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Public REITs vs. Private Real Estate: Assessing Your Options

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In the past decade, publicly traded REITs (Real Estate Investment Trusts) have emerged as a respectable alternative for equity investments in real estate. With the entry of new capital into the sector via IPO's and Secondary offerings, over one hundred equity REITs offer a combined $150 billion opportunity for investment, up from only $9 billion in 1991.[1] Though these figures still serve to classify all but a few REITs as small-cap stocks, they are nonetheless large enough to attract some attention from institutional investors.

Public REITs appeal to investors for several reasons:

- Access to diversified property portfolios for investors with funds too limited to accomplish this on their own;
- Sufficient liquidity to allow daily trading activity for all but the largest holders; and
- Daily pricing established by stock market trades.

However, how satisfactory are public REITs in providing an alternative to direct ownership of real estate? The simple answer is that in the long run REITs behave like real estate, but in the short run they behave like common stocks. This paper, then, will review a number of important conclusions:

- For investors with long time horizons (15-20 years), REITs can provide returns comparable to those from a moderately-leveraged private property portfolio;
- For investors with short (1 year) to medium term (5 year) horizons, public REITs can behave much more like common stocks than a real estate investor might expect.
- Investors must invest in a *portfolio* of REITs in order to achieve a reasonable level of diversification.
- Initial valuations at the time of investment can be an important determinant of returns over the holding period for public REITs, more so than for private real estate.

The Long Term Performance of REITs vs. Private Real Estate

Over the very long term (15 years or more), public REIT returns are nearly identical to those of comparably leveraged private property portfolios. One academic study found that REIT returns were helped by an average of 3.7% per year from 1975-83 by borrowing against their assets.[2] In the 24 years since the inception of the NCREIF Index (institutionally-held private real estate), the NAREIT (National Association of Real Estate Investment Trusts) Index (equity REITs only, not including the special category of health care REITs) has outperformed the private market by 3.5% in annualized return. While the mix of property types and geographies is not identical between the two indices, the general sense is that the two returns are measuring the same thing—private market real estate returns—with the difference being explained by the use of leverage on the part of REITs.

	Since Inception of NCREIF 24 Years, 1978-2002	20 Years 1983-2002	15 Years 1988-2002
NCREIF Index	9.47%	7.88%	6.80%
NAREIT Index (Equity – Health Care)	13.0%	11.96%	9.86%
NCREIF+3.5% (approx. leverage adj.)	13.0%	11.4%	10.3%

Further, for the most recent 15-year period, both methods of investing were substantially driven by their current income return. 72% of the REIT returns were the result of dividend income, and 88% of the NCREIF return came in the form of cash distributions (the NCREIF "Income Return" less capital reinvestments).[3]

The Medium-Term Performance of REITs vs. Private Real Estate

In the analysis of periods shorter than the very long term, stock market influences begin to materially affect the performance of public REITs. From 1993 through 1997, REITs were a darling of Wall Street, where REIT equity offerings (IPO and secondary) consistently ranked in the top five industries for investment banking activity. In the chart below, this shows up as an 18.1% annual performance for REITs in the five years ending 1997, far ahead of the private market returns of 7.8% (un-levered).

Once this REIT bubble burst, the NAREIT index has under-performed NCREIF for every rolling five-year period since. When one considers that REITs are leveraged about 40%, REIT returns should have been more like 14-16% during those years of underlying property market strength. The five years ending 2001 showed the worst performance, with the unwinding of the high 1997 valuations more than off-setting the high dividend income from REITs.

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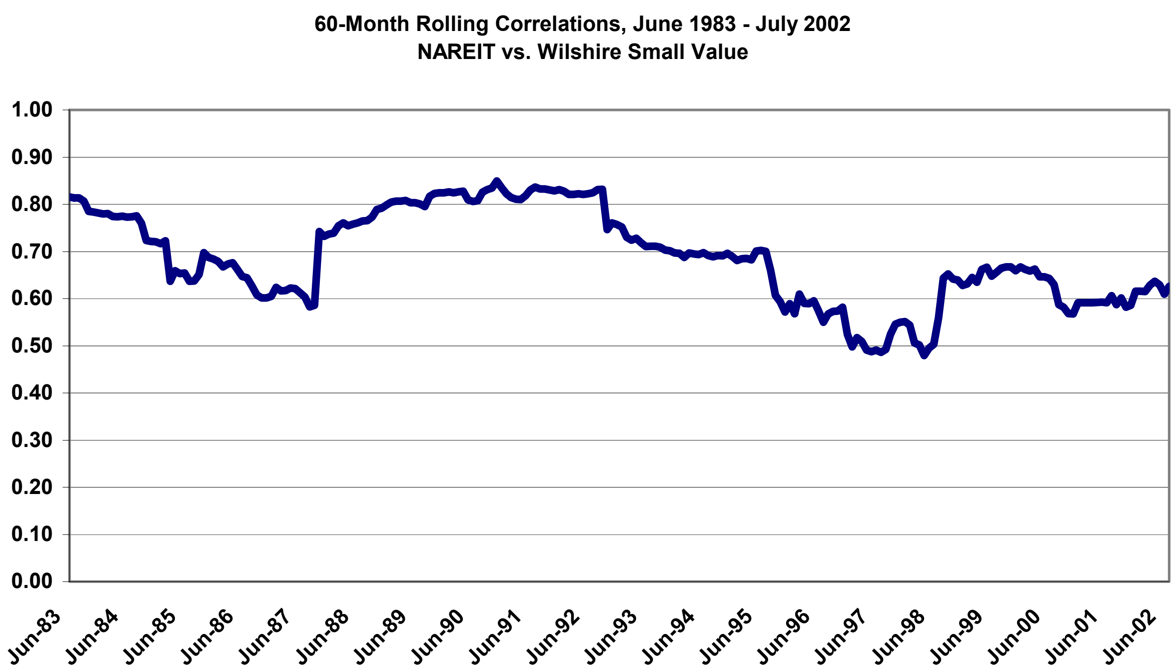
[1] *Source: NAREIT (National Association of Real Estate Investment Trusts)*

[2] Geltner, D., J. Rodriguez' and D. O'Connor, The Similar Genetics of Public and Private Real Estate and the Optimal Long-Horizon Portfolio Mix, *Real Estate Finance,* Fall 1995.

[3] Source: NAREIT (National Association of Real Estate Investment Trusts), NCREIF (National Council of Real Estate Investment Fiduciaries), and Bailard, Biehl & Kaiser, Inc. (BB&K)

Annualized Returns Over 5 Years			
Five Years Ending December	NCREIF	NAREIT	Wilshire Small Cap Value
1997	7.8%	18.1%	20.4%
1998	10.8	9.8	14.0
1999	11.8	8.4	13.6
2000	12.8	10.6	12.9
2001	12.2	2.6	10.7

Interestingly, while REITs do not reflect the pattern of return shown by NCREIF, they do show some similarity to that of small capitalization value stocks. The Wilshire small cap value index had its best five years in the period ending 1997, and its worst five years in the period ending 2001, the same as public REITs. The next chart illustrates how important this effect is.

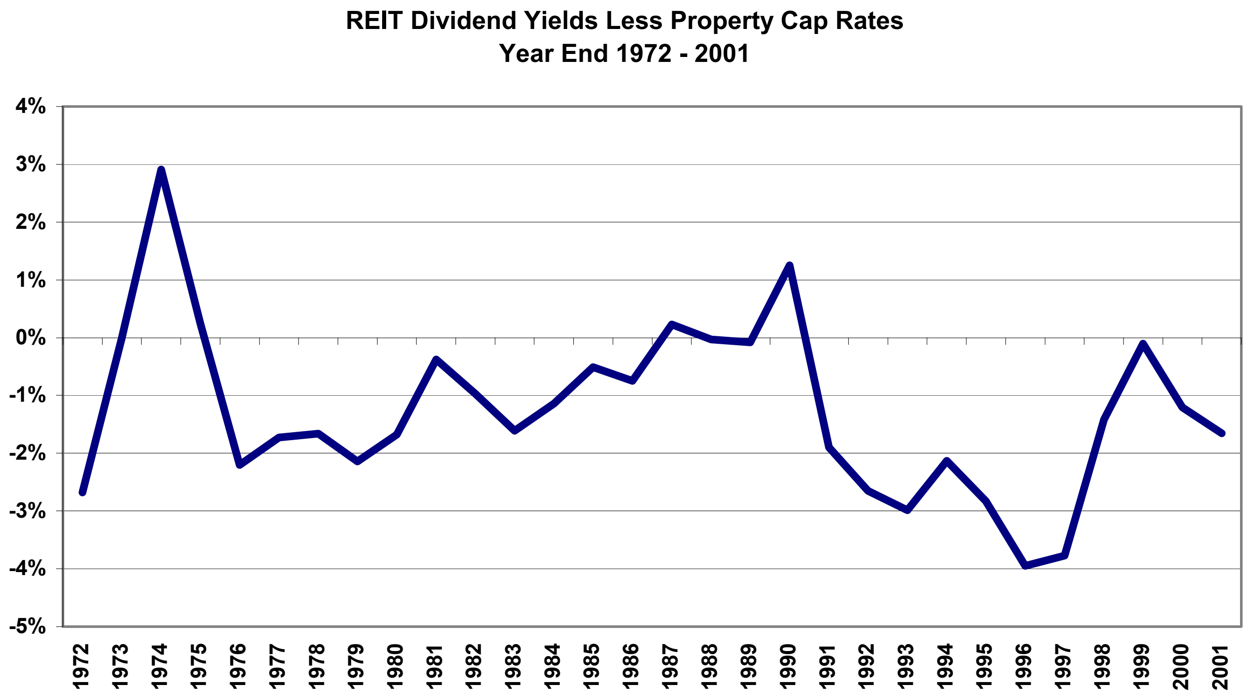


Source: NAREIT, BB&K

In short, 5 years in public REITs is not nearly a long enough term to assure investment returns comparable to those achievable with private real estate investments.

While NAREIT proponents have trumpeted the declining correlation of REIT returns with the S&P 500 Index, they fail to note that REIT returns continue to exhibit a roughly 60% correlation with small cap value stocks. (In recent years, the S&P 500 Index has exhibited a declining correlation with many industry sectors, as large cap growth stocks—essentially the S&P profile—have marched to their own market rhythms.)

Another way to observe how stock market capital flows impact REITs vs. private real estate is in the exhibit below which shows the NAREIT dividend yield at year end, less private market property capitalization rates. Private market real estate typically sells at a net operating income (NOI) yield of 8.5% to 10.0%. Normally, about 2% of that is reinvested annually in capital improvements to maintain a property's competitiveness.[4] On average, REIT dividends have run about 1% below cap rates, reflecting a combination of two factors: capital reinvestment, which tends to reduce cash yields; and the use of leverage, which tends to increase cash yields (when debt costs run lower than cap rates). Since inception in 1972, the NAREIT dividend yield has shown wider swings than private property cap rates, and has ranged between 5% to 10%.



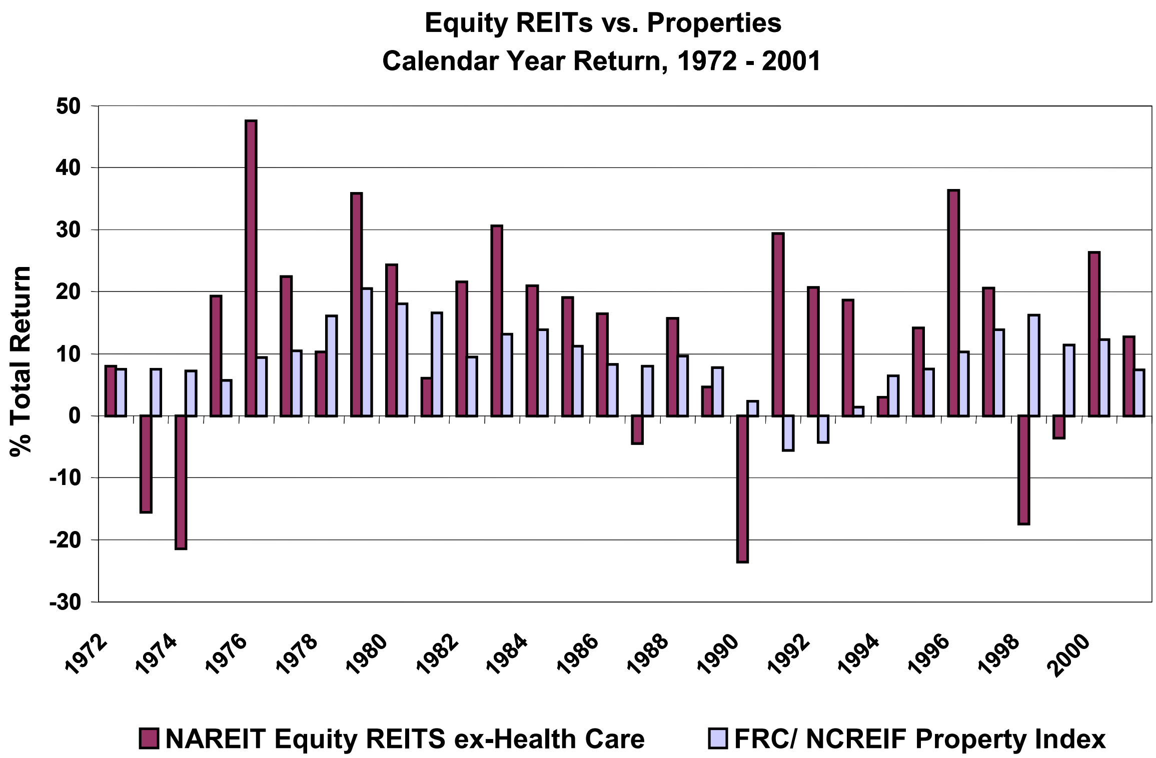
Source: NAREIT, BB&K

The chart shows considerable volatility around the –1% level. In the 1971-72 and 1993-97 REIT bubbles, dividend yields ran more than 3 percentage points below cap rates, while in the depressed REIT markets of 1974, 1982, 1988-1990 and 1999 REIT dividend yields were equal to or greater than cap rates.

[4] Source: Bailard, Biehl & Kaiser, Inc. (BB&K)

Volatility of Annual Returns: NAREIT vs. NCREIF

Another way of looking at the stock market effect on REITs in the short term is to compare annual total returns of NAREIT to NCREIF. Not only have REITs experienced three times more negative return years than private real estate since 1972 (6 vs. 2), the magnitude has been considerably greater. In the chart below, in the boom years, REITs can show 30% to 40+% returns, while the down years can show losses of –15% to –20+%. Private market returns, using the un-leverage NCREIF (and predecessor) data, offer greater consistency, ranging from booms of 15-20% to down years of –5%.



*Source: NAREIT, NCREIF and Frank Russell Company**

Individual REITs have exhibited even more breathtaking extremes. Two of the institutional darlings of the 1997 bull market were Crescent (+54%) and Vornado (+84%). In 1998, Crescent dropped 42% while Vornado declined 29%. In August 2002, they still trade well below their 1997 highs.

Obviously, it is easier for REIT investors to be affected by such stock market emotions as either euphoria or panic than it is for private market investors.

The Starting Point Matters

Earlier we noted how five-year annualized returns depended on the starting and ending points: the five years ending in 1997 enjoyed 18.1% annual returns, while the five years ending 2001 only saw 2.6%. Over even 10-year periods, the effect of the starting point can be significant. Annualized NAREIT returns for the decade following the September 1972 bubble peak ran 10.8% per annum through September 1982, while investors who bought at the end of 1974 enjoyed 23.4% returns through the end of 1984. Even over the longer term, returns continued to be affected: for *twenty-year holders*, the annual return to the September 1982 investor ran 11.9%, vs.15.9% for the investor who waited until December 1974 to buy.[5]

Factors for Prospective Public REIT Investors to Consider Before Investing

- *Long term investors should expect total returns approximating those achieved from a moderately-leveraged private property portfolio.* Remember that "long term" in this context means at least 15 or 20 years, not 5 or 10 years.

- *To improve your chances of achieving NAREIT index returns, a diversified portfolio approach must be taken.* This is particularly true in the REIT industry sector, where most REITs focus on a fairly narrow strategy—a single property type in a limited regional geography. A prudent diversification would include all major property types spread over most of the country and involve perhaps 20 to 30 different REITs.

- *Evaluate your emotional ability to "stay the course".* If you are at risk of being scared out of public REITs after one of their bear market years, you will then be likely to miss out on the very large return years that typically come right after such declines. To obtain the long term return, you must stay in the game. Remember, in the short run, REITs behave a lot more like stocks than real estate.

- *Be sensible in picking your entry points.* Since 65-75% of REIT returns comes from their high level of dividends, it makes more sense to invest in periods where REIT dividend yields are running 7-8% (or higher) than it does when they are running below 6%. The risky periods of REIT bubbles (1971-72 and 1996-97) have historically occurred when REIT dividend yields have fallen below 6%.

In summary, an investor's satisfaction with public REITs as an alternative to direct ownership of real estate is a function of his or her time horizon, entry point valuations, liquidity needs, and tolerance for short-term volatility. The surest way to achieve the risk/return/correlation characteristics inherent in private real estate investments is to invest in private market vehicles. Anything less is a compromise.

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[5] NAREIT data calculated by BB&K

[*] FRC (Frank Russell Company) Index data used was from 1972 thru 1977. The FRC Index was a predecessor to - and similar in style to – the NCREIF Index, but covered a smaller database of properties.

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