

# A Compelling Opportunity in REITs



INSIGHTS | GLOBAL LISTED REAL ASSETS TEAM | August 2024

## Key Takeaways

- REITs have significantly underperformed the broader U.S. equity market over the past five years, primarily due to the effects of COVID-19 and rising interest rates
- As a result, REITs are inexpensive today, especially when compared to the broader equities market
- REITs also have historically performed well when interest rates stabilize and start to drop
- Given the Fed is expected to start cutting interest rates in 2H24, we believe now is an excellent time to consider an allocation to REITs

A retrospective of REIT returns tells an interesting story. In *Display 1*, a 20-year lookback shows U.S. REITs<sup>1</sup> have underperformed the broader U.S. equity market by about 2.4%. However, a closer look shows that over the first 15 years of this 20-year period (6/30/2004-6/30/2019), REITs outperformed the broader U.S. equity market by about 0.7%. But over the past 5 years the REIT story changes dramatically. In an economic environment impacted by the COVID-19 outbreak and Quantitative Tightening (QT) by the Fed, REITs have underperformed significantly, generating total returns of only 3.40% on an annual basis, compared to 15.05% for U.S. equities.

### DISPLAY 1

#### REITs Have Had a Rough Five Years, but Is There Opportunity Ahead?

REIT returns compared to the broader U.S. equity market over three time frames

	FTSE NAREIT ALL EQUITY REITS	S&P 500	S&P 500 EQUAL WEIGHTED
20-year through 6/30/2024 (6/30/2004-6/30/2024)	7.87%	10.29%	10.06%
15-year through 6/30/2019 (6/30/2004-6/30/2019)	9.41%	8.75%	9.77%
5-year through 6/30/2024 (6/30/2019-6/30/2024)	3.40%	15.05%	10.94%

Source: Morgan Stanley Investment Management, S&P, FTSE Nareit. Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

<sup>1</sup> REITs are represented by the FTSE Nareit All Equity REITs Index.

### AUTHOR



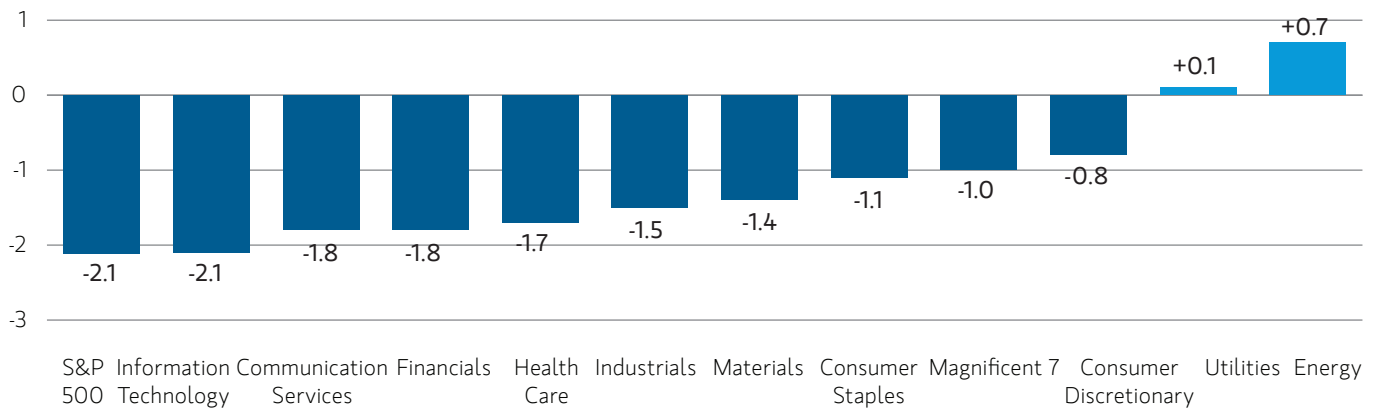
**LAUREL DURKAY, CFA**  
Head of Global  
Listed Real Assets

“We believe there will be a REITs breakout when Quantitative Tightening morphs into Quantitative Easing. The reason is that history tells us REIT total returns have a strong negative correlation to interest rates, a relationship that certainly persists today”

**DISPLAY 2**

**U.S. REIT Valuation Support Widespread vs. U.S. Equities**

10-Year Z-Score of multiple spread between U.S. REITs and U.S. Equities



Source: Bloomberg, UBS Global Real Estate Research. As of 6/30/2024.

Interestingly, this outperformance of broad U.S. equities versus REITs has resulted in a significant valuation discrepancy. Over the past 20 years, U.S. REITs have traded at a +0.5x premium to U.S. equities on a multiple basis, but today U.S. REITs are trading at a -4.3x multiple discount. Bringing this relationship back to par would imply between 30-40% of relative outperformance of REITs compared to equities.

The Magnificent 7<sup>2</sup> have propelled U.S. equities more recently and one might assume this vast valuation discount for REITs is primarily attributable to the market dominance of this group. However, further analysis negates this contention; the multiple discount is evident across almost all Global Industry Classification Standard (GICS) sectors within the broader U.S. equities market, with the exception of energy and utilities (*Display 2*). The bottom line? REITs are cheap versus the overall S&P 500, the vast majority of GICS sectors within the S&P 500 and the Magnificent 7 based on a 10-year z-score.<sup>3</sup>

The obvious question is whether REITs are in fact “broken” or is this a rare opportunity to deploy capital in a sector on the precipice of a compelling change. Spoiler alert: we think there will be significant opportunity based on compelling change. And what is that change, one might ask? Well, we believe there will be a REITs breakout when QT morphs into Quantitative Easing. The reason is that history tells us REIT total returns have a strong negative correlation to interest rates, a relationship that certainly persists today (*Display 3*).

Central banks across the globe have begun a rate cutting cycle, and the Fed is widely anticipated to follow suit, with two cuts anticipated in 2H24. In fact, the market implied policy rate one year from now stands at roughly 4%, appreciably lower than today’s target range of 5.25% - 5.50%.

Market returns after the first rate cut can vary widely depending upon sector. However, as seen in *Display 4*, the average performance of REITs stacks up well versus other sectors one year after the first rate cut.

Active management within the REIT space has historically produced what we believe are compelling returns for investors – and today is no different. Not all real estate is created equal, nor are all companies created equal. Since 2007, the annual spread between the best and worst performing U.S. REIT sub-sectors has ranged from 30% to 76%. On a YTD basis through 2Q24, REIT returns for the best and worst performing sub-sectors varied by over 35%. On the basis of individual stocks, the variation of return was upwards of 80%.

The bottom-up, fundamental research and investment process we adhere to at Morgan Stanley Investment Management allows us to identify those sectors and stocks that we believe have the ability to outperform – and capture excess returns through alpha generation, in addition to the beta of this recovery. We use internal proprietary research to invest in publicly traded real estate securities that we believe offer the best value relative

<sup>2</sup> Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, Tesla.

<sup>3</sup> Z-score is a statistical measure that quantifies the distance between a data point and the mean of a dataset. It’s expressed in terms of standard deviations.

to their underlying assets and earnings. Our investment approach is based on 3 core principles:

1. Relative value support
2. Downside risk mitigation through an integration of risk factors
3. High-conviction positioning with an identifiable investment thesis and positive trajectory on critical factors for the company

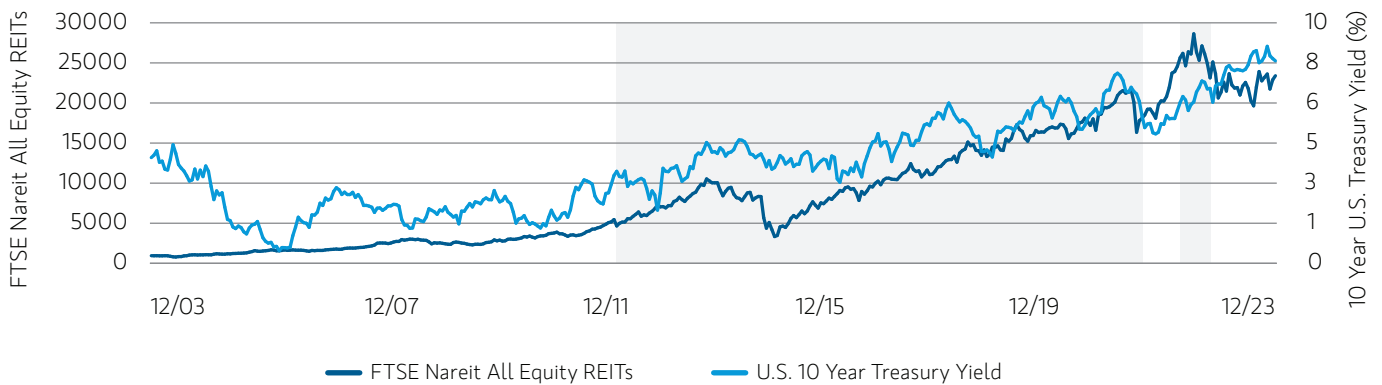
These principles, as well as an evaluation of trends unfolding within the real estate sector, facilitate our portfolio positioning.

In summary, REITs have significantly underperformed the broader U.S. equity market over the past five years, primarily due to the impact of COVID-19 and the rise in interest rates. As a result, REITs are trading at attractive valuations. Furthermore, REIT total returns historically have a strong negative correlation to interest rates and typically do particularly well in stabilizing and declining interest rate environments. Given that the Fed is expected to cut interest rates in 2H24, we believe today is a great time to consider an allocation to REITs.

**DISPLAY 3**

**History Suggests that as Interest Rates Drop, REIT Values Will Increase**

REITs vs. U.S. 10-year Treasury Yield

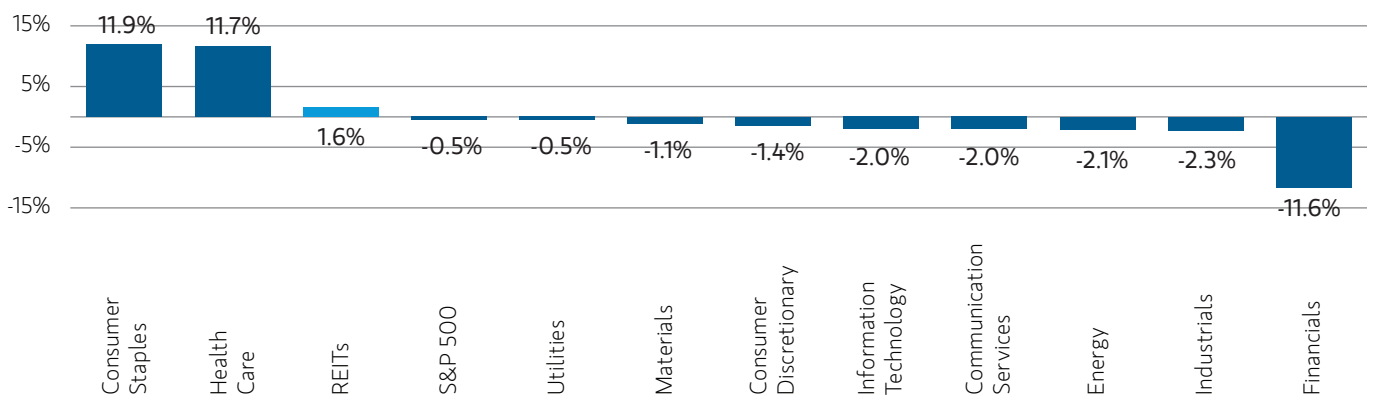


Source: Bloomberg, FTSE Nareit. Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

**DISPLAY 4**

**On Average, Real Estate Has Outperformed the S&P 500 and Most GICS Sectors After the First Rate Cut**

Average Total Returns One Year After the First Rate Cut - Since 1989\*



Source: Bloomberg, S&P, FTSE Nareit. Index performance is provided for each GICS sector within the S&P 500 Index, except the FTSE Nareit All Equity REITs Index is provided for REITs. Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** \*Since the beginning of 1989 there have been five first rate cuts: 6/5/1989, 7/6/1995, 1/3/2001, 9/18/2007, 7/31/2019. The above reflect the average of the one-year total returns after each of those cuts.

## RISK CONSIDERATIONS

The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in the Europe and global markets. The value of equity securities is sensitive to stock market volatility. **Real Estate Risk:** The risks associated with ownership of real estate and the real estate industry in general include fluctuations in the value of underlying property, defaults by borrowers or tenants, market saturation, decreases in market rents, interest rates, property taxes, increases in operating expenses and political or regulatory occurrences adversely affecting real estate. **Real estate investment trusts (REITs)** are subject to risks similar to those associated with the direct ownership of real estate, and they are sensitive to such factors as management skills and changes in tax laws. **Concentration Risk:** Concentration in a single region may make the portfolio more volatile than one that invests globally.

## INDEX DEFINITIONS

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **S&P 500® Equal Weight Index (EWI)** is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight of 0.2% of the index total at each quarterly rebalance.

The **FTSE Nareit All Equity REITs Index (FNER)** is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

## IMPORTANT INFORMATION AND DISCLOSURES

The views and opinions and/or analysis expressed are those of the author or the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively "the Firm"), and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors or the investment team. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific strategy or product the Firm offers. Future results may differ significantly depending on factors such as changes in securities or financial markets or general economic conditions.

This material has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and the Firm has not sought to independently verify information taken from public and third-party sources.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The Firm does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. It was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. Each Jurisdiction tax laws are complex and constantly changing. You should always consult your own legal or tax professional for information concerning your individual situation.

Charts and graphs provided herein are for illustrative purposes only. **Past performance is no guarantee of future results.**

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

This material is not a product of Morgan Stanley's Research Department and should not be regarded as a research material or a recommendation.

The Firm has not authorised financial intermediaries to use and to distribute this material, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this material is appropriate for any person to whom they provide this material in view of that person's circumstances and purpose. The Firm shall not be liable for, and accepts no liability for, the use or misuse of this material by any such financial intermediary.

This material may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this material in another language, the English version shall prevail.

The whole or any part of this material may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without the Firm's express written consent. This material may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

## DISTRIBUTION

**This material is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.**

**MSIM, the asset management division of Morgan Stanley (NYSE: MS), and its affiliates have arrangements in place to market each other's products and services. Each MSIM affiliate is regulated as appropriate in the jurisdiction it operates. MSIM's affiliates are: Eaton Vance Management (International) Limited, Eaton Vance Advisers International Ltd, Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC, and Atlanta Capital Management LLC.**

This material has been issued by any one or more of the following entities:

## EMEA

This material is for Professional Clients/Accredited Investors only.

In the EU, MSIM and Eaton Vance materials are issued by MSIM Fund Management (Ireland) Limited ("FMIL"). FMIL is regulated by the Central Bank of Ireland and is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at 24-26 City Quay, Dublin 2, DO2 NY19, Ireland.

Outside the EU, MSIM materials are issued by Morgan Stanley Investment Management Limited (MSIM Ltd) is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

In Switzerland, MSIM materials are issued by Morgan Stanley & Co. International plc, London (Zurich Branch) Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland.

Outside the US and EU, Eaton Vance materials are issued by Eaton Vance Management (International) Limited ("EVM") 125 Old Broad Street, London, EC2N 1AR, UK, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

**Italy:** MSIM FMIL (Milan Branch), (Sede Secondaria di Milano) Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy. **The Netherlands:** MSIM FMIL (Amsterdam Branch), Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. **France:** MSIM FMIL (Paris Branch), 61 rue de Monceau 75008 Paris, France. **Spain:** MSIM FMIL (Madrid Branch), Calle Serrano 55, 28006, Madrid, Spain. **Germany:** MSIM FMIL Frankfurt Branch, Große Gallusstraße 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Denmark:** MSIM FMIL (Copenhagen Branch), Gorrissen Federspiel, Axel Towers, Axeltorv2, 1609 Copenhagen V, Denmark.

## MIDDLE EAST

**Dubai:** MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

This document is distributed in the Dubai International Financial Centre by Morgan Stanley Investment Management Limited (Representative Office), an entity regulated by the Dubai Financial Services Authority ("DFSA"). It is intended for use by professional clients and market counterparties only. This document is not intended for distribution to retail clients, and retail clients should not act upon the information contained in this document.

This document relates to a financial product that is not subject to any form of regulation or approval by the DFSA. The DFSA has no responsibility for reviewing or verifying any documents in connection with this financial product. Accordingly, the DFSA has not approved this document or any other associated documents nor taken any steps to verify the information set out in this document, and has no responsibility for it. The financial product to which this document relates may be illiquid and/or subject to restrictions on its resale or transfer. Prospective purchasers should conduct their own due diligence on the financial product. If you do not understand the contents of this document, you should consult an authorized financial advisor.

## U.S.

**NOT FDIC INSURED | NOT BANK GUARANTEED | MAY LOSE VALUE  
| NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT  
A BANK DEPOSIT**

**Latin America (Brazil, Chile Colombia, Mexico, Peru, and Uruguay)**

This material is for use with an institutional investor or a qualified investor only. All information contained herein is confidential and is for the exclusive use and review of the intended addressee, and may not be passed on to any third party. This material is provided for informational purposes only and does not constitute a public offering, solicitation or recommendation to buy or sell for any product, service, security and/or strategy. A decision to invest should only be made after reading the strategy documentation and conducting in-depth and independent due diligence.

## ASIA PACIFIC

**Hong Kong:** This material is disseminated by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this material have not been reviewed nor approved by any regulatory authority, including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this material shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This material is disseminated by Morgan Stanley Investment Management Company and should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section

304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This material is provided by Morgan Stanley Investment Management (Australia) Pty Ltd ABN 22122040037, AFSL No. 314182 and its affiliates and does not constitute an offer of interests. Morgan Stanley Investment Management (Australia) Pty Limited arranges for MSIM affiliates to provide financial services to Australian wholesale clients. Interests will only be offered in circumstances under which no disclosure is required under the Corporations Act 2001 (Cth) (the "Corporations Act"). Any offer of interests will not purport to be an offer of interests in circumstances under which disclosure is required under the Corporations Act and will only be made to persons who qualify as a "wholesale client" (as defined in the Corporations Act). This material will not be lodged with the Australian Securities and Investments Commission.

## Japan

For professional investors, this material is circulated or distributed for informational purposes only. For those who are not professional investors, this material is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This material is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.