



BOCCONI STUDENTS FOR  
ALTERNATIVE INVESTMENTS

# REITS: UNDERSTANDING THEIR STRUCTURE AND MARKET DEPENDENCE

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## **Real Estate Investment Trusts (REITS):**

### **Navigating market dynamics and the role of interest rates**

Real Estate Investment Trusts (REITs) have emerged as a cornerstone of modern investment portfolios, offering accessibility to the real estate sector through publicly traded entities. Over the decades, their unique structure and high dividend yields have attracted a diverse range of investors. This article explores the structural aspects of REITs, their role in diversification, and the impact of market conditions - particularly interest rate fluctuations - on their performance.

### **Structure of REITs**

REITs function as entities that own, operate, or finance income-generating real estate. Established under specific regulations, they must distribute at least 90% of taxable income as dividends to shareholders, ensuring consistent returns. There are three main types:

1. *Equity REITs*: Directly own and manage real estate properties.
2. *Mortgage REITs*: Provide financing by investing in mortgages and mortgage-backed securities.
3. *Hybrid REITs*: Combine aspects of both equity and mortgage REITs.

The Dow Jones U.S. Select REIT Index, for example, focuses exclusively on equity REITs, excluding entities like mortgage brokers or timber REITs. This concentration highlights the core operational model: leveraging real estate ownership to generate steady income while maintaining liquidity for investors.

### **Investment strategy and portfolio diversification**

REITs are pivotal in creating balanced portfolios. Their benefits include:

- *High Dividend Yields*: A primary attraction, particularly for income-focused investors.
- *Liquidity*: As publicly traded entities, REITs offer easier exit strategies compared to direct real estate investments.
- *Diversification and Inflation Hedge*: They often perform independently of traditional equities and bonds, making them a stabilizing asset during economic uncertainty.

Moreover, in inflationary periods, REITs benefit from the ability to increase rents, supporting both income growth and asset appreciation.

## Impact of market conditions

- *Interest Rate Sensitivity:* Market conditions, particularly interest rates, significantly influence REIT performance. Rising interest rates pose challenges by increasing borrowing costs and reducing the relative appeal of REIT yields compared to fixed-income securities. Yet, historical data shows that during certain periods of rising rates, REITs have delivered positive total returns. This anomaly is often tied to concurrent economic growth, which drives higher property demand and occupancy rates.
- *Economic Growth and Inflation:* While higher interest rates can suppress property valuations, they are frequently accompanied by robust economic expansion. This growth boosts real estate fundamentals -demand, rental income, and cash flows- offsetting rate-induced pressures.
- *Market Volatility:* Unexpected shifts in interest rate policies can result in heightened volatility. For instance, the "taper tantrum" of 2013 led to a temporary sell-off in REITs, but they recovered alongside broader market stabilization.

## Data analysis

Our analysis highlights the relationship between interest rates and the performance of Real Estate Investment Trusts (REITs):

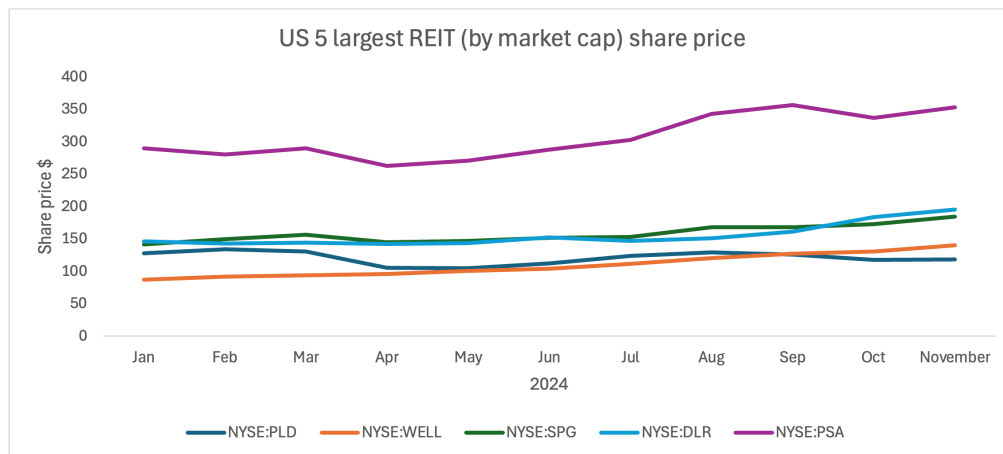
### Sensitivity to interest rates and economic growth

REITs are sensitive to changes in interest rates. On average, a 1% rise in rates leads to a 35% drop in total returns over six months. Mortgage REITs are even more affected, with returns falling 6-7% due to their reliance on debt financing. However, strong economic growth can offset this effect. For example, during the Fed's tightening cycle from 2015 to 2018, REITs still delivered positive returns of 13.7%, even as rates rose by 2.25%.

Also, economic growth plays a major role in supporting REIT performance. In 2014, despite a 1% interest rate hike, the U.S. economy grew by 2.5%, and equity REITs posted an 18.2% return. Retail real estate performed particularly well this shows that strong demand for properties helps REITs prosper even when borrowing costs rise.

Another important finding is that during the inflation surge of 2021-2022, rents in residential and industrial sectors grew by 5-10%, helping REITs offset higher financing costs. So, actually, rising rents supported income growth during inflationary times.

But REITs can also be volatile during sudden policy changes such as the 2013 “taper tantrum”. On that occasion the S&P 500 REIT Index dropped by 10% after the Fed’s announcement of reduced asset purchases. But then REITs gained a 15% again the following year.



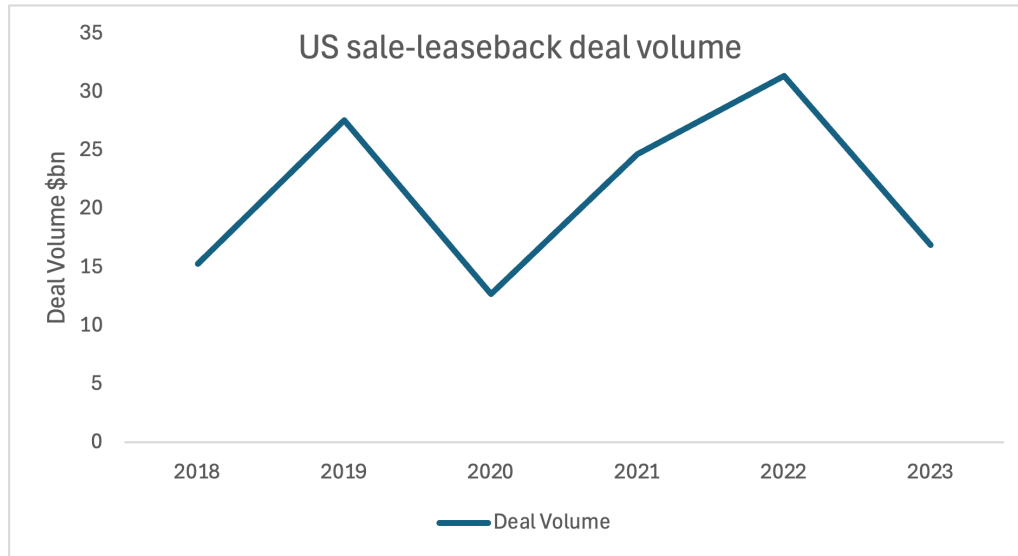
### The largest in the market

Looking at the five largest U.S. REITs by market capitalization -Prologis (PLD), Equinix (EQIX), Public Storage (PSA), Simon Property Group (SPG), and Digital Realty (DLR)- gives us further insight:

- *Prologis (PLD)*: Focused on industrial properties, Prologis averaged a 10.3% annual growth in share price over the last five years. It showed resilience during rate hikes, with minor losses followed by strong rebounds.
- *Equinix (EQIX)*: A data center REIT that gained 15% in 2023 despite a 1.5% rate hike, demonstrating how digital infrastructure demand supports its growth.
- *Public Storage (PSA)*: Known for self-storage, it grew by 12% in 2022, proving that stable rental income models can succeed even in high-rate environments.
- *Simon Property Group (SPG)*: While challenged by e-commerce trends, Simon recovered from an 8% drop in 2023 to gain 10% in 2024, showing the potential for retail REITs to bounce back.
- *Digital Realty (DLR)*: Focused on data centers, DLR posted 11% growth in 2023, benefiting from the steady rise in digital demand.

These examples specifically show that REITs in sectors with strong long-term growth drivers can handle in a better way rising rate, while in sectors like retail are characterized to short- term volatility.





### Sale-leasebacks

A popular strategy for REITs to increase the liquidity and secure long-term income. In 2023, sale-leaseback deals hit a record \$23.7 billion, up 15% from the previous year.

### Industrial and retail sectors

Industrial REITs saw a 25% increase in sale-leasebacks, driven by demand for warehouses, while retail REITs accounted for 20% of these deals as stores shifted their focus to online strategies.

REIT performance depends on a mix of factors: interest rates, economic growth, sector specific dynamics, and strategies like sale-leasebacks. While rising rates generally hurt short-term returns, REITs exposed to high-growth sectors like industrial and data centers tend to perform well over time. Still REITs remain a valuable addition to any diversified investment portfolio, as REITs in most cases continue delivering good performance in the long term. While they are undeniably sensitive to market conditions, particularly interest rate fluctuations, their resilience in sectors with strong growth drivers, demonstrates their ability to weather economic uncertainty. The ability of REITs to adapt through strategies like sale-leasebacks further enhances their long-term stability and growth potential.

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