Morgan Stanley

INVESTMENT MANAGEMENT


# A Compelling Opportunity in REITs

**INSIGHTS** | GLOBAL LISTED REAL ASSETS TEAM | August 2024

## Key Takeaways

- REITs have significantly underperformed the broader U.S. equity market over the past five years, primarily due the effects of COVID-19 and rising interest rates
- As a result, REITs are inexpensive today, especially when compared to the broader equities market
- REITs also have historically performed well when interest rates stabilize and start to drop
- Given the Fed is expected to start cutting interest rates in 2H24, we believe now is an excellent time to consider an allocation to REITs

A retrospective of REIT returns tells an interesting story. In *Display 1*, a 20-year lookback shows U.S. REITs[1] have underperformed the broader U.S. equity market by about 2.4%. However, a closer look shows that over the first 15 years of this 20-year period (6/30/2004-6/30/2019), REITs outperformed the broader U.S. equity market by about 0.7%. But over the past 5 years the REIT story changes dramatically. In an economic environment impacted by the COVID-19 outbreak and Quantitative Tightening (QT) by the Fed, REITs have underperformed significantly, generating total returns of only 3.40% on an annual basis, compared to 15.05% for U.S. equities.

**DISPLAY 1**

**REITs Have Had a Rough Five Years, but Is There Opportunity Ahead?**

*REIT returns compared to the broader U.S. equity market over three time frames*

| | FTSE NAREIT ALL EQUITY REITS | S&P 500 | S&P 500 EQUAL WEIGHTED |
|---|---|---|---|
| **20-year through 6/30/2024** (6/30/2004-6/30/2024) | 7.87% | 10.29% | 10.06% |
| **15-year through 6/30/2019** (6/30/2004-6/30/2019) | 9.41% | 8.75% | 9.77% |
| **5-year through 6/30/2024** (6/30/2019-6/30/2024) | 3.40% | 15.05% | 10.94% |

Source: Morgan Stanley Investment Management, S&P, FTSE Nareit. Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

AUTHOR

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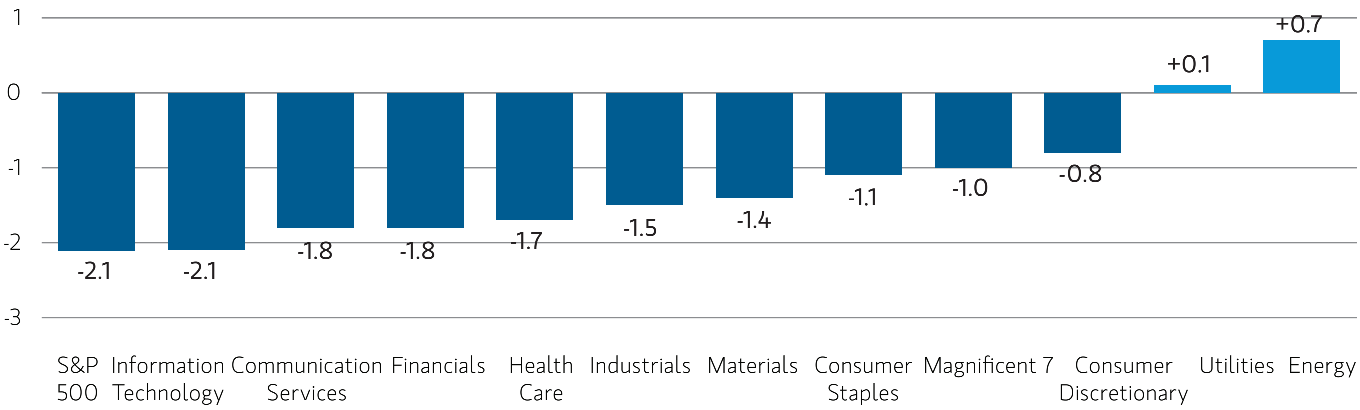
"We believe there will be a REITs breakout when Quantitative Tightening morphs into Quantitative Easing. The reason is that history tells us REIT total returns have a strong negative correlation to interest rates, a relationship that certainly persists today"

[1] REITs are represented by the FTSE Nareit All Equity REITs Index.

**DISPLAY 2**

**U.S. REIT Valuation Support Widespread vs. U.S. Equities**

*10-Year Z-Score of multiple spread between U.S. REITs and U.S. Equities*




Source: Bloomberg, UBS Global Real Estate Research. As of 6/30/2024.

Interestingly, this outperformance of broad U.S. equities versus REITs has resulted in a significant valuation discrepancy. Over the past 20 years, U.S. REITs have traded at a +0.5x premium to U.S. equities on a multiple basis, but today U.S. REITs are trading at a -4.3x multiple discount. Bringing this relationship back to par would imply between 30-40% of relative outperformance of REITs compared to equities.

The Magnificent 7[2] have propelled U.S. equities more recently and one might assume this vast valuation discount for REITs is primarily attributable to the market dominance of this group. However, further analysis negates this contention; the multiple discount is evident across almost all Global Industry Classification Standard (GICS) sectors within the broader U.S. equities market, with the exception of energy and utilities *(Display 2)*. The bottom line? REITs are cheap versus the overall S&P 500, the vast majority of GICS sectors within the S&P 500 and the Magnificent 7 based on a 10-year z-score.[3]

The obvious question is whether REITs are in fact “broken” or is this a rare opportunity to deploy capital in a sector on the precipice of a compelling change. Spoiler alert: we think there will be significant opportunity based on compelling change. And what is that change, one might ask? Well, we believe there will be a REITs breakout when QT morphs into Quantitative Easing. The reason is that history tells us REIT total returns have a strong negative correlation to interest rates, a relationship that certainly persists today *(Display 3)*.

Central banks across the globe have begun a rate cutting cycle, and the Fed is widely anticipated to follow suit, with two cuts anticipated in 2H24. In fact, the market implied policy rate one year from now stands at roughly 4%, appreciably lower than today’s target range of 5.25% - 5.50%.

Market returns after the first rate cut can vary widely depending upon sector. However, as seen in *Display* 4, the average performance of REITs stacks up well versus other sectors one year after the first rate cut.

Active management within the REIT space has historically produced what we believe are compelling returns for investors – and today is no different. Not all real estate is created equal, nor are all companies created equal. Since 2007, the annual spread between the best and worst performing U.S. REIT sub-sectors has ranged from 30% to 76%. On a YTD basis through 2Q24, REIT returns for the best and worst performing sub-sectors varied by over 35%. On the basis of individual stocks, the variation of return was upwards of 80%.

The bottom-up, fundamental research and investment process we adhere to at Morgan Stanley Investment Management allows us to identify those sectors and stocks that we believe have the ability to outperform – and capture excess returns through alpha generation, in addition to the beta of this recovery. We use internal proprietary research to invest in publicly traded real estate securities that we believe offer the best value relative

[2] Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, Tesla.

[3] Z-score is a statistical measure that quantifies the distance between a data point and the mean of a dataset. It’s expressed in terms of standard deviations.

to their underlying assets and earnings. Our investment approach is based on 3 core principles:

1. Relative value support
2. Downside risk mitigation through an integration of risk factors
3. High-conviction positioning with an identifiable investment thesis and positive trajectory on critical factors for the company

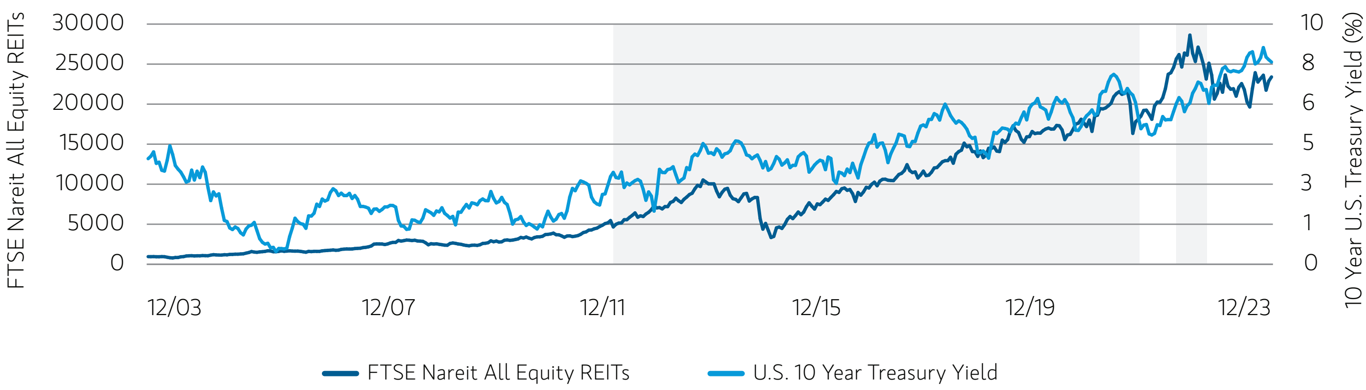
These principles, as well as an evaluation of trends unfolding within the real estate sector, facilitatez our portfolio positioning.

In summary, REITs have significantly underperformed the broader U.S. equity market over the past five years, primarily due to the impact of COVID-19 and the rise in interest rates. As a result, REITs are trading at attractive valuations. Furthermore, REIT total returns historically have a strong negative correlation to interest rates and typically do particularly well in stabilizing and declining interest rate environments. Given that the Fed is expected to cut interest rates in 2H24, we believe today is a great time to consider an allocation to REITs.

**DISPLAY 3**

### History Suggests that as Interest Rates Drop, REIT Values Will Increase

*REITs vs. U.S. 10-year Treasury Yield*

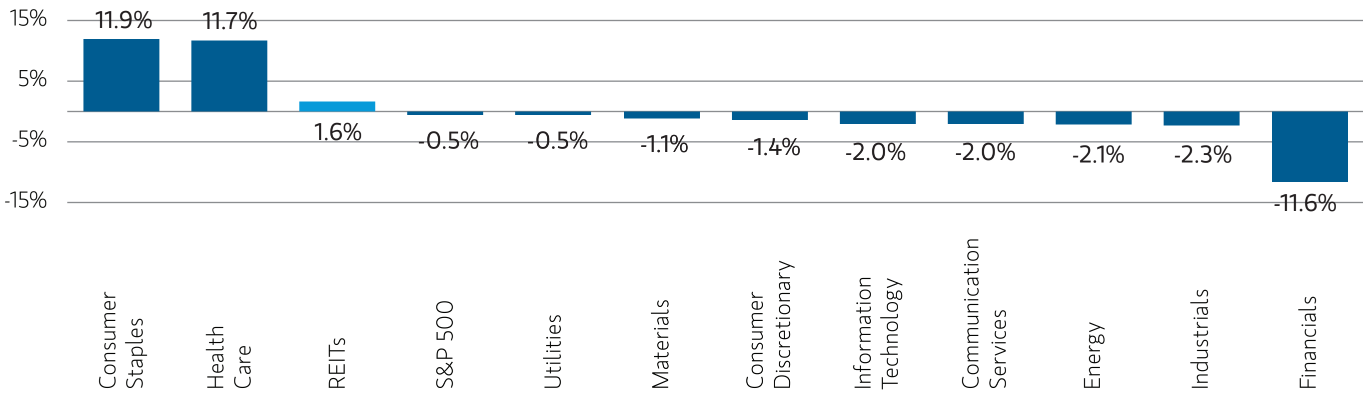



Source: Bloomberg, FTSE Nareit. Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

**DISPLAY 4**

### On Average, Real Estate Has Outperformed the S&P 500 and Most GICS Sectors After the First Rate Cut

*Average Total Returns One Year After the First Rate Cut - Since 1989**




Source: Bloomberg, S&P, FTSE Nareit. Index performance is provided for each GICS sector within the S&P 500 Index, except the FTSE Nareit All Equity REITs Index is provided for REITs. Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** *Since the beginning of 1989 there have been five first rate cuts: 6/5/1989, 7/6/1995, 1/3/2001, 9/18/2007, 7/31/2019. The above reflect the average of the one-year total returns after each of those cuts.

## RISK CONSIDERATIONS

The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in the Europe and global markets. The value of equity securities is sensitive to stock market volatility. **Real Estate Risk:** The risks associated with ownership of real estate and the real estate industry in general include fluctuations in the value of underlying property, defaults by borrowers or tenants, market saturation, decreases in market rents, interest rates, property taxes, increases in operating expenses and political or regulatory occurrences adversely affecting real estate. **Real estate investment trusts (REITs)** are subject to risks similar to those associated with the direct ownership of real estate, and they are sensitive to such factors as management skills and changes in tax laws. **Concentration Risk:** Concentration in a single region may make the portfolio more volatile than one that invests globally.

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**INDEX DEFINITIONS**

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **S&P 500® Equal Weight Index** (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight of 0.2% of the index total at each quarterly rebalance.

The **FTSE Nareit All Equity REITs Index** (FNER) is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

**MIDDLE EAST**

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