Finding Factor Alpha in REITs

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TRANSCRIPT

Jim O'Shaughnessy (Jim): Hello and welcome everyone. I'm Jim O'Shaughnessy and this is the "What Works on Wall Street" podcast. My goal is to make the sometimes archaic-sounding language of the investment world more simple and approachable for our listeners. Today, my guest is Travis Fairchild, one of my colleagues here at O'Shaughnessy Asset Management and the topic is real estate investment trusts. Welcome.

Travis Fairchild (TF): Thank you very much.

Jim: Travis, this is a really interesting part of the market because it's very different than traditional stocks, if you will. Talk a little bit about the efficiency or inefficiency of this market, kind of the size of the market, and why those things make it quite different from other sectors that we look at.

TF: Yes, absolutely. That's in fact one of the things that attracted us to this space was the inefficiency of the space. We did some [due diligence] and realized that several of the managers within this space had very low active shares and very low active portfolios, combined with it being a very top-heavy part of the market. The top 25 names make up over half of the index and the top three sectors within the REIT space also make up over half. Then outside of those top-heavy names, they tend to be overlooked within the smaller and mid-cap portions of the REIT space.

Some of the ways that we've quantified that is we looked at analyst coverage and institutional ownership, and looking at both of those, the analyst coverage tends to be very low outside of the largest-cap REITs and at levels that we're used to seeing within the micro-cap space within the rest of the market.

Then the institutional ownership of those smaller and mid-cap names also tend to be 75% less than the larger-cap REIT names and so there tends to be a lot of smaller-cap names that get overlooked and they don't get the respect and attention that their larger-cap REIT peers tend to get and there tend to be a lot of very good investments that we can take advantage of with a factor-based, quantitative, systematic approach to investing in this space.

Jim: Right, and you had mentioned to me that even if they call themselves active, there are really very, very few truly active managers in the space.

TF: Correct, yes, and another way that we looked at that, we have access to the Envestnet database and of all of the managers within that database, only 20% of them have an active share of over 60%.

Jim: Just describe active share for our listeners.

TF: An active share of 60% means that 60% of your portfolio does not overlap with the benchmark. Said another way, 40% of your portfolio does overlap with the benchmark and a rule of thumb within the industry tends to be anything below 60% is labeled a closet indexer and we've seen that 75% of active REIT managers fall below that 60% and that's by count. If we adjust that to market cap and the amount of assets that these managers actually have, it's well above 75%.

Jim: Wow. No doubt they are charging active fees as opposed to passive fees.

TF: Correct, and that's another very interesting aspect of this market is that if you do an active fee adjustment to what the active managers are charging their customers and investors, the average is about 1.5%. The active fee adjustment would basically mean what are you paying for the active portion of that manager's portfolio? If 50% of their portfolio's different from the market, then you would basically double their fee. If only 10% of their portfolio's different than the market, then that would increase their fee by 10 times. If you do that analysis, the average within the industry is about 1.5% active fee and we've actually seen some that are north of 3% or 4% active fee within the industry.

Jim: We've gone back to the Eighties when there were 5% and 8% loads on mutual funds.

TF: Yes. We were very shocked when we did this analysis and some others in the industry that have repeated it said that it made them a little sick to look at the results when they've replicated our analysis.

Jim: It should. It definitely should.
What's OSAM's "edge"? Talk a bit about our edge in our process for identifying the best REITs.

TF: Okay, and so this is another thing that makes the REIT industry different is they deserve and need their own unique factors within the space. Some of the most common definitions of say, value, can't be used within the REIT space because of accrual accounting versus cash flow accounting. The best examples are P/E and price-to-book ratios. Both very popular valuation ratios in the rest of the equity market, but because of the large depreciation expense that REITs take, it tends to distort both P/E and price-to-book because a lot of times when they're taking these depreciation expenses, the assets that they're depreciating against are more often than not increasing in value. Corporate real estate tends to go up more often than it goes down. That really distorts in those time periods of increasing real estate values both the earnings and the price-to-book ratio and so neither of those work.

To replace those, we use REIT-specific factors like price-to-FFO, which is funds from operations, and price-to-NAV, which is net asset value. Funds from operations pretty much replaces P/E ratios and net asset value tries to get at what is the market value of those assets that they're holding on their book, and not the book value that's been depreciated down to a distorted level. What is the market value of those assets and what is the price of that REIT versus that market value?

Jim: I remember you telling me that market cap was a very poor factor to use in REIT selection. Why is that?

TF: Correct. Yes, … those tend to be the most over-owned of any of the REITs within the public space. Also, a lot of the active managers and index funds and ways that people get access to REITs tend to be over-invested within those larger-cap, with larger-cap REITs and if you're investing on anything that's very close to market cap, then you're not paying attention to valuation, you're not paying attention to quality, do they have over-levered balance sheets, what are their growth prospects? If you're only investing on something that's very close to market cap, you're ignoring all of those things.

To quantify how poor of an investment decision that is to invest on market cap alone, the largest 20% of REITs since 1990 have underperformed by 2.1% the rest of the REIT market annualized.

Jim: Wow. Another one that I'm sure many of our listeners will be really surprised to hear is dividend yield is not a good factor.

TF: Correct. Yes, and that is another factor that is very common outside of REITs, but we've looked at it and realized that chasing yield within the REIT space is a very dangerous thing to do. The highest dividend payers tend to underperform and there are a lot of periods where the lowest dividend payers tend to outperform, so it's kind of the inversion of what you would see in a lot of other areas of the market where dividend yield is a proxy for value and tends to perform very well.

Some of the reasons for that are REITs are required to pay out 90% of their net income as dividends, and so there doesn't seem to be as much of a signal there if they're required to pay the dividends. Also, because they're required to pay out 90% of their net income, the only way that a REIT can grow organically is to retain a lot of their earnings and use that money to buy properties so they can take large depreciation expenses and other expensive expenses that will decrease their net income, save the money that they don't have to pay out in dividends, and then use that money to grow. Those companies that are paying lower dividends, there are time periods where they have higher growth than the dividend payers.

Jim: Yeah, fascinating. It's kind of like when you're so used to doing traditional quantitative analysis, you really have to have a completely different toolkit for doing it right in REITs, which sort of leads to my next question. Could you walk us through what filters and factors we run the universe through to get down to our holdings in the portfolio?

TF: Yes, absolutely. We've talked about a couple of them. First is valuation. REITs that have attractive valuations relative to their peers tend to outperform and we have those factors that we talked about earlier, price-to-FFO and price-to-NAV. Then we also combine those with an EBITDA-to-enterprise value and a price-to-cash flow value as well. Then we also look at buyback yields so similar to the rest of the market, when REITs are buying back shares or issuing less shares than their peers, they tend to outperform in the future and the REITs that are issuing the absolute most shares tend to underperform in the future.

It makes sense. A REIT, when they're going to issue shares to make acquisitions of other companies or new real estate assets, they're going to do that when their share price is overvalued or when they feel the share price is overvalued. That's a signal to us that the price is expensive and so that goes into what we call our REIT value composite, and that's a proprietary view of what value is within the REIT space that we have that kind of gives us our edge and our unique vision to build our portfolios within REIT.

Then in addition to that, we use momentum scores and just like value, we have our own proprietary look at momentum. We use a combination of 3-, 6-, and 9-month momentum into a composited score and that becomes a score that we can rank the REITs across percentiles and look at the recent price performance within REITs. Momentum's one of the strongest signals that we've seen in public equity markets and it works in real estate markets as well. There tends to be some inertia. The REITs that have performed very well it the past tend to perform well in the future, and the REITs that have done very poorly continue to perform very poorly in the future as well.

One good example of that right now is a lot of the retail names we are avoiding because of their poor momentum score and that has worked out in our favor.

Jim: What's our final criteria for getting into the portfolio?

TF: Valuation and momentum would be our final criteria. I'll take a step back. Before we get to valuation and momentum, this is similar to all of our strategies where we tend to have a quality overlay. We have a lot of research that shows that one of the most powerful tools an active manager has is knowing what names to avoid. Not just knowing what names to invest in, but a negative screening process to exclude the worst of the worst right off the bat. Names are guilty until proven innocent and if a name like Simon or American Tower doesn't have the quality that we feel are the characteristics that we're looking for, we're fine owning a 0% weight in those so we'll exclude names at the very outright that have the worst quality characteristics.

We have three themes that make up what we call overall call quality. The first would be financial strength, and so we're looking at how aggressive are they with their balance sheet? How loaded are their balance sheets? What are their debt ratios? What's been the change in debt over the recent year and how much cash flow are they generating internally to be able to pay down their current debt levels?

The next would be earnings quality. This is another one that has a proprietary factor for REITs. We've talked a little bit about FFO or funds from operations. One of the important aspects of FFO is that it's a non-GAAP measure and so it gets reported on the financial statements of REITs without the scrutiny that you would have for earnings and EBITDA and some of the other items that are regulated under GAAP. It's also one of the factors that REITs analysts tend to pay the most attention to, so there's a lot of incentive to tweak the dial up and down on FFO.

One of the ways that we found around this is NAREIT defines and publishes what they would recommend how FFO be calculated. NAREIT's recommendation on the FFO calculation, we can back into that using GAAP measures. We do that and we call that our calculated FFO and then we look at the difference of the reported FFO versus the calculated FFO and if there's a big difference, that's a huge red flag and those names tend to underperform.

One of the most well-known example of that is American Realty, which had a big scandal and they were dialing up their FFO. It came out later that they were making aggressive assumptions in that calculation and had some errors in the calculation that they knew about and chose not to fix and there was a large scandal where their stock price went down and if anybody was paying attention to the gap that was growing in their FFO reported versus their calculated FFO, they could have avoided that name back in 2014, and that's probably the most well-known example of avoiding a name that's going to underperform based on earnings quality.

Jim: Yeah, and it seems to me that, like microcap, this is a section of the market that is absolutely kind of ideally suited to quantitative selection process.

TF: Yes, absolutely. Again, that goes back to some of the smaller-cap names that tend to get overlooked and where there's low analyst coverage and some of the names that are just outside of the core definition of what corporate real estate is. One of the best recent examples for that might be Getty Realty, which is within the retail space of REITs and retail has done very poorly this year and over the first six months of the year, I believe that space was down 12–15% and Getty was one of the examples of where it decreased with the rest of the retail market but since then, in the third quarter, it's up quite a bit because they aren't really getting disrupted by Amazon because the stores that they own are gas stations and convenience stores. Amazon's not doing anything to disrupt that like the worries are for the rest of the retail space and some of the malls that are down quite a bit within the retail space of REITs.

That's something that if you used any type of valuation screen, it would show up very high, very good quality, decent momentum and very cheap relative to the rest of the REITs and the rest of the retail REITs and that was a name that we were able to find and get an overweight to and it worked out very well for us.

Jim: Yeah, and a lot of counterintuitive things, right?

TF: Correct.

Jim: Which you would lump something into one category that it probably doesn't belong in, you know what I mean?

TF: Right.

Jim: We all known the Fed has decided to cease doing a lot of its special activities. Many are speculating that interest rates will rise as a result of what the Fed is doing. What effect does that have on REITs?

TF: We think this is one of the big misperceptions within REIT investing is there's a lot of studies and kind of a rule of thumb that REITs are going to do very poorly in a rising rate environment, and if you actually look at the data, it doesn't support that rule of thumb.

A few examples of that. The modern REIT era, when the laws changed and there tended to be a lot of REIT IPO's in the early Nineties, if we look from the early Nineties on to today, there have been nine times where the long-term interest rate has risen 20% or more and a raise of 50bps or more. I'm sorry, seven times. In those seven times, six of those seven times REITs have had positive performance.

Jim: Wow.

TF: In four of those seven times, so more than half of the time, the majority of the time, REITs have actually outperformed the S&P 500 in those rising rate environments. We've went back and looked at some of these studies that have been referenced in the REITs are negatively correlated to interest rates and one of the most interesting findings there is the longest you can pull the returns of the NAREIT Index is back to the early Seventies and so people have regressed that versus long-term interest rates and seen the negative correlation and then that negative correlation gets quoted as REITs are negatively correlated and REITs are going to do terrible in a rising rate environment.

If you look closer, the evidence seems damning just looking at that, but if you take a step back and think about that analysis, rates have really only gone in one direction since the early Seventies and that's down.

Jim: Right, right.

TF: In addition to that, public equities in general have really only gone generally in one direction — and that's up.

Jim: Right.

TF: To say over that time period…

Jim: Financial crisis notwithstanding.

TF: Exactly, but over the longer-term trend, the equities have gone up and so one of the fun experiments that we decided to do was alright, so I think that all of equities are going to have a negative relationship over this period. Let's do that for every single industry group and then rank them. If you do that for all of the 24 GICS industry groups, so the four-digit code on GICS, REITs rank at the bottom, so they are less negatively correlated to interest rates over that time period than the rest of the market. It was I think a -0.6, the S&P was a -0.8 correlation to the market and there were I believe somewhere around like 18 other industries that were more negatively correlated to rates over that time period than REITs.

Jim: That's why I am a huge believer in always having to do our own research because so much can get disseminated and then other people cite that study and then that study is cited by someone else and suddenly something is taken as true, which when you really dig in you find well, may not be as true as you might have thought.

TF: Right. Yeah.

Jim: Talk a little bit about the difference between privately-held REITs and public.

TF: Privately-held REITs, the most common way that institutional investors will gain access to private is through a private equity fund. We've also done some analysis on this as well because there's kind of a perception that private real estate is superior to public real estate (REITs) and a lot of things that are referenced there is the volatility, returns being a bit higher, and that there may be a liquidity premium for investing in the private since it's such an illiquid space.

When you really look at it, there are a lot of studies out there that are starting to show that the returns are actually very similar. If you look at the private real estate benchmarks and adjust for things that are creating a bias and kind of an apples-to-oranges comparison within the look at private versus public, you start to see that returns and volatility are very similar.

A couple of those things, that kind of bias, the returns, and volatility better for private real estate within those benchmarks is they're appraisal based, so they get priced much slower and much more infrequently than public, because public is priced every single day. It's basically marked to market.

Jim: Right.

TF: Then also the benchmarks don't include any leverage. They include the properties, but they don't include any of the leverage that are used to buy those properties. Then if you add that leverage and back out the fact that it's appraisal based, the returns and volatility are very similar. It varies depending on the time period you look at and who's doing the study, but there are several studies now that show that the returns and volatility are very similar and you're getting very similar exposure between REITs and public equity.

Then on top of that, that doesn't include the fees and the cash drag...

Jim: Yeah, I was doing to say, the much higher fees.

TF: The much higher fees within the private space and the cash drag that at times studies have shown have been over 25% within the private real estate space. Once you factor those in, REITs start to look much more attractive than ... the rule of thumb within and the general knowledge within the industry.

Jim: Yeah, you mean publicly traded REITs, right?

TF: Yeah, publicly traded REITs.

Jim: Right, yeah. Now you've already given us some examples, but can you think of another case study where quality really saved us from buying something that other REIT managers would love?

TF: The one that comes to mind is, and this is another extreme examples and well-known case, is General Growth Properties. They went bankrupt in the credit crisis and if you were looking at financial strength, you could have very easily avoided General Growth Properties. When they went bankrupt their assets were just barely above their debt levels. Very, very high leverage ratios. If you look at the chart of their total debt in the 10 years leading up to when they went bankrupt, their debt increased 1,100%.

Jim: Oh, God.

TF: They were very, very aggressively buying companies and it did not work out well for them when the debt markets froze up and they couldn't refinance all of their mortgages. If you were just looking at very, very simple things like leverage ratios and their ability to pay down that debt, we talked about cash flow-to-debt ratios earlier within our financial strength. On all of those, they ranked within the worst 5% — or even worse than that — of any of the REITs. That's a reason that we would have steered very clear from them and at the very first step in our investment process we would exclude that name. That's a good example of financial strength and avoiding REITs that were going to underperform.

Some other good examples, probably one that we haven't talked about much is earnings growth. That's the third kind of pillar in our overall quality screen.

Jim: You already anticipated my next question.

TF: Yes. I think Simon Properties is a great example there. Simon Properties over the last year is down 25–30% and they rank in the worst 25% on Earnings Growth, so if you're using Earnings Growth and excluding poor quality companies based on that composite, then you would have avoided a lot of the downturn in Simon Properties recently. Really, that goes for a lot of the retail REITs that are underperforming.

Also, if you rewind even the year before that, so 2016 as a calendar year, we'll hit a couple of the themes here. If you looked at the top 10 names within the NAREIT Index, seven of them underperformed the index during that time.

Jim: Wow, 70% underperformed.

TF: Yes. 70% of the top 10 names within the NAREIT Index underperformed in 2016. Four of them by more than 10% under-performance and a lot of those names you could have avoided if you just had the simple quality metrics that we have. Financial Strength, Earnings Quality, and Earnings Growth would have helped you avoid a lot of those names and a lot of that under-performance in 2016.

That also goes back to speak to why in that year specifically, market cap, as any investment process or anything that looks very similar to market cap, like a closet index active management approach, is a very poor investment in the REIT space.

Jim: Yeah. Okay, so someone listening might think okay, this sounds very interesting, but I think I've got a pretty well diversified portfolio. I have U.S. equities, I have international equities, I might even have emerging market equities. Make the case for why I should consider adding REITs to my capital allocation.

TF: There's a lot of benefits to adding REITs. This may be one of the other misperceptions about REITs is people sometimes want to categorize them as either equities or put them in the bucket of bonds because they have the high dividend, but we really view REITs, and a lot of people view REITs, as their own distinct asset class, deserving their own slice of the asset allocation puzzle for your portfolio. Some of the reasons why, they tend to have low correlation with both bonds and equities over the long term. I believe with equities the correlation is about 0.5 or just a little bit above that. With bonds, it's about 0.15, so very low correlation with the other buckets of your portfolio.

Then in addition to that, there's a lot of benefits to where in inflationary environments they tend to do very well because when prices are increasing, REITs are able to raise rents and then pass that off to you.

Then there's a lot of other benefits as well. They have very attractive risk return. Historically they tend to do very well at times when bonds and equities are doing poorly and so they have the diversification piece to your portfolio as well.

Jim: Yeah, sounds like quite a bit.

TF: Yeah.

Jim: You also have a paper on our website (osamlibrary.com) on the REIT market, which I think is a great read should anyone listening want to take a look. They can find it there. Well with that, I will thank you for your encyclopedic knowledge of the REIT market. You've got me as an investor.

TF: Yes we do.

Jim: Let's hope others can see their way into getting better diversification and a little inflation protection, perhaps. Nobody thinks about inflation anymore because we really haven't had it and that's one of the dangers, right, because I remember inflation in the double-digits and it was pretty crazy. Obviously, we hope that we never get back into anything like that, but if we're long REITs, a little less painful.

TF: Absolutely.

Jim: Thank you very much for being with me today and, until our next podcast, thanks for listening.

TF: Thank you, Jim.

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