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REITs Have Arrived

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MSCI and S&P are creating a new sector for Real Estate.

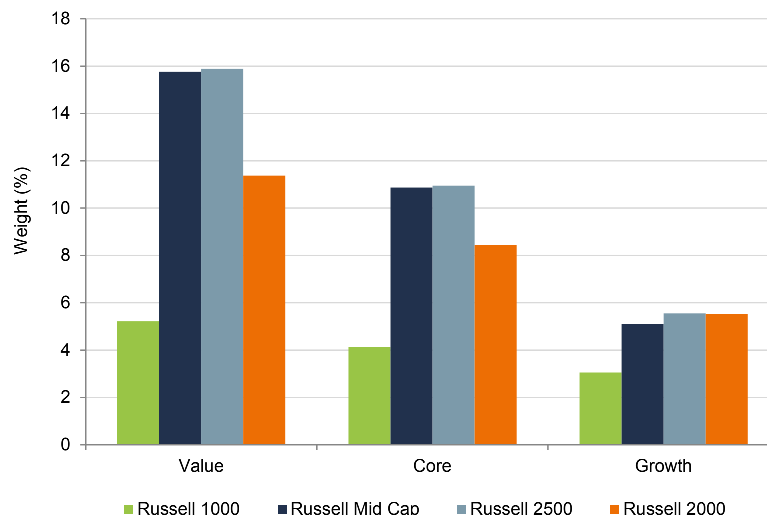
As the calendar shifts to September, MSCI and Standard & Poor's will classify Real Estate Investment Trusts (REITs) into their own Global Industry Classification Standard (GICS) sector, putting a brighter spotlight on an often ignored group. As a U.S. Small and SMID Cap Value manager, we have analyzed REITs separately for years. The elevated GICS status is long overdue. In the pages that follow, we address two questions. First, what impact will the new GICS structure have on a group that has frequently been ignored by diversified portfolio managers? Second, what will newcomers to the group discover when they take a closer look?

The Impact of GICS Sector Classification

REITs have long existed in relative obscurity inside the broader Financials sector. Intermingled with banks, brokers, and insurance companies, it has been easy for portfolio managers to ignore REITs. But with the advent of this new classification, portfolio managers are likely to pay a bit more attention as the new Real Estate sector now carries a significant weight in most major U.S. benchmarks.

Small, Mid and Value benchmarks will see the largest REIT weights.

Exhibit 1: New Real Estate Sector Weights (%)

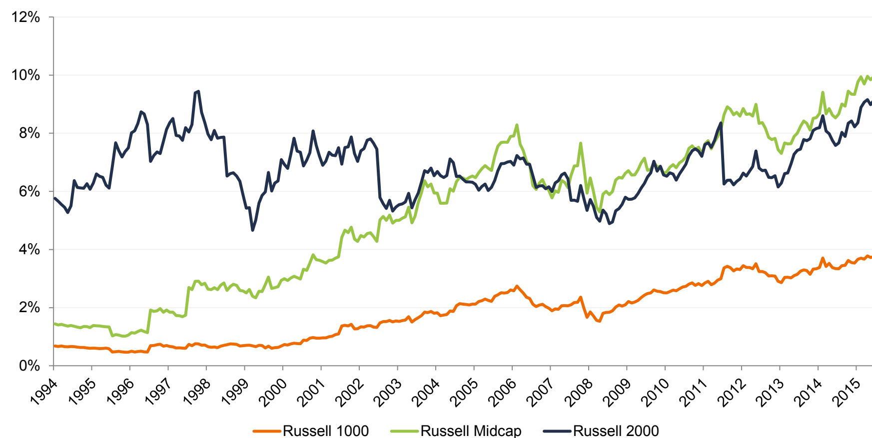


Source: FactSet Research Systems, as of 7/15/2016.

REIT benchmark weights have steadily increased over the last 20 years.

The ascent of REITs has been 20 years in the making. A combination of persistent equity issuance, IPOs, spinoffs, conversions, and stock performance has led to a steady increase in REIT weightings across all of the major indices. These weights are no secret to active managers, but they have reached a point where they will now garner more attention.

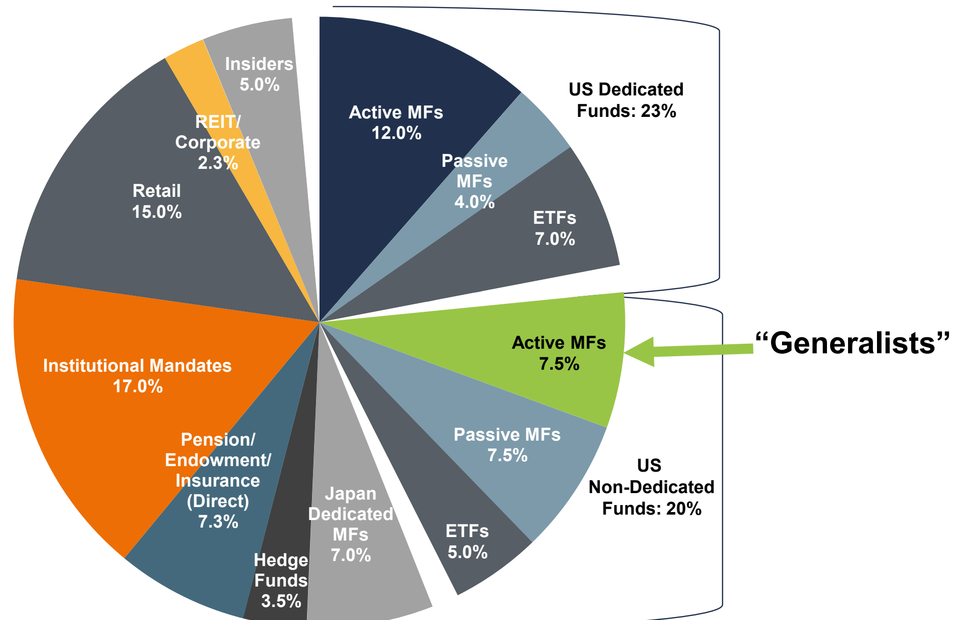
Exhibit 2: Russell Index REIT Weights



Source: FactSet, as of 7/29/2016.

To understand the potential impact of the new classification, we first need to look at who currently owns REITs. Dedicated REIT funds are the largest and most influential owner of the asset class. Non-dedicated funds, pension funds, retail investors, and institutions all have notable ownership stakes.

Exhibit 3: REIT Ownership by Investor Source



Source: Citi Research, SNL, Lipper, FactSet financial data and analytics, as of 3/31/2016.

Investor attention has centered on the potential behavior of the actively managed non-dedicated funds, referred to as "generalists" in the REIT community. As Exhibit 3 on the previous page illustrates, these managers represent 7.5% of the aggregate REIT ownership, but that figure only accounts for mutual funds and does not take into consideration the institutional mandates these managers control. It is no secret that these funds have been underweight REITs for years and there is much speculation about what they will do going forward. To put this in context, it is worth exploring how underweight these managers are. The JP Morgan analysis below suggests it would require over $100 billion of incremental capital *if* generalist mutual fund managers decided to neutralize the underweight. They estimate that represents an incremental 12% of the total REIT equity capitalization, and this only pertains to the mutual funds these managers control.

There is broad speculation that managers will need to allocate significant capital to REITs.

Exhibit 4: REIT Weights Across Long-Only 1940 Act Mutual Funds

Asset Class	Assets (billions)	Wgt. Avg REIT Weight (%)	Index REIT Weight (%)	Relative Weight vs. Index (%)	Assets Needed to Get to Neutral Weight (billions)
Large Cap Core	$1,669	2.5	3.0	-0.4	$7
Large Cap Growth	$1,146	1.1	2.7	-1.5	$18
Large Cap Value	$796	1.3	5.0	-3.7	$30
Mid Cap Core	$225	6.8	10.1	-3.3	$7
Mid Cap Growth	$229	2.4	4.7	-2.3	$5
Mid Cap Value	$172	4.8	15.3	-10.5	$18
Small Cap Core	$185	6.9	9.9	-3.0	$6
Small Cap Growth	$165	2.5	3.6	-1.1	$2
Small Cap Value	$100	5.7	15.9	-10.2	$10
Total	**$4,686**	**2.5%**	**4.7%**	**-2.2%**	**$103**

Source: J.P.Morgan, FactSet, Morningstar, as of 3/29/2016.

There is a fair amount of excitement in the REIT community about the coming inflow of new capital and a lively debate about the size and impact of the increased funds. This has been a recurring and high interest topic in our discussions with the sell-side, fellow buy-side investors, as well as REIT management teams themselves.

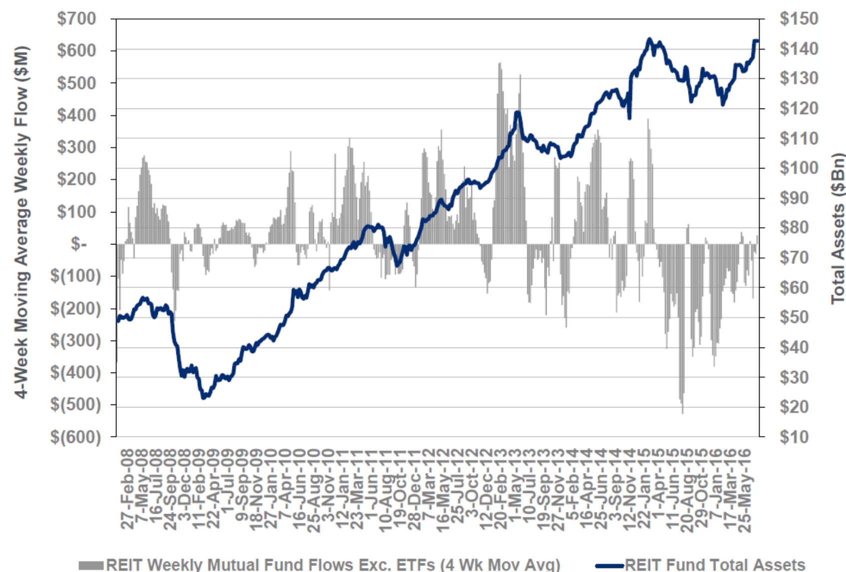
Optimist Case	Pessimist Case
▪ Active managers have been able to conceal their REIT underweight inside the broader Financials sector. ▪ These managers will not want to show a zero or low weight in the sector and will seek to fill the gap by allocating more capital to REITs. ▪ A large number of active managers have client guidelines that will force them to allocate new capital to the sector. ▪ It would require tens of billions of dollars for these managers to neutralize their underweight.	▪ U.S. Large Cap managers will only face a 3% to 5% benchmark weight, which is not likely to dictate a change in strategy. ▪ U.S. Small and Mid Cap managers face a higher benchmark weight, but these managers control fewer assets. ▪ Value managers have been dealing with high REIT weights for years and already have a strategy in place. ▪ Many managers are philosophically opposed to REITs given their capital structure and are unlikely to change their opinion.

We believe new capital will flow to REITs, but it will move slowly and be modest in size.

Our belief is that the GICS sector status will be an incremental positive for REITs. Heightened visibility will lead to increased attention and ultimately larger allocations. We have already witnessed anecdotal evidence that generalists are indeed paying more attention to the group. While we expect new capital will find its way into REITs, we expect it will occur slowly and will be modest in size. Any new flows that do occur will be dwarfed in the near term by the fund flows from existing institutional and retail REIT investors. Performance will continue to be driven by interest rate expectations in the short term, and real estate fundamentals over the long term. The bottom line is that we view the new sector status for REITs as a tailwind, but not a panacea for REIT performance.

REIT fund flows will continue to drive performance.

Exhibit 5: Registered Weekly REIT Mutual Fund Flows and Total Assets Under Management



Source: Citi Research and Lipper, as of 7/28/2016.

What Will Newcomers to REITs Discover?

So, what will these generalists find when they begin to take a closer look? REITs are often dismissed as merely an interest rate proxy or bond substitute with no potential for alpha due to high correlations. There is a misperception that all REITs are the same, offering limited diversification within the sector. The reality is that the new Real Estate sector will have sub-industries with significant differentiation in returns, as portrayed in the table below.

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Exhibit 6: Russell 2000 Index - Table of REIT Returns

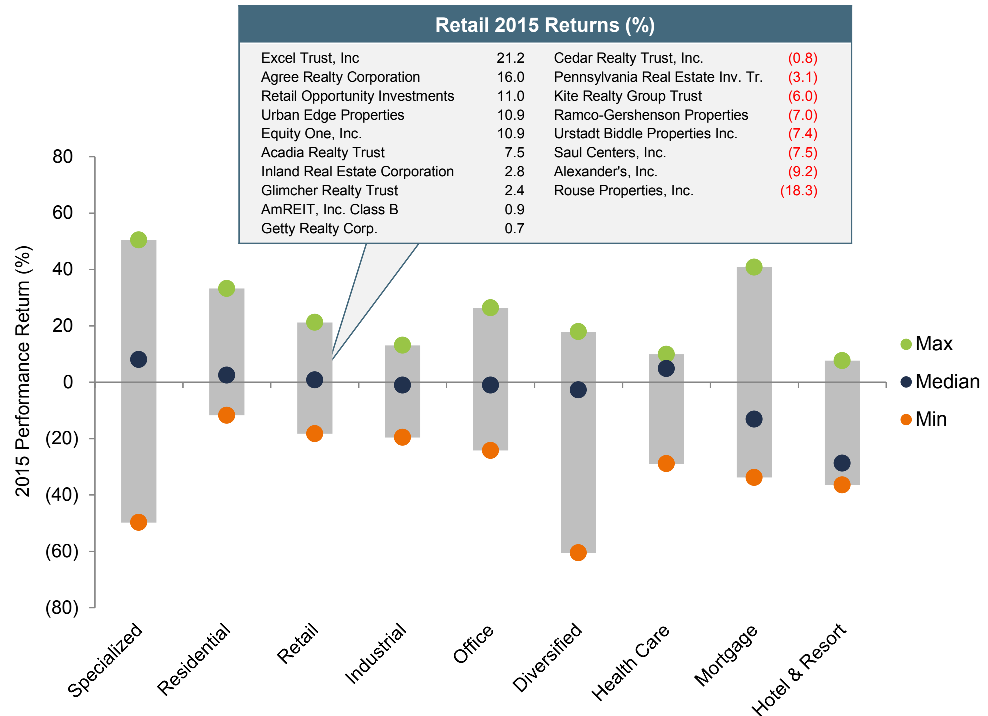
REITs Sub-Industry Returns Ranked in Descending Order of Performance							
2008	2009	2010	2011	2012	2013	2014	2015
Health Care (11.2)	Hotel 82.2	Hotel 49.3	Residential 16.9	Specialized 39.2	Hotel 28.8	Hotel 37.8	Specialized 12.4
Retail (23.4)	Residential 34.2	Retail 42.2	Specialized 7.4	Health Care 36.0	Diversified 16.2	Residential 30.6	Residential 10.8
Residential (24.6)	Office 32.2	Residential 38.0	Industrial 5.9	Industrial 33.0	Industrial 15.5	Specialized 30.1	Retail 2.0
Office (27.8)	Specialized 29.3	Total REITs 28.5	Total REITs (0.9)	Mortgage 32.6	Specialized 13.3	Health Care 28.6	Industrial 1.9
Diversified (29.6)	Health Care 25.6	Mortgage 24.7	Health Care (2.2)	Total REITs 26.8	Office 12.3	Retail 24.6	Office 0.2
Specialized (31.5)	Total REITs 25.0	Diversified 24.3	Retail (2.2)	Retail 26.6	Total REITs 11.8	Total REITs 23.2	Total REITs (5.5)
Total REITs (33.6)	Retail 22.0	Specialized 24.3	Office (3.4)	Office 24.9	Retail 9.0	Industrial 22.7	Diversified (6.1)
Industrial (44.5)	Mortgage 19.2	Industrial 20.4	Mortgage (4.4)	Hotel 24.1	Health Care 8.3	Office 14.0	Health Care (6.5)
Mortgage (46.8)	Industrial 4.7	Health Care 18.0	Diversified (7.2)	Diversified 23.9	Mortgage 2.2	Diversified 13.9	Mortgage (13.3)
Hotel (72.6)	Diversified 4.2	Office 9.3	Hotel (17.4)	Residential 8.6	Residential (1.3)	Mortgage 11.2	Hotel (23.3)

Source: FactSet Research Systems. Note: Mortgage REITs will not be included in the new Real Estate sector and will remain embedded in the Financials sector.

Beyond industry classifications, REITs have different exposures to asset quality, tenant mix, lease structure, and geography, creating intra-industry dispersion in returns. In Exhibit 7 on the following page, we use 2015 performance to provide an example. The table at the top highlights the significant performance spread amongst the individual REITs that make up the Retail sub-industry. The gray dispersion bars show that this level of dispersion was present in all of the sub-industries. Clearly, all REITs are not the same.

All REITs are not the same.

Exhibit 7: Russell 2000 Index - 2015 REIT Performance Dispersion by Sub-Industry



Retail 2015 Returns (%)

Company	Return	Company	Return
Excel Trust, Inc	21.2	Cedar Realty Trust, Inc.	(0.8)
Agree Realty Corporation	16.0	Pennsylvania Real Estate Inv. Tr.	(3.1)
Retail Opportunity Investments	11.0	Kite Realty Group Trust	(6.0)
Urban Edge Properties	10.9	Ramco-Gershenson Properties	(7.0)
Equity One, Inc.	10.9	Urstadt Biddle Properties Inc.	(7.4)
Acadia Realty Trust	7.5	Saul Centers, Inc.	(7.5)
Inland Real Estate Corporation	2.8	Alexander's, Inc.	(9.2)
Glimcher Realty Trust	2.4	Rouse Properties, Inc.	(18.3)
AmREIT, Inc. Class B	0.9		
Getty Realty Corp.	0.7		

Source: FactSet Research Systems, as of 12/31/2015.

We think investors will find that, in many ways, REITs look like any other sector. They will find individual companies with different strategies, exposures, capital structures, and valuations. All of which set the stage for stock selection.

However, newcomers will also discover some aspects of REITs that they don't find elsewhere. Some will find these differences insurmountable from a philosophical standpoint and remain underweight the group. Others will accept the nuances of REITs and begin to adjust their investment processes accordingly. Some examples include:

- Business models are built on a persistent call on capital. Because REITs have to pay out 90% of GAAP pre-tax income in dividends, they are forced to come back to the equity and debt markets in order to grow. Secondary stock issuance and debt offerings are often a daily occurrence in the REIT world.

Generalists will need to get comfortable with the nuances of REITs.

- Investors will also have to get used to some different valuation techniques. Public REITs make up a small portion of the U.S. real estate landscape and thus lean on valuation methods preferred by the much larger private real estate market. Transactions and valuations based on Net Asset Values and Capitalization Rates are the norm, and experienced REIT investors rely heavily on these metrics. Generalists may choose to use their own valuation parameters, but will have to at least acknowledge the REIT-specific methods.

- The sector is highly levered relative to the broad equity universe.

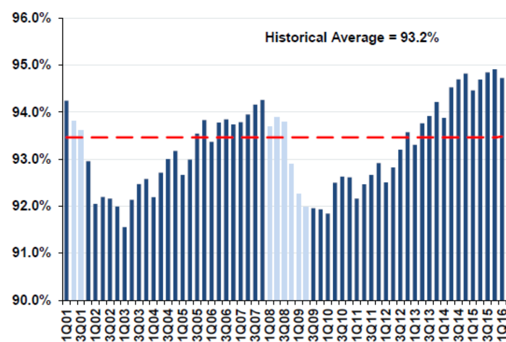
- Dedicated REIT investors are often reluctant to traffic in smaller and more specialized REITs with a lack of history or appropriate comparables. But inside this cohort, generalists will often find lower valuations, better balance sheets and even some familiar names that have made the C-Corp to REIT conversion.

- New investors will struggle with the occasional "questionable" corporate governance issues that are unique to the REIT universe.

Finally, a comment regarding the timing of the new GICS status - it could be argued it is a dangerous time for REITs to be receiving an elevated level of attention. We are now seven years into a real estate cycle and the REIT performance indexes are testing all time highs. As seen in the exhibits below, occupancies are at very high levels and the capitalization rates are at all time lows. There are plenty of positives for the bulls, but contrarians will argue this is the worst possible moment for generalist investors to begin paying increased attention to the sector.

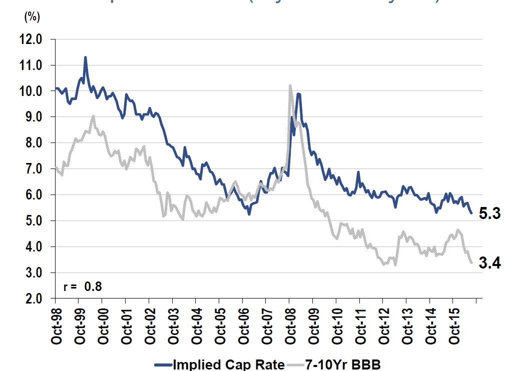
Be warned, REITs are achieving sector status with all-time high occupancy and valuations.

Exhibit 8: REIT Occupancy Is at Peak Levels



Source: Company Reports, Citi Research, as of 3/31/2016.

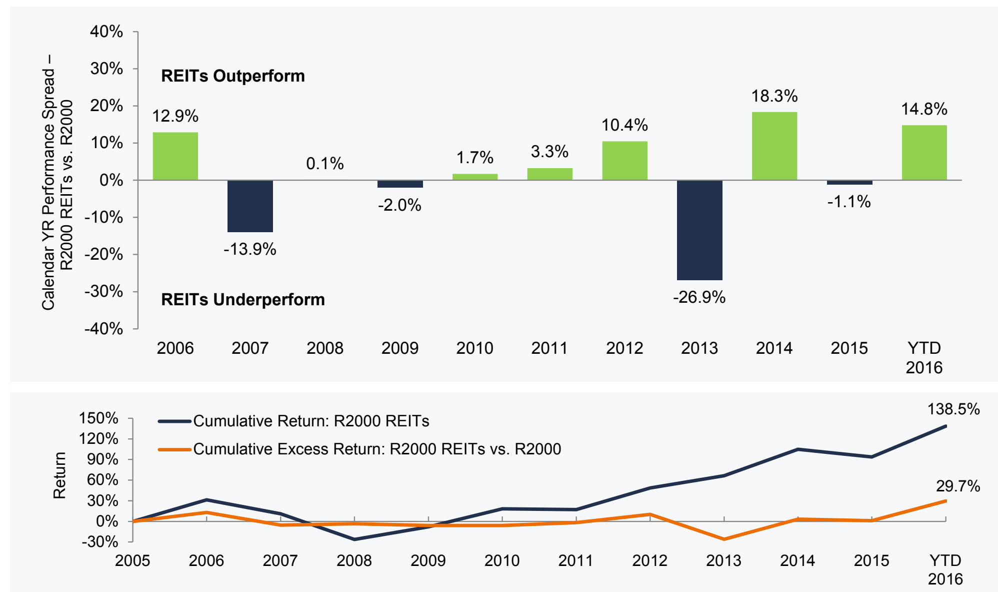
Exhibit 9: REIT Implied Cap Rate vs. BBB Corporate Yield (7 year to 10 year)



Source: Citi Research, Yieldbook, FactSet financial data and analytics, as of 7/29/16.

The timing may not be optimal, but the change is appropriate as REITs simply don't belong inside a broader Financials sector. Like any other sector, REITs will have periods of good and bad performance, as exhibited in the following charts. Investors will have to consider if this is an appropriate time to increase their real estate exposure.

Exhibit 10: Performance Spread of Russell 2000 REITs vs. Russell 2000 Index & Cumulative Return of Russell 2000 REITs (Jan 2006 - Jul 2016)



Source: FactSet Research Systems, as of 7/29/16.

We believe REITs are on their way to becoming a more mainstream investment for the generalists among us.

Summary

A separate Real Estate sector has been 20 years in the making and long overdue in our view. While an incremental positive, we do not believe the new classification will cause a seismic shift in allocations to the group. Some generalist funds will increase their REIT exposure in the near term, but the magnitude and pace will not be enough to drive sector performance. We expect the near term to resemble status quo, with a modest tailwind of incremental capital. Over time, the new GICS status will draw more attention to these companies and the investor base will broaden. Industry consolidation will result in larger companies, thereby increasing sector relevance as the weights in large cap benchmarks increase. Portfolio managers who have long ignored these companies will begin to incorporate them into their investment process. It will take time, but REITs are on their way to becoming a more mainstream investment for the generalists among us. REITs have arrived.

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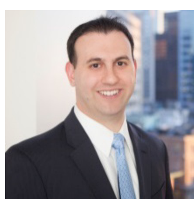
Ed is a senior portfolio manager on the US Small and Small/Mid Cap Value Equity team. He began his career in 1989 at Standish, Ayer & Wood. Ed has served in various roles, ranging from analyst to portfolio manager, across small-cap, large-cap, value, growth, international and domestic portfolios. In addition, he has covered a wide variety of sectors and industries during his tenure. Ed has a degree in finance from Villanova University and holds the Chartered Financial Analyst® designation.



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Joe is a portfolio strategist for The Boston Company, focused primarily on the U.S. retail channel and the firm's US Small Cap Value investment team, involved in the team's daily activity without stock decision-making responsibility. He is responsible for communicating the team's strategies to clients, prospective clients and consultants, serving as the critical interface between client-facing staff and investment team. In this role, Joe guides the messaging and positioning of investment strategies, helping to create marketing materials and content, responding to investment-related client inquiries, and ensuring that relevant investment insights of the portfolio-management teams are delivered internally and externally in a timely and effective way. Previously at The Boston Company, Joe was a product manager, providing market research, analysis and project support to enhance the development and promotion of the firm's products and capabilities. Before that role, he was a client service analyst, responsible for generating a diverse range of analytical data and client reporting materials. Prior to joining The Boston Company, Joe was a senior portfolio accountant at Standish/Mellon Asset Management, where he was responsible for account maintenance, trade processing, cash and asset reconciliations. He also previously served as a trust specialist at Mellon Financial Corp. Joe received a B.A. in finance from Bryant University and an M.B.A. from Bentley University.

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