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INVESTMENTS

REITs 101: Unlocking the Value of Public Real Estate

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In our last research article, titled "The Current Opportunity in REITs" we posited that REITs may have reached an inflection point after several years of underperformance. Building on that view, this article delves deeper into the fundamental reasons for investing in REITs, emphasizing the advantages of this unique asset class such as income generation, diversification, and inflation protection. We also touch on the role of active management within the REIT space, highlighting how it can potentially outperform passive strategies, particularly in today's climate of economic volatility and sector-specific opportunities.

Dividend Income:
Reliable and Attractive Yields

A key advantage of REITs is their ability to provide consistent and growing dividend income. Due to their legal structure, REITs are mandated to distribute most of their taxable income to shareholders in the form of dividends, making them particularly appealing for income-focused investors. This requirement has resulted in REITs offering dividend yields that are typically higher than those available from other types of equities and are competitive with bond yields in the current high-rate environment.

Figure 1 - U.S. REITs Yield Comparison - as of August 31, 2024

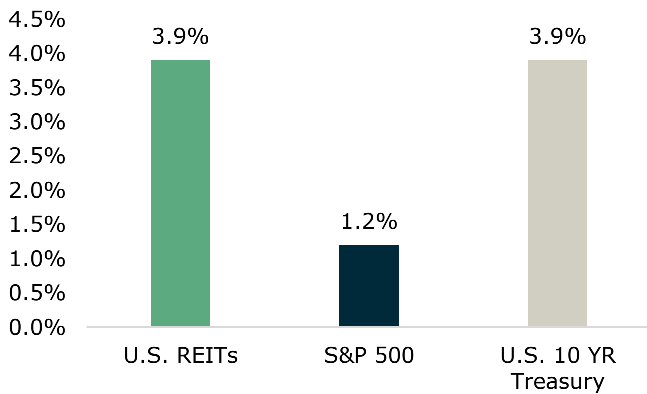
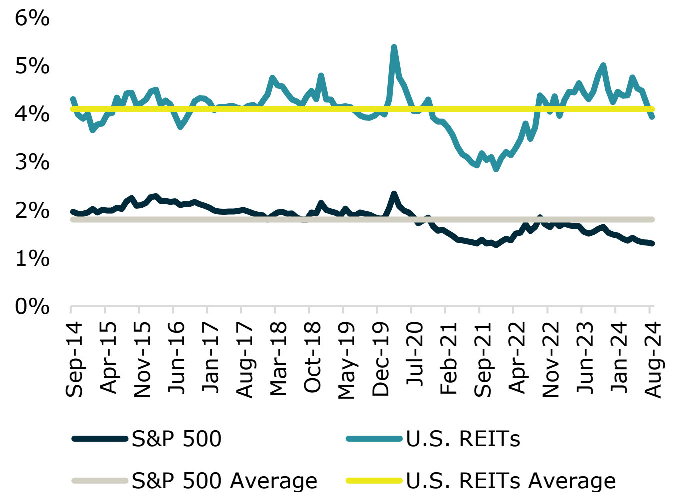


Figure 1 shows the average dividend yield for U.S. REITs, (represented by The FTSE NAREIT All REITs Index) at the end of August was approximately 3.9%, significantly higher than the S&P 500's dividend yield of 1.2% and on par with the 10-year U.S. Treasury yield[1].

Observed over a 10-year timeframe, as displayed in Figure 2, U.S. REITs have demonstrated a consistently higher dividend yield relative to the broader U.S. equity market[2]. While U.S. REITs averaged an impressive annual dividend yield of 4.1% during this period, the broader U.S. equity index averaged 1.8%.

This yield advantage is particularly important in a low-interest-rate environment, where traditional fixed-income investments provide limited returns. Recent rate cuts by major central banks, including the ECB, Bank of England, Bank of Canada, and Federal Reserve suggest a shift towards a new lower-rate environment.

Figure 2 - U.S. REITs v S&P 500 Dividend Yield - 10 YR

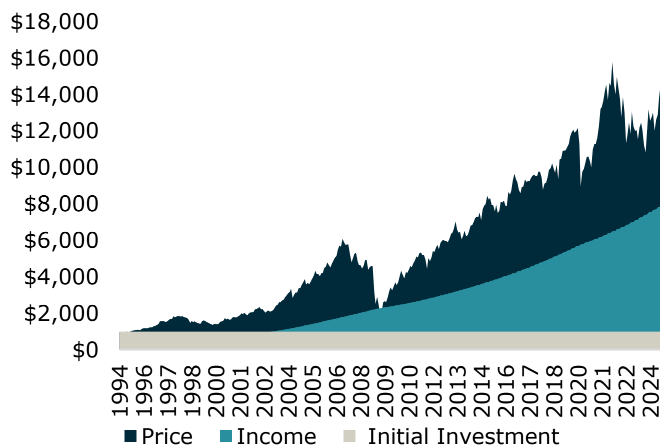


Furthermore, for income-focused investors, partnering with an active REIT manager offers the potential to enhance dividend yields beyond those of the broader REIT market. Active managers leverage their expertise to identify REITs with a proven track record of consistent and robust dividend payments, as well as those positioned for future dividend growth based on factors like financial health, property portfolio quality, and market trends. By strategically curating and managing a portfolio of such REITs, active managers can not only deliver a higher dividend yield but also position the portfolio for greater income stability and potential dividend increases over time.

Capital Appreciation:
Unlocking Growth Potential

Beyond providing reliable income, REITs also offer significant potential for capital appreciation. Over the past 30 years, the FTSE NAREIT All REITs Index has delivered an impressive annualized return of 9.3%, driven by a combination of capital gains and dividend income. This performance is comparable to the S&P 500, which achieved an annualized return of 10.7% over the same period. As illustrated in Figure 3, a $1,000 investment in U.S. REITs over 30 years would have grown to $14,553, with capital appreciation playing a substantial role in that total return.

Figure 3 - Growth of $1,000 invested in U.S. REITs - 30 YR



Notably, the appreciation of REITs is not only solely driven by market conditions but also by the strategic decisions of the management teams responsible for the portfolio of real estate assets. These teams are tasked with determining the strategic direction of the company to ultimately drive portfolio growth, thereby increasing shareholder value. Key decisions may include property redevelopment, tenant mix optimization, and strategic asset sales, all of which can significantly enhance portfolio value. Moreover, a REIT's ability to leverage their balance sheet to acquire additional properties can lead to gains, especially in a lower rate environment or when property values are increasing faster than borrowing costs.

Investors who select REITs with strong management teams skilled at optimizing and expanding their portfolios can significantly boost their potential for capital appreciation. Such management teams make strategic decisions that often lead to outperformance compared to the broader market. This underscores the value of active management in the REIT space, where a hands-on approach can uncover opportunities that passive index strategies may overlook. By actively navigating market conditions and capitalizing on emerging trends, skilled managers position investors to benefit from both income and long-term growth.

Inflation Protection:
A Tangible Hedge

Another major benefit to investing in REITs is their ability to act as a hedge against inflation—an attribute that gained prominence in the economic landscape post-COVID. While inflation concerns have recently eased, REITs continue to offer a compelling hedge against inflation due to the nature of their underlying assets and revenue models. Real estate, as a tangible asset, tends to appreciate over time, particularly during periods of rising inflation. Both property values and rental incomes generally rise in line with, or even exceed, inflation rates, thereby preserving the purchasing power of invested capital. This inflation protection is driven by two main factors:

1

Property Values - Cost of Replacement:

Inflation increases the costs of constructing new properties—materials, labor, and land—making existing properties more valuable as they become harder to replace at the same price. This scarcity effect boosts property values.

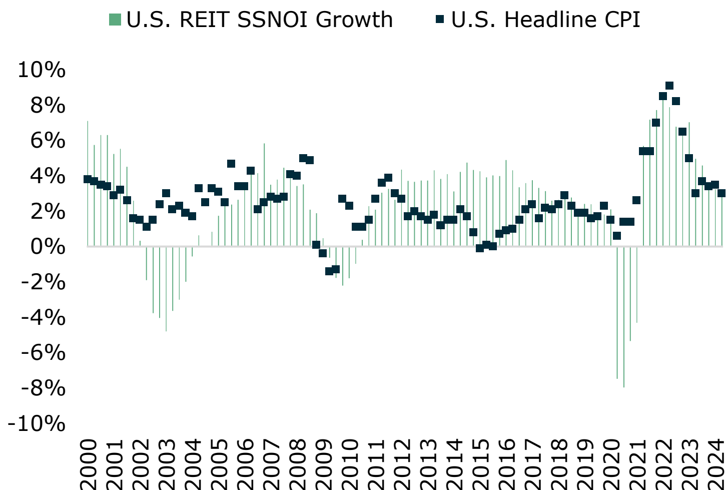
2

Rental Income - Lease Structures:

REITs benefit from rental income that typically rises with inflation, thanks to lease structures that allow for periodic rent increases. REIT sectors with longer-term leases, such as healthcare or net-lease properties, often include annual rent escalators, either as fixed-rate increases (typically 2-4%) or adjustments based on Consumer Price Index (CPI) changes. In contrast, REIT sectors with shorter lease terms, such as residential or self-storage, provide landlords the flexibility to reset rents more frequently, often annually, capturing higher market rates in inflationary environments.

One clear way U.S. REITs demonstrate their inflation-protective attributes is through the growth of Same Store Net Operating Income (SSNOI) at rates comparable to, or often exceeding, inflation. SSNOI provides a more conservative measure of REIT growth as it excludes income from acquisitions and omits high-growth property sectors such as data centers and other specialty sectors. This allows for a more accurate reflection of organic growth driven by existing properties. Figure 4, displayed below, contrasts the growth in U.S. REIT SSNOI with U.S. CPI since the year 2000[4] .

Figure 4 - U.S. REIT SSNOI Growth v U.S. CPI - Since 2000



The inflation-linked nature of REIT income, highlighted by their ability to grow SSNOI at rates that often match or exceed inflation, makes them a prudent choice for investors seeking to safeguard their portfolios against inflationary pressures. This growth in SSNOI not only supports dividend increases but also enhances overall capital appreciation, as higher income often signals robust property performance as well as the management team's effectiveness.

Diversification: Enhance Stability & Returns

From a portfolio management perspective, one of the most compelling reasons to allocate to REITs is the diversification benefits they provide. REITs typically exhibit a lower correlation with traditional asset classes, such as stocks and bonds, which can help reduce overall portfolio risk while potentially enhancing returns. This characteristic is particularly valuable in the context of modern portfolio theory, which emphasizes the importance of diversification in achieving optimal risk-adjusted returns. Figure 5 summarizes the correlation between U.S. REITs, U.S. Bonds, and the broader U.S. stock market represented by the S&P 500 over 25 years[5].

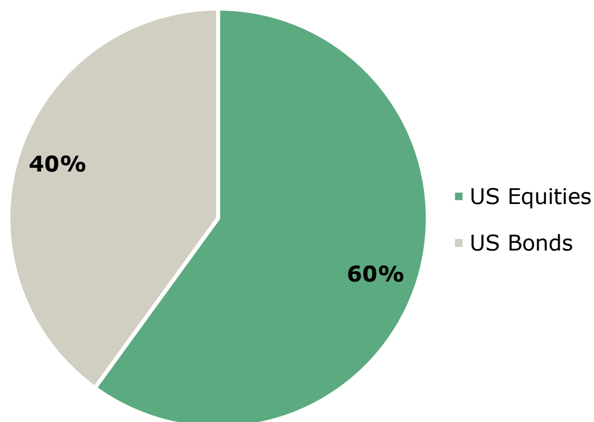
Figure 5 - U.S. REITs Correlation Matrix – 25 YR

	U.S. REITs	S&P 500	U.S. Bonds
U.S. REITs	1	.67	.33
S&P 500	.67	1	.12
U.S. Bonds	.33	.12	1

To illustrate the diversification benefits of allocating to REITs, consider two hypothetical portfolios for a traditional investor over 25 years. This investor has a medium risk tolerance and seeks a balanced investment objective of stable income and capital appreciation. The first portfolio is a traditional 60/40 split between stocks and bonds with no allocation to REITs, while the second portfolio allocates 10% to U.S. REITs instead of the broader equity market, as displayed below:

— **Portfolio #1 - Traditional (no REITs):** Comprising of 60% stocks (S&P 500) and 40% bonds (Bloomberg U.S. Aggregate Bond Index).

Portfolio #1



— **Portfolio #2 - (with REITs):** Comprising of 50% stocks (S&P 500), 40% bonds (Bloomberg U.S. Aggregate Bond Index), and 10% U.S. REITs (NAREIT All REITs Index).

Portfolio #2

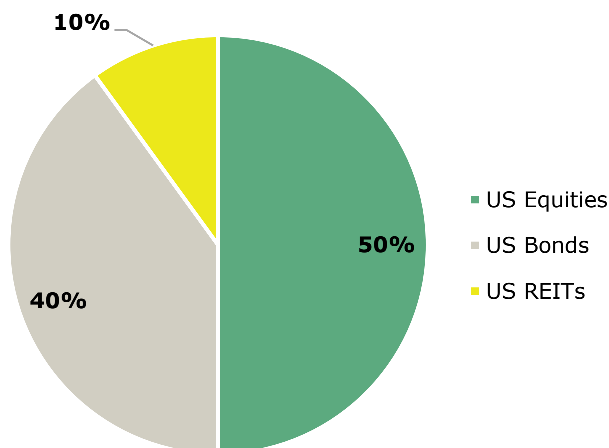


Figure 6 - Traditional Portfolio v REIT Portfolio – 25 YR*

Performance Metrics	Portfolio #1	Portfolio #2
Annualized Return	6.7%	7.0%
Standard Deviation	9.6%	9.5%
Risk to Return Ratio	0.70	0.73
Sharpe Ratio	0.36	0.39

***For Illustrative purposes only**

Figure 6, displayed above, summarizes the performance of the two portfolios[6]. Portfolio #1 generated an annualized return of 6.7% with a standard deviation of 9.6%. In contrast, Portfolio #2, with REIT exposure, produced a higher annualized return of 7% and had a slightly lower standard deviation of 9.5%. This demonstrates that adding REITs to a traditional portfolio can not only improve returns but also enhances risk-adjusted performance, as indicated by the higher Sharpe ratio of 0.39 for the REIT-enhanced portfolio compared to 0.36 for the traditional portfolio.

Active Management v Passive Investment in REITs: A Case for Expertise

While passive investment strategies, such as REIT ETFs, are valued for their cost-efficiency and simplicity, active management can offer substantial advantages in the public real estate sector, which is notably heterogeneous and less efficient compared to other public stock markets. The REIT market is characterized by its fragmentation, with a diverse range of property types and geographic locations. This complexity can hinder passive strategies, which often rely on broad indexes, from capturing and accurately reflecting the unique value of each property type.

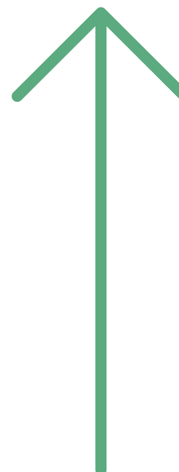
Active managers, with their specialized knowledge and regional insights, are better positioned to navigate this intricate landscape. Market sentiment and speculation can play a significant role in REIT pricing, often leading to price distortions and inefficiencies. Skilled active managers can identify undervalued REIT stocks and emerging trends that passive strategies might overlook; for instance, they may take an active position in a promising, smaller cap REIT, that has not yet been included in major indices.

Moreover, active management allows for the flexibility to adjust sector allocations based on evolving market conditions and trends. During the COVID-19 pandemic, for example, many active managers redirected their focus from challenged sectors such as retail and office to growth-oriented areas such as industrial and data centers, effectively capitalizing on the accelerated expansion of e-commerce and digitalization.

The combination of local expertise, flexibility in portfolio adjustments, and the ability to identify trends as well as undervalued securities highlights the benefits of active management in the REIT sector. Although we have discussed these benefits at a high level, we plan on releasing a separate research article that explores the case for active management within the REIT space in greater detail.

Recap

The inclusion of REITs in a diversified investment portfolio can enhance risk-adjusted returns and provides stability in an increasingly volatile economic environment. REITs have a strong historical record of providing inflation protection, potential for capital appreciation, diversification, and robust dividend yields. Additionally, active management within the REIT space has the potential to outperform passive strategies, particularly in a complex and dynamic real estate market.



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