August 2018

REIT Industry Update

Commercial Real Estate Hits a Pause

After years of REIT outperformance relative to the S&P 500® Index, REITs took a breather in 2017. Amidst the expectations of a rising rate environment, REITs finished up 5.22 percent as the 10 year closed at 2.40 percent by year-end. Thus far in 2018, REITs continue to lag the S&P 500® Index, up 2.09 percent with the 10 year hitting 2.98 percent.[1] Meanwhile, private market valuations are holding firm, with Green Street Advisors' Commercial Property Price Index suggesting that values have stayed steady over the past twelve months. Their data shows commercial property having fully recovered from the 2009 lows, now surpassing the 2007 peak levels by 27 percent.[2] Providing support for real estate valuations are capital markets that remain robust with multiple financing alternatives open. With a healthy economic backdrop, growth in real estate demand has been sufficient to stabilize occupancy levels in the mid-90 percent range.[3] Steady gains in leasing amidst low supply are translating into solid pricing power for landlords and stable to rising market rents for most subsectors. Guggenheim believes overall property-level operating income is expected to grow at roughly 3 percent annual pace. As a result of the positive fundamentals, REIT earnings should pace in the mid-single digit range for 2018.[3] Guggenheim believes dividend growth should parallel earnings growth, as current dividend payout ratios remain below historical norms.

Interest Rate Fears vs. Underlying Real Estate Value

Rising rates have caused some turbulence in recent returns. History has shown that rising 10-year Treasuries have not necessarily caused REITs to underperform vs. S&P500® Index over a lengthy period (1.98–12.11).[4] More recently (1.12–05.18) however, rising rates seem to have hampered relative REIT returns. There are two important factors to consider when examining the recent evidence. Firstly, the initial period of underperformance is generally met with sharp reversals, suggesting much of the initial moves may be an overreaction by jumpy capital markets. Secondly, the private market is poised to capitalize on excessive overreactions—whether driven by rates, management strategies, transitory factors, etc. Private equity has stepped in when public markets don't fairly value REITs. Firms such as Blackstone Real Estate Partners VIII, Brookfield Property Partners L.P., and Brookfield Asset Management Inc. have privatized multiple public companies this year alone.[5] Guggenheim believes such a valuation backstop, paired with the high current dividend of REITs, should provide investors with some measure of comfort even during volatile times.

The Case for REITs

During the second quarter of 2018, equity REITs delivered a 10.03 percent total return compared to 3.43 percent for the S&P 500® Index.[1] Guggenheim feels public real estate offers several benefits for an individual investor's portfolio that are particularly relevant in today's environment:

- REITs may provide attractive current income with the potential for future dividend growth as underlying property cash flows grow over time.
- Real estate provides inflation hedging characteristics as underlying rents, property cash flows, and replacement costs have historically adjusted with inflation over the long run.
- REIT earnings should be relatively resilient during economic downturns as a large portion of rental revenues are derived from contractual lease obligations.

1 Bloomberg, February 6, 2018. **2** Green Street Advisors, Inc., Commercial Property Price Index, July 6, 2018. Past performance does not guarantee future results. Index performance is presented for illustrative purposes only and is not meant to represent any particular fund. Returns do not reflect any management fees, transaction costs or expenses. The Index is unmanaged and not available for direct investment. **3** Citi Investment Research & Analysis, Weekly REIT and Lodging Strategy, February 2, 2018. **4** Green Street Advisors, Inc., Heard on the Beach, 6.13.2018. **5** Companies that have either been privatized or have accepted offers to be privatized include: GGP, GPT, DCT, EDR, LHO, and FCE.

For information on investment products offering REIT market exposure, please contact your financial advisor or visit GuggenheimInvestments.com.

Index Definitions (Each index is unmanaged and it is not possible to invest directly in any index.) **S&P 500® Index** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Green Street Commercial Property Price Index** ("CPPI") is a time series of unleveraged U.S. commercial property values. CPPI captures the prices at which commercial real estate transactions are currently being negotiated and contracted.