Real Estate in a Rising Rate Environment

SIGNATURE GLOBAL ASSET MANAGEMENT™

By Josh Varghese
March 23, 2018

Recently I attended the 2018 Citigroup Global Property CEO Conference, where over 1,200 of the world's leading property-sector chief executive officers and investors were in attendance. The event saw a record turnout – the highest in over 20 years – which highlights the continued interest in and appetite for global property.

While demand for property remains robust, audience polls revealed the following: (1) Operating fundamentals are at a later stage broadly across real estate (supply/demand fundamentals are currently leading to slower rent growth; (2) Interest rates should rise gradually; and (3) Supply and leverage are sufficiently moderate that the long-term value of real estate should hold up relatively well.

While at the Citigroup conference, I also noticed a sizable number of pension funds and private real estate investors. While this could be a coincidence, it could also be due to the fact that private real estate investors are finding Real Estate Investment Trusts (REITs) that are attractively priced relative to what they can buy directly within the property market.

REIT valuations have suffered against the backdrop of higher economic growth and higher interest rates; however, demand in the private real estate market remains strong, with 2017 representing a record year for fundraising within global real estate. Institutions such as pension funds and sovereign wealth funds continue to allocate capital to real estate as they believe they are still under-allocated to the asset class.

While most investors understand the effects of the interest rate environment we are in, many also seem to believe that even in a rising rate environment, real estate returns can be solid. This is especially the case if you own real estate assets that are operationally tied to an improving economy. For example, this can include apartments or other residential housing in which the rent can be raised annually to generate an attractive return, even in the face of rising rates. On the other hand, a commercial property with a 20-year locked-in lease, for example, cannot capture any cash flow growth and so rising rates may have a negative impact.

The ability of REITs to broadly capture the benefits of economic growth has led to historically high performance during rising interest rate environments; however, some REITS tend to benefit more than others. See the chart below on how REITs have performed in past periods of rising rates:

Real Estate in a Rising Rate Environment

Exhibit 3: Total Returns in Periods of Rising Treasury Yields

	10-Year Treasury Yield			Cumulative Total Return During Periods of Rising Rates	
Periods of Rising Rates	Beginning	Ending	Total Increase (bps)	U.S. REITs	U.S. Stocks
12/1995–3/1997	5.6%	6.9%	134	**36.2%**	26.3%
9/1998–1/2000	4.4%	6.7%	224	-7.1%	39.4%
2/2001–3/2002	4.9%	5.4%	50	**24.0%**	-6.1%
5/2003–5/2004	3.4%	4.7%	129	**26.1%**	18.3%
6/2005–6/2006	3.9%	5.2%	121	**19.1%**	8.6%
12/2008–12/2009	2.3%	3.9%	160	**28.0%**	26.5%
7/2012–12/2013	1.5%	3.0%	153	3.3%	38.3%

At December 31, 2015. Source: Bloomberg and Cohen & Steers.

Source: Evercore ISI

When looking at the REIT index, it's important to understand the wide range of property types it includes: shopping malls including smaller plazas or strip malls, apartments, single family homes, offices, hotels, data centers, industrial buildings, cell towers, timberlands, and triple-net lease properties. It's also important to know that each of these property types has a different cash flow profile, is at a different stage in their cycle, and is either facing tailwinds or headwinds (structural or cyclical). Add to this the fact that each geographic region has its own profile, and it's evident that we should not draw broad conclusions for REITs based on where we guess interest rates could go.

In terms of real estate sector holdings, Signature is currently focused on companies that are at a strong point in their cycle: they are able to drive revenue growth, improve margins and take market share that will allow them to thrive even in a rising rate environment. We have recently added positions to the Signature High Income Fund, Signature Diversified Yield II Fund and the Signature Real Estate Pool that each fit the funds' specific mandate. These include a life sciences-focused office company, two companies focused on single-family homes, and a Paris office company. To the extent that concerns about future interest rates cause further price dislocations among REITs, we will look to add more REITs that we believe will fare well in the future.

Please contact your CI Sales Team if you have further questions.

Thank you again for your continued support.

Josh Varghese

Real Estate in a Rising Rate Environment