MYWORD

Reassessing REITs

ARE REAL ESTATE INVESTMENT TRUSTS FINALLY POISED TO TAKE A MAJOR TUMBLE IN THE MARKET?

BY TIMOTHY J. MCINTOSH

LIKE THE TECHNOLOGY BEARS OF THE LATE 1990S, REAL ESTATE investment trust (REIT) skeptics have been wrong more often than they've been right. Since 2004, REIT bears have been crowing about overvaluation and predicting an ugly end for investors. Still, REITs have sailed on, outperforming the Standard & Poor's 500 for seven consecutive years. But a closer look at where the REIT market has been and where it's heading, shows why skeptics may finally have their day.

Since its inception in June 2000, through March 31, 2007, the iShares Dow Jones U.S. Real Estate Index ETF (IYR) produced an cumulative return of 247.1%. During the same period, the S&P 500 had an 11.9% cumulative return. This superior performance has led to much growth for the REIT industry. There are currently 358 REIT mutual funds, along with 10 large REIT exchange-traded funds (ETFs). In fact, five of the 10 ETFs were launched just this year by Barclays. Before 2000, there were only 78 REIT funds and no ETFs.

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BLOATED VALUATIONS

The consequence of this growth is that REIT valuations have hit a level never seen before. From the late 1990s through the early 2000s, REIT shares traded at multiples of eight to twelve times funds from operations (FFO) per share. (The FFO per share ratio is used in lieu of earnings per share when evaluating REITs.) At the peak of the tech boom, REIT shares were priced at 8.5 times FFO—extremely undervalued compared with the S&P 500, which was trading at nearly 30 times trailing earnings. The REIT multiple has now soared to an average of 16 times FFO—nearly identical to the P/E ratio of the S&P 500.

REIT yields have also declined. In August 2001, REIT dividend yields averaged 8.1% or nearly double the 4.5% yield on the 10-year Treasury bond. Today, REITs offer an average yield of only 3.7%, while the 10-year Treasury yield recently crossed 5.2%. The spread between REIT yields and the 10-year Treasury has plunged to a new 10-year low. The last time 10-year Treasury's yield was above the yield of the REIT index was 1998. This period marked a 20-month selloff from the second quarter of 1998 to the first quarter of 2000 where $2.9 billion was pulled from REIT funds and the NAREIT Composite Index fell nearly 20%.

The current pullback in REIT shares is eerily reminiscent of the late 1990s. It started in late February, initiated by the sharp decline in the Asian stock markets and the subprime mortgage crisis. The IYR ETF topped out on Feb. 20, 2007 at $92.50 per share and dropped to a new yearly low of $78.80 on June 22. As REIT share values have decreased, volatility has increased. The IYR ETF has advanced or declined by 1% or more in 52 of 119 trading days up through June 22. The S&P 500, by comparison, has moved by 1% or more on just 17 of 119 days.

How far can REITs fall? A correction from the current multiple of 16 times FFO to the historical average of 10 times FFO would mean losses in excess of 35%. If the price of IYR dropped 45% in value, the yield would rise to 7.2%. This yield would be 200 basis points above the current Treasury yield, in line with historical averages. Also remember that REITs must pay out 90% of their income as dividends, leaving little room for earnings growth, except in the form of rising property values and rental rates. As property values have stagnated this year and the outlook for future price growth is meager, REITs are highly susceptible to an extensive correction.

Over the past seven years, financial planners have been rewarded by recommending REITs to their clients. Planners who utilize significant portions of REITs in their clients' portfolios should reevaluate their recommendations. A sustained interest rate move above 5% might well mark the end of REIT outperformance for the balance of the decade. FP

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