

Term Paper

Real Estate Investment Trust (REITs) is a special type of securitization that securitizes real estate properties. Since real estate has a low correlation with equity market, and REITs provide a less expensive opportunity to invest in real estate, it is an efficient way to diversify the investment portfolio by investing in REITs. REITs are often regarded as a kind of distinct asset class, and there are three types of REITs including equity REITS, mortgage REITs and hybrid REITs.

REITs invest in a wide range of real estate property types including offices, apartment buildings, warehouses, etc. The majority of REITs specialize in a particular property type, while some hold multiple types of properties in their portfolios. It operates by leasing the real estate property, the company collects rent income and then pays investors in the form of dividends. The company must pay out at least 90% of the taxable income to investors, and the majority even pay out 100%.

For different property sectors of REITs, their differences are very large. Office, retail, and residential REITs account for the largest weight among equity REITs, and they are also closely related to the five indexes including S&P500, S&P400MidCap, S&P600SmallCap, Treasury and Bond. In addition, hotel REITs show a high correlation with S&P400MidCap and S&P600SmallCap. The correlation of health REITs with Bond is slightly higher. Self-storage REITs show a relatively low correlation with all five indexes (Li & Orzano 2020).

In terms of historical return, REITs have a good performance in the long run. Due to REITs According to chart 1, the average annualized rolling 10-year average returns for REITs in United States have outperformed the stock market most of the time, and the annualized return shows lower variability reflected in a lower standard deviation of 9.0% compared with 16.0% of U.S. stock. From chart 2, REITs have a very distinct advantage in annualized 20-years returns which also accompanied by a lower standard deviation of 9.0% compared with 13.8% of stock.



Source: Nareit analysis of Factset monthly returns from January 1990 through October 2020

In 2020, risky assets have experienced a V-shaped rebound in general. Assets which are low correlated with social distance have rebounded earlier and faster, and they have significantly exceeded the highs at the beginning of the year such as technology stocks. The outbreak of Covid-19 results in an increase in social distance and a decrease in social activities, which has a more direct and lasting impact on commercial real estate. Although the U.S. equity REITs index has rebounded from a low point by more than 20%, YTD is still down by about 6%, and the retail sector is particularly prominent which has fallen 25% till now.

In 2021, with the broad application of vaccines and the recovery of economic, the demand for commercial real estate will have a significant growth. Compared with U.S. stocks which have more optimistic expectations and high valuations, REITs have more space to repair, so it might be a good investment strategy to allocate a moderately high proportion of REITs.

In conclusion, REITs is a great investment. They provide investors high dividend income and long-term capital appreciation, and they have a relatively competitive and stable returns compared with U.S. stocks. Furthermore, their low correlation with equity market can well diversify the investment portfolio. Next, due to Covid-19, REITs have more repair space than U.S. stocks. Therefore, I would allocate 20% of my own asset to invest self-storage REITs since its low correlation in different property sectors, and hold for a long-time horizon like 5 to 10 years.

Reference

Funari, N 2020, *REIT Average & Historical Returns VS U.S. Stock*, viewed 15 June 2021, <<https://www.reit.com/news/blog/market-commentary/reit-average--historical-returns-vs-us-stocks>>.

Li, Q & Orzano, M 2020, *Understanding REIT Sectors*, viewed 14 June 2021, <<https://www.spglobal.com/spdji/en/documents/education/education-understanding-reit-sectors.pdf>>.