

What Drives Equity REIT Returns? The Relative Influences of Bond, Stock and Real Estate Factors

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Executive Summary

Much of the growth in REIT market capitalization since the early 1990s is the result of increased institutional involvement. Investors who became disenchanted with direct property investments looked to the public markets (REITs) for a more liquid way to participate in the real estate market. As this change takes place, the question of what role securitized real estate plays within a portfolio has become more important. Specifically, the transition from private to public market real estate investment raises the question of whether REITs share the same investment performance characteristics as the underlying direct property. Does the purchase of REIT shares represent an investment in real estate, stocks, or a hybrid of stocks and bonds? Furthermore, has the relative contribution of these factors changed over time as the REIT sector has matured? Does it continue to change with the general business and real estate cycles? Finally, does it vary cross-sectionally by REIT characteristics (eg. size, focus, advisor-type) or property type? Answers to these questions are of direct importance to investors. As well, answers will help to shed light on the relationship between securitized assets and their unsecuritized counterparts, when the two trade under very different market mechanisms. Given the rise in securitization (of many different asset types) in recent years, this is a topic of relevance beyond the REIT market

This paper offers a new approach to answering the question, “how much of a REIT’s return is driven by real estate market influences, and how much by stock and bond factors?” Specifically, we develop a method that allows for the decomposition of the volatility of REIT returns into stock market, bond market, real estate market and idiosyncratic effects. A multi-factor return generating approach is utilized in order to break down the proportion of REIT volatility due to large cap stocks, small cap stocks, bonds and unsecuritized real estate. This is done on a both a market wide basis with the NAREIT index, as well as for individual REITs.

Our results show that from 1978 to 1998, the REIT market has gone from being driven mostly by large cap stocks to being driven by both a small cap stock factor and a real estate factor. While unsecuritized real estate accounts for a negligible proportion of volatility over the whole sample period, a significant real estate factor emerges during the 1990s. There is also a steady increase over time in the proportion of volatility not accounted for by any stock, bond or real estate factors. Our analysis indicates that some of this unaccounted for volatility is due to a REIT sector factor that is common to most REITs but independent of the stock, bond and real estate markets. The results are consistent with the returns to securitized real estate gradually beginning to reflect the nature of the underlying, unsecuritized assets. It is also consistent with information gathering and dissemination of information on REITs becoming more widespread over

time as their returns become less dependent on major stock indices and more akin to real estate and sector effects.

Unfortunately, when we attempt to identify which types of individual REITs are more like real estate and which are more like stocks, we can explain only a small portion of cross-sectional differences. However, it seems that an increase in REIT market capitalization is associated with a significantly larger proportion of variance due to stocks. Counter-intuitively, REITs become more like small cap stocks as they become larger. When classifying the REITs by property type, we find that apartment and industrial REITs are less “like” the unsmoothed NCREIF returns. However, we are unable to conclude whether this is because of underlying differences between these types of REITs and other types, or because of the bias towards office properties in the NCREIF index itself.