Real Estate ETF Performance Sours As Broader Economy Declines

June 06, 2012 • Andrea Murad

Page 1 of 2

"We house our families in our homes, and we house our economy in commercial real estate," says Michael Grupe, head of research at the National Association of Real Estate Investment Trusts (NAREIT). "As the economy grows, the demand for commercial real estate space typically increases." And that applies to ETFs that track publicly-traded REITs since real estate ETFs move in line with the broader economy and their peaks and troughs follow the business cycle.

As such, REIT ETFs enjoyed a strong start to 2012 but recent weeks have seen that performance deteriorate as the market declined. This has been worsened by the variety of economic factors that impact real estate ETFs, with office, industrial, retail and residential property often bound-up in a single product.

The FTSE NAREIT All REITs Index, which includes all types of commercial properties, had a 2012 year-to-date total return (including dividends) of 9.02 percent at May 31, while the 50 more frequently traded REITs tracked by the FTSE NAREIT Real Estate 50 Index had a total return of 8.54 percent. The iShares ETF FTSE NAREIT Real Estate 50 Index Fund (NYSE: FTY) holding those same 50 REITs returned 8.31 percent for that period.

"The year started off very well but REIT ETFs have all soured over the past month," says Stijn Van Nieuwerburgh, Professor of Finance at NYU Stern and director for Stern's Center for Real Estate Finance Research. "Markets have perceived a higher probability of a macroeconomic slowdown."

In the short-term, REIT ETFs have experienced the same volatility as most stocks since they're affected by the daily information flow into the markets. "Over the long-term, a lot of that noise tends to wash out," says Grupe. "Individual sectors will tend to reflect the economic fundamentals that drive that performance."

Overall, REIT performance is heavily dependent on continued job growth. "The REITS have had such a strong rally in stock prices over the past three years, but they're getting fully priced without a lot of job growth," says Royal Shepard, REITs analyst at S&P Capital IQ.

A majority of REITs hold commercial real estate used for industrial or office, retail, or residential purposes. What happens in the economy and whether there's a change in employment, manufacturing, consumer spending, for example, can have a direct effect on REIT performance.

REITs holding properties with office space are dependant on location and employment.

When companies hire, they rent office space. Properties located in central business districts have clearly outperformed suburban markets, particularly for energy and technology sectors. “The biggest recovery has been in highest quality office buildings owned by the public REITs,” says Jeff Spector, REITs analyst at Bank of America Merrill Lynch.

Companies have been renting less space to house the same number of employees which may be a permanent change, says Spector. For fundamentals in this sector to improve, companies need to spend the cash sitting on their balance sheets. Suburban office fundamentals have stabilized due to public REITs luring tenants away from private property owners that are not well capitalized.

The manufacturing sector is turning around, as demonstrated by performance of REITs holding properties with industrial space.

The nation is also experiencing a real rebound in manufacturing from increased industrial production, says Calvin Schnure, Vice President, Research and Industry Information at NAREIT. REITs owning industrial space have had strong performance, with year-to-date total returns through May 31 at 12.59 percent.

The FTSE NAREIT Industrial/Office Capped Index Fund (NYSE: FNIO) ETF year-to-date return through May 31 was 9.08 percent versus the NAREIT Industrial/Office Capped Index’s return of 9.35 percent.

The housing market and whether people decide to rent or own can boost or deteriorate performance for REITs holding residential properties.

“Apartment fundamentals have been very strong over the past two years,” says Spector. People in their 20s have made a lifestyle choice to rent instead of own because of the convenience, social factors, and mobility. At the same time, baby boomers are selling their homes and moving into rentals.

“Apartments have had their good year and are settling into a strong hold position,” says Schnure. There’s a huge shadow demand due to people who used to live alone but now share apartments. As employment improves and more households enter the market, the rental market will become tighter from limited new construction to meet demand.

1 | 2

Real Estate ETF Performance Sours As Broader Economy Declines

June 06, 2012 • Andrea Murad

"You didn't have the same level of overbuilding in commercial real estate," says Shepard. "There's an undersupply of properties." This is most prevalent within residential properties where, on the demand side, housing is more affordable but people aren't buying new homes.

With existing new construction expected completion dates in 2014, many are underestimating the pent-up apartment demand and time needed to satisfy this demand. Whether this has been priced into the market is not clear, says Grupe.

The FTSE NAREIT Residential Plus Capped Index Fund (NYSE: REZ) ETF year-to-date return through May 31 was 5.42 percent versus the FTSE NAREIT All Residential Capped Index's return of 5.64 percent.

The retail sector has stabilized but vacancy rates are still high, slightly above 10 percent, with improvements in performance from lower unemployment numbers and increased consumer spending, says Schnure. REITs tend to purchase the high-end trophy properties that are performing well. "The retail sector will ride the tides of the economy," says Schnure.

The FTSE NAREIT Retail Capped Index Fund (NYSE: RTL) ETF year-to-date return through May 31 was 13.17 percent versus the FTSE NAREIT Retail Capped Index's return of 13.40 percent.

"The liquidity of the REIT [ETF] market ebbs and flows," says Kevin Quigg, Global Head of SPDR ETF Strategy & Consulting at State Street Global Advisors, as this market is affected by the broader real estate market and U.S. economy.

1 | 2

LEAVE A COMMENT

NAME

EMAIL

How big will JPMorgan's loss on the Whale trade end up being?

- More than $5 billion
- Between $2 billion and $5 billion