

NEW SECTOR CLASSIFICATION OF REITS TAKES OFF



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Since the end of the Great Recession, one of the highest performing investment sectors has been Real Estate Investment Trusts. In September 2016, the impressive growth of REITs compelled S&P Dow Jones Indices and MSCI Inc. to name Real Estate the eleventh GICS (Global Industry Classification Standard) stock classification. Previously, there were ten stock classifications, with real estate contained within the financials sector classification.

The new sector recognizes the impressive growth of [REITs](#), which have outperformed the S&P 500 each year since 2009, [up 24 percent](#) annually versus 18 percent for the stock market index. Over the past 15 years, more than a net \$62 billion has been invested in U.S. REITs alone. The equity market capitalization of U.S. REITs [nearly tripled](#) over the past decade to slightly more than \$1 trillion.

For the first time, investors can now track the real estate asset class free of the distractions caused by non-real estate financial businesses like banks and brokerages. “The most important consequence of introducing the new Real Estate Sector (classification) is to provide a much greater level of visibility for real estate in the economy,” [said Mike Grupe](#), executive vice president for research and investor outreach at the National Association of Real Estate Investment Trusts (NAREIT). Real estate will become “a much more prominent part of the conversation” for investment decision makers as they design portfolio strategies and set asset allocations, he added. This new sector encompasses the performance of both real estate investment trusts (other than mortgage REITs) and real estate management and development companies, although REITs account for the bulk of the sector. Mortgage REITs will continue to be classified as part of the Financials sector.

STATUS POWER SHIFT

The reclassification already is driving money into the sector, as managers respond to real estate’s new status as a standalone investment class. This includes renewed investor attention as well as newer sources of capital, such as small and mid-cap equity funds, [new mutual funds](#), [ETFs](#) and [institutional investors](#) that have yet to invest in listed real estate. [New tax incentives](#) for U.S. REITs also may generate increased demand among foreign investors.

Nevertheless, REITs face stiff challenges, which includes raising rental and lease fees on apartment buildings and office structures in regions of the country that are already experiencing record rents. The strengthening economy is another challenge if it inevitably prompts the Federal Reserve to significantly increase interest rates, which would make REITs less attractive by comparison with bonds. REITs in the past have underperformed in the immediate aftermath of a rate hike.

“When the Federal Reserve hinted at tighter monetary policy in 2013, REITs prices dropped by 13.5% in five weeks,” The Economist [reported](#). But as time progresses and economic

[continued on page 2](#)

growth accompanies an interest rate hike, their performance generally [tends to improve](#).

Other causes for concern include questions over the continuing resilience of the commercial real estate and rental markets in the U.S., the growing impact of online buying trends on shopping malls, and the slowdown in the formation of REITs composed of timberlands and other non-traditional investments. New Internal Revenue Service [regulations](#) now ban companies outside the property industry from abusing the tax-free REIT structure. And some investors have maintained that REITs are overpriced, noting the 59 percent rise in the S&P U.S. REIT Index over the last five years.

These factors may be taking a toll on REIT formation. Only [one REIT](#) listed its shares as of mid-September 2016, compared to seven REITs in 2015 and 19 in 2013, according to The Economist.

Despite these downsides, REITs have posted [solid results](#) in 2016, with shares generally tracking the broader market—up more than 4 percent for the year, compared to about 5 percent for the S&P 500-stock index. A key factor in this performance is the increase in rents and occupancies in the recovering economy, with rents up as much as [3 percent to 6 percent](#) in major metropolitan markets like New York and San Francisco.

Since 2001, REITs have generated a [cumulative return of 414 percent](#), outperforming both the S&P 500 index and the Barclays Aggregate US Bond index, according to ETF Trends. The dividend yields from REITs also are [nearly twice](#) that of the S&P 500 index, an appealing alternative for yield-hungry investors in today's low yield environment.

LOOKING AHEAD

Whether or not the positive results will persist into 2017 is debatable. The *Wall Street Journal* reported that some investors are concerned that REIT shares are trading at numbers below the market value of the owned property. No one predicts an overflow of funds streaming into the new sector, with the *Financial Times* projecting more gradual investments, “as investors start to take real estate more seriously”.

Although the stock market in the first week after the election of Donald Trump as President reached record highs, it is still too early to determine what impact the real estate tycoon will have on REIT performance and activity. “I’d say overall it’s positive for real estate just because you have someone in office who is in the industry,” said Sandler O’Neill analyst Alexander Goldfarb. He projected that the Trump Administration is not likely to scrap the 1031 tax exchange

allowing an investor to sell a property, reinvest the proceeds in a new property, and thereby defer capital gain taxes.

The election outcome did have a negative impact on some global REITs, given the incoming President’s stance on reduced globalization. “Anything that’s got ‘global’ in it was probably hurt,” Goldfarb said. He’s correct: Following the election, the stock of global industrial REITs Prologis and Brookfield Asset Management fell 4.84 percent and 1.02 percent, respectively. More puzzling is the lackluster performance of major apartment REITs: Equity Residential fell 2.03 percent and Avalon Bay fell 1.92 percent. Adding to these woes is the [jump in the yield](#) on 10-year Treasury bonds—up 20 basis point to 2.07 percent, marking T-bonds’ biggest one-day increase in the past three years. Higher treasury yields tend to increase the cost of debt, putting pressure on real estate prices.



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In Europe, REITs are expected to be more in demand by investors as an income play, trading at premiums in Germany, Scandinavia, and other safe harbors in the wake of Brexit. According to [Emerging Trends Europe](#), the five leading cities for overall investment and development prospects in 2017 are Berlin, followed by Hamburg, Frankfurt, Dublin and Munich.

Some analysts are taking the high road, projecting continuing REIT growth. Deepika Sharma, managing director of investments and portfolio manager at Astor Investment Management, projected [rising demand](#) by investors for REITs over the course of the next three to five years. And Steve Buller, portfolio manager with Fidelity Investments, agreed that real estate funds in the U.S. and across the world are likely to experience [increasing capital flows](#).

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