PORTFOLIO: THE CASE FOR LISTED

The crisis brought into focus real estate portfolio construction. Adding REITs could improve performance and liquidity, says Joseph Harvey

Allocations: the truth

As the recovery in the commercial US real estate sector continues, institutional investors are re-evaluating the composition of their real estate allocations. In our view, the historical performance of private real estate funds does not justify the high allocations to direct property typically found in corporate and public pension plan portfolios. Notably, investors have not been compensated for the costs or risks of illiquidity. The recent downturn has illuminated those costs, and has demonstrated why US REITs provide a superior investment vehicle for core and value added real estate allocations.

We will make the case that:

- Listed REITs have outperformed core and value added real estate funds consistently over the long term, while providing the benefit of liquidity;
- Returns for opportunistic funds have been comparable to REIT returns over time. However, their different return cycles have resulted in distinct periods of outperformance for each;
- Core and value added funds have not adequately compensated investors for the risks of illiquidity, and they do not generate enough alpha to justify their fee structures;
- The REIT business model explains most of REIT performance advantage over private real estate funds;
- In a good vintage year, opportunistic funds can be an attractive vehicle for distressed, appreciation-oriented real estate strategies;
- A rational, merit-based reallocation would drive significant capital flows away from core and value added allocations and into REITs.

Historical performance of listed vs direct

Over the past 30 years, which encompass two commercial real estate crashes, REITs have outperformed diversified core funds by 470bps annually. Over the past 10 years, they outperformed core funds by 560bps annually.

We measured listed REIT performance using the FTSE NAREIT Equity REIT Index (NAREIT Index) – a market-capitalisation-weighted index of 106 US REITs. We used the NCREIF Fund Index – Open-End Diversified Core Equity (NFI-ODCE) series, which is also capitalisation-weighted, to chart the performance of those open-end commingled funds that pursue a diversified core investment strategy. At 31 March 2010, the REITs in the NAREIT Index had an aggregate market capitalisation of $273bn and owned an estimated $515bn (€422.7bn) of real estate. As of 31 December 2009, the last period for which data are available, the funds in the NFI-ODCE had appraised net equity of $488bn and owned gross real estate assets of $571bn.

Table 1 compares their performance. Both indexes show results on a leveraged basis, with NFI-ODCE funds operating with less leverage (33%) than the NAREIT Index companies (47%, per Cohen & Steers estimates). Leverage, which adds to the volatility of returns, is a drag on returns in bear markets but enhances returns in up markets. Greater leverage has benefited REIT performance versus core funds over the long term, but has detracted from performance since the peak in real estate values in 2007.

In practice, the advantage for REIT investors shown in table 1 is understated, as most institutional investors hire active managers for their REIT allocation, many of whom outperform the NAREIT Index benchmark. Active REIT management for a diversified strategy should add 200bps of alpha; REITs’ stock-exchange liquidity enables portfolio managers to capitalise on valuation anomalies and performance variances across property types and markets as economic and real estate cycles change.

REITs vs core, value added and opportunistic

We expanded our study to evaluate the returns of REITs, core, value added and opportunistic strategies. Gross of expenses, opportunistic funds performed the best over 15 years and actively managed REIT portfolios placed second. For the past 10 years, actively managed REIT portfolios performed best, while a passive REIT portfolio strategy based on the NAREIT Index was second.

However, looking at the more important net-of-expenses returns, actively managed REIT investors realised the highest returns for the five-, 10- and 15-year periods. For the 15-year period, they earned an annualised 10.6%. Of the other active strategies, opportunistic funds placed second, at 9.8%. Core and value added funds lagged significantly, with annualised returns of 6.5% and 5.6%, respectively, over 15 years.

Looking at expenses over the 15-year holding period, REIT investors with actively managed portfolios saw the greatest efficiency, with just 7% slippage from gross to net returns. Core funds lost 13% of their gross returns to fees and expenses. Value added funds had 21% slippage and opportunistic funds lost 22%. While opportunistic fund expenses appear to be high, the index data include the promote fees that the successful funds earned above their hurdle rates.

Rolling return analysis

We also looked at rolling periods of returns, to eliminate any bias from endpoints selected that may favour one strategy. Table 3 tallies the NAREIT Index and three private fund strategies for rolling three-, five-, 10- and 15-year periods. Note that all results are gross of expenses, which provides a performance advantage to private funds.

Starting with a comparison of REITs with core funds, we analysed 85 quarterly periods of 10-year returns. The simple average of compounded REIT returns was 12.7%, compared with 7.8% for core funds. REITs outperformed in 96% of the periods. For 15-year periods, REITs outperformed core funds in each of the 65 periods. Over the three- and five-year rolling periods, REITs outperformed core funds by 79% and 81% of the time, respectively.

REITs’ record of outperformance tells the same story when compared with value added funds. Opportunistic funds outperformed REITs in 68% of the rolling 15-year periods and 74% of the 10-year periods. Looking at net returns, however, passive REIT strategies and opportunistic funds performed about the same. Even though the net returns are similar, REITs still have the advantage over the opportunistic fund averages due to their lower-risk business models and liquidity.

Interestingly, while the returns are similar, the return cycles for REITs and opportunistic funds had distinct, sustained periods where one outperformed the other, suggesting meaningful diversification benefits between these two strategies.

Liquidity comparison

Of the $270bn in property held in private fund indexes, just 38% is controlled by open-end vehicles; the remaining 62% is controlled by closed-end vehicles, which have no investor liquidity. The broader

TABLE 1: ANNUALISED TOTAL RETURNS THROUGH 2009 LISTED REITS VS DIVERSIFIED CORE EQUITY FUNDS

<table>
<thead>
<tr>
<th></th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
<th>15 Years</th>
<th>20 Years</th>
<th>30 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAREIT index</td>
<td>29.00%</td>
<td>-12.4%</td>
<td>0.40%</td>
<td>10.00%</td>
<td>9.80%</td>
<td>9.90%</td>
<td>11.80%</td>
</tr>
<tr>
<td>NFI-ODCE Core (gross)</td>
<td>-29.7%</td>
<td>-9.8%</td>
<td>0.70%</td>
<td>5.00%</td>
<td>7.50%</td>
<td>5.40%</td>
<td>7.10%</td>
</tr>
<tr>
<td>NFI-ODCE Core (bps)</td>
<td>5,770</td>
<td>-260</td>
<td>-30</td>
<td>560</td>
<td>230</td>
<td>450</td>
<td>470</td>
</tr>
</tbody>
</table>

Source: Cohen & Steers, NAREIT and NCREIF

FIGURE 1: RMZ INDEX LIQUIDITY (SBNS)

Source: Cohen & Steers, Bloomberg as of April 2010

FIGURE 2: NET ACQUISITIONS LESS DISPOSITIONS OF COMMERCIAL REAL ESTATE

Source: Real Capital Analytics and Green Street Advisors

Joseph Harvey is president and CIO of Cohen & Steers.
2,700 private fund universe controls significantly more property than the funds in this study, and comprises predominantly closed-end vehicles. Open-end fund liquidity ranges from quarterly (in most cases) when times are good, to zero when private market transaction activity shuts down – as it did from 2007 to 2009. When redemption requests spiked in early 2009, most open-end private funds were forced to rescind liquidity and halt redemptions.

The liquidity in the REIT market has grown significantly, as the market developed and more investors embraced the investment case for REITs. The growth has been driven by new strategies, such as income-oriented strategies; new vehicles, such as closed-end funds; the development of indexing and ETFs; the addition of REITs to the S&P 500; and the entrance of more participants, including hedge funds. Over the past year, REIT volume averaged $219bn weekly, as measured by the MSCI U.S. REIT Index (RMZ). While liquidity in the private market shut down during the global financial crisis, significant liquidity for REITs was sustained, enabling REIT portfolio managers and asset allocators to rebalance.

Business models favour REITs

We believe structural factors explain the majority of REIT outperformance. First is the agency issue: investment decision makers for most core and some value added private funds are paid fees based on assets under management. Once private fund capital is raised, they have strong motivations to put the money to work, regardless of available returns. By contrast, REIT managements have significant ownership stakes, and that acts as a governor on capital allocation decisions. In addition, REITs are subject to performance-based incentive compensation tied to fundamental objectives. Further, REIT management teams are governed by boards of directors, SEC and NYSE regulations and, perhaps most importantly, by the invisible, efficient hand of the public market.

Value added and opportunistic fund advisers also have incentive compensation through promoted fee structures tied to hurdle rates, but several factors make these features less effective. First, there has been an asymmetrical payoff opportunity between co-investment amounts compared with the reward of management fees plus a 20% promote. Second, many sponsors move on to the next fund in the series, where a poor vintage fund might be followed by a strong vintage fund. These structural dynamics are illustrated by the capital allocation decisions made through the peak of the last real estate cycle. Figure 3 shows that REITs sold $130bn in assets from 2005-08, while private real estate investors were net buyers.

REITs have a significant advantage today through their access to low-cost capital in the public market. In the depths of the credit crisis, they raised significant common equity to address debt maturities and deleveraging. Since March 2009, US REITs have raised more than $45bn through common stock, corporate debt and convertible offerings. By contrast, many private real estate owners have been unable to recapitalise. Without equity injections, they will be hard pressed to refinance loans that exceed lenders’ current underwriting criteria. Overleveraged owners may be forced to default, bringing in high-cost equity partners or sell outright.

Volatility

Historically, proponents of direct real estate investment have argued that real estate is less volatile than other asset classes. This is misleading, in our view, because real estate cannot be measured in a real-time transactional framework in the same way that stocks and bonds are measured in the capital markets. Furthermore, the appraisal-based valuations for the NCREIF Index or the private fund indexes smooth other asset classes. This is misleading, in our view. Nevertheless, some investors have been more sensitised to illiquidity risks, and will demand a premium for locking up their capital for the long haul. Some institutions the costs of illiquidity were devastating. Investors have become more sensitised to illiquidity risks, and will demand a premium for locking up their capital. Some institutions are starting over to create a portfolio with the proper beta and alpha components.

We believe that institutional real estate investors know that with private real estate, investing is more a function of timing the cycle than picking the right property sector, strategy or manager. Accordingly, we expect to see institutions and their consultants design frameworks that allocate effectively along the cycle and opportunity set, and between private and listed real estate.

Crisis is often the catalyst for change. We believe the global recession and financial crisis will be the catalyst for institutional investors to re-evaluate their real estate investment decisions. Considering the case put forward in this paper, we believe that many institutional investors will seek to increase their investments in listed real estate over time; the data simply do not support the old way of making real estate allocations.
This article is for informational purposes, and reflects prevailing conditions and our judgment as of this date, which are subject to change. It does not constitute investment advice or a recommendation or offer. We consider the information in this article to be accurate, but we do not represent that it is complete or should be relied upon as the sole source of suitability for investment.

There is no assurance that any historical trend illustrated above will be repeated in the future or any way to know in advance when such a trend might begin. There is no guarantee that any market forecast set forth in this article will be realized.

Please consider the investment objectives, risks, charges and expenses of any Cohen & Steers fund carefully before investing. A prospectus containing this and other information may be obtained by visiting cohenandsteers.com or by calling 800.330.7348. Please read the prospectus carefully before investing.

Risks of investing in real estate securities are similar to those associated with the direct ownership of real estate due to its policy of concentration in the securities of real estate companies. Real estate valuations may be subject to factors such as changing general and local economic, financial, competitive and environmental conditions.

Cohen & Steers Capital Management, Inc. (Cohen & Steers) is a registered investment advisory firm that provides investment management services to corporate retirement, public and union retirement plans, endowments, foundations and mutual funds.

This article must be accompanied by the most recent applicable quarterly Cohen & Steers mutual fund fact sheet(s) if used in connection with the sale of mutual fund shares.