perform in an inflationary environment and periods of higher interest rates. In part, we attribute these results to the close ties in their performance to improving economic conditions and real estate fundamentals. Our analysis finds no historical linkage between the cap rates used to value real estate and movements in risk-free interest rates.

We have also illustrated the ability of REITs to outperform stocks and bonds in periods of both rising and moderating inflation. With varying degrees of cyclicalities across property sectors, and a long history of dividend growth at a pace faster than that of inflation, U.S. REITs have proven to be an effective inflation hedge. In our view, this will hold true as the next cycle takes shape.

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*Past performance does not guarantee future results.* There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. There is no guarantee that a market forecast made in this commentary will be realized.

**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.

This commentary must be accompanied by the most recent Cohen & Steers Fund fact sheet if used in connection with the sale of mutual fund shares.

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