Principal Real Estate

Principal Asset Management℠

Listed REITs versus equities: Time to buy?

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In 2023, the combination of peaking real yields, slowing economic growth, and attractive relative valuations makes a compelling case for an allocation to listed REITs versus equities.

We believe the cycle of U.S. Federal Reserve (Fed) tightening and more importantly, rising long-term real yields, has entered the late stages. As a result, the playbook of REITs outperforming when interest rate headwinds fade is starting to repeat itself.

The reason why is that REITs typically behave as higher duration equity given their visible and durable income streams generated from medium to long-term lease periods. This cash flow profile is advantageous when the economy slows and contributes to the overall sensitivity REITs possess with long-term real yields. In our view, this will be supportive for REITs relative to other equities as real yields peak (see Exhibit 1) or possibly decline (Exhibit 2) over this year.

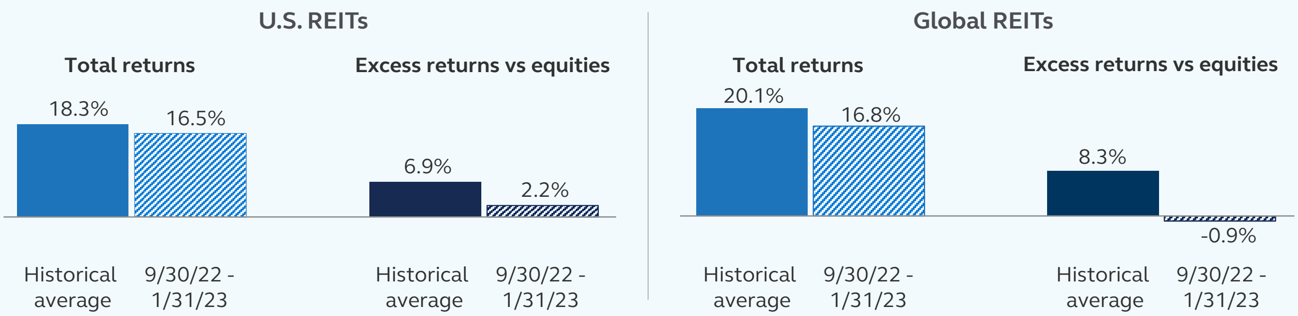
Three reasons to consider buying listed REITs:

1. **Interest rate headwinds are fading and REITs have outperformed** after real yields peak or fall.

2. **Growth is slowing and REITs have outperformed** in the slowdown phase of the business cycle.

3. **REIT valuations are attractive relative to equities** after the big sell-off in 2022.

EXHIBIT 1: Average 12 month returns after a peak in real yields



As of 31 January 2023. Source: FactSet. Returns data is showing FTSE NAREIT Equity REITs Index (U.S. REITs) and FTSE EPRA/NAREIT Developed Index (global REITs) average annualized total and excess returns over the S&P 500 Index (U.S. equities) and MSCI World Index (global equities), respectively, after the last 7 periods of rising real yields have peaked (an increase of at least 75 bps represented by the US 10-year TIPS). The latest period after real yields peaked on 30 September 2022 is broken out separately and is less than a 12 month period. Analysis goes back to January 1997, the inception of U.S. TIPs bond market. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index. See important information for index descriptions.

EXHIBIT 2: Returns from listed REITs during periods of falling real yields

Time period		Annualized total return		Excess return vs. equities	
Peak in real yield	**Trough in real yield**	**U.S. REITs**	**Global REITs**	**U.S. REITs**	**Global REITs**
31-Dec-1999	31-Oct-2001	17%	1%	32%	20%
31-Dec-2001	28-Feb-2003	2%	1%	26%	23%
31-Jul-2003	31-Mar-2004	28%	37%	13%	16%
30-Jun-2007	29-Feb-2008	-14%	-13%	-4%	-5%
31-Oct-2008	31-Mar-2009	-39%	-27%	-22%	-12%
31-Mar-2010	31-Oct-2010	13%	14%	11%	10%
31-Jan-2011	30-Nov-2012	11%	8%	3%	5%
31-Dec-2015	31-Jul-2016	18%	15%	10%	10%
31-Oct-2018	29-Feb-2020	10%	9%	1%	2%
31-Mar-2020	31-Aug-2020	17%	16%	-19%	-17%
	Average (all time periods)	**6%**	**6%**	**5%**	**5%**
	Average excluding major real estate shocks of 2007-2009, 2020:	**14%**	**12%**	**14%**	**12%**

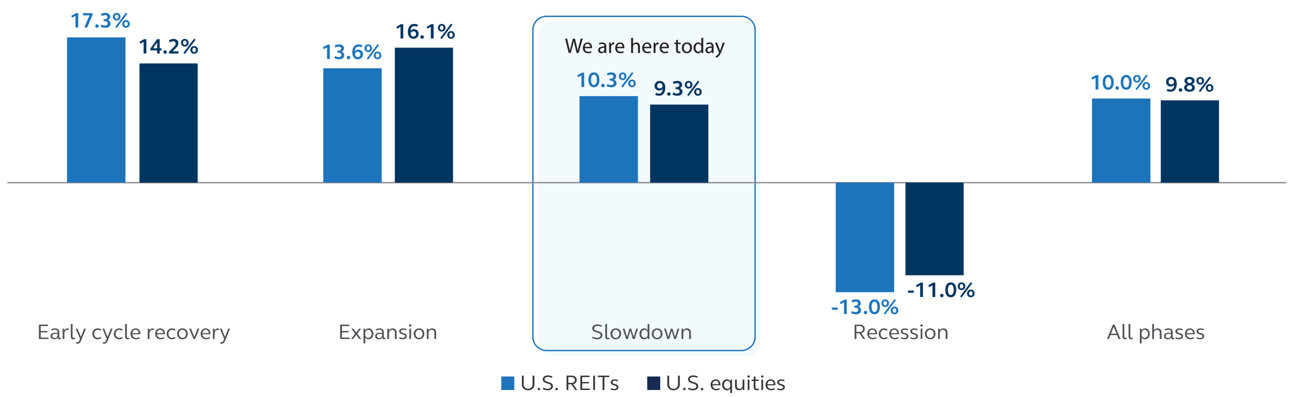
As of 31 January 2023. Source: FactSet. Returns data is showing FTSE NAREIT Equity REITs Index (U.S. REITs) and FTSE EPRA/NAREIT Developed Index (global REITs) average annualized total and excess returns over the S&P 500 Index (U.S. equities) and MSCI World Index (global equities), respectively, after periods of falling real yields (a decrease of at least 75 bps represented by the US 10-year TIPS). Analysis goes back to January 1997, the inception of U.S. TIPs bond market. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index. See important information for index descriptions.

REITs have outperformed in the slowdown phase of the business cycle

Restrictive monetary policy has created a slowdown in growth. The long duration and staggered nature of property leases over multiple years may help insulate REIT earnings against a weakening economy. This allows embedded rent growth late into a business cycle as the leases coming due can still be renewed at premiums to the last signed rents from years prior. The defensive and durable income streams of REITs can look appealing during this part of the cycle and REITs have historically outperformed the S&P 500 during this phase.

EXHIBIT 3: Total returns during different phases of the business cycle

Average annualized returns since 1990



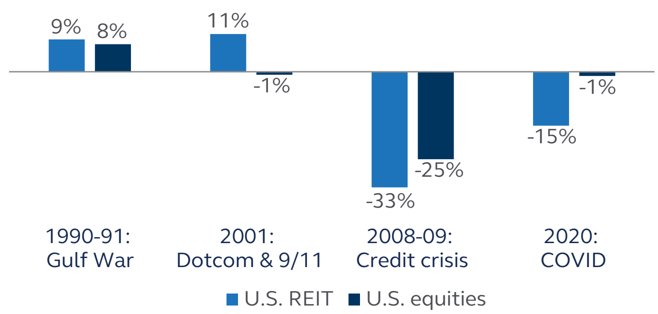
As of 31 January 2023. Source: The Conference Board Leading Economic Index (LEI), National Bureau of Economic Research (NBER), FactSet. LEI and NBER were utilized to identify business cycle phases since 1990. Returns data is showing average annualized returns that occurred from the FTSE NAREIT Equity REITs Index (U.S. REITs) and S&P 500 Index (U.S. equities) indices during each phase. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index. See important information for index descriptions.

Currently, it is our base expectation that the economy is continuing a path towards a moderate recession in 2023. Going into this potential recession, it is our view REITs may perform well relative to equities because of healthy balance sheets, resilient demand in sectors that benefit from less economically sensitive structural demand drivers, and generally low supply conditions.

It's important to take note every recession is different and so too was the corresponding performance of REITs. The last two recessions had an outsized negative impact on REITs: the credit crisis in 2008-09 really hurt a capital heavy sector like real estate and in 2020, COVID social distancing efforts restricted the use of many forms of real estate. However, in the other two U.S. recessions since 1990, REITs performed well and outperformed the S&P 500.

EXHIBIT 4: No two recessions are the same

Average annualized returns



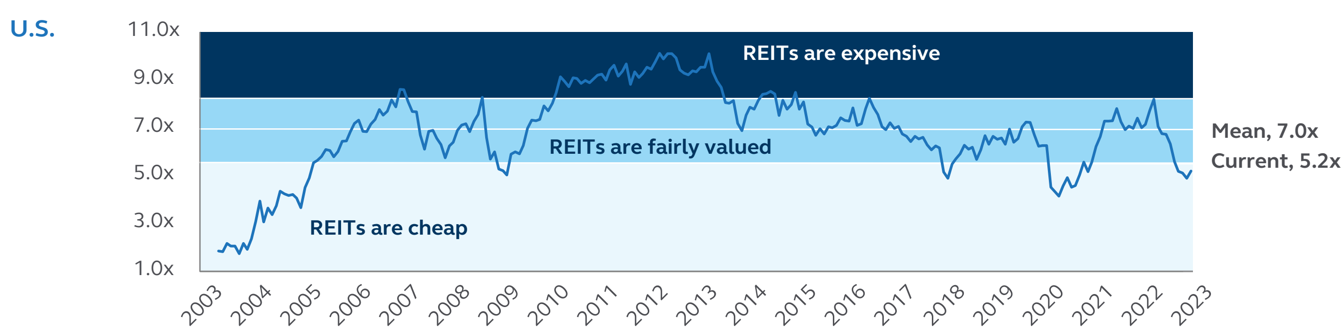
As of 31 January 2023. Source: National Bureau of Economic Research (NBER), FactSet. NBER was utilized to identify past recessions since 1990. Returns data is showing average annualized returns realized during these recession periods from the FTSE NAREIT Equity REITs Index (U.S. REITs) and S&P 500 Index (U.S. equities) indices. Past performance does not guarantee future results. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index. See important information for index descriptions.

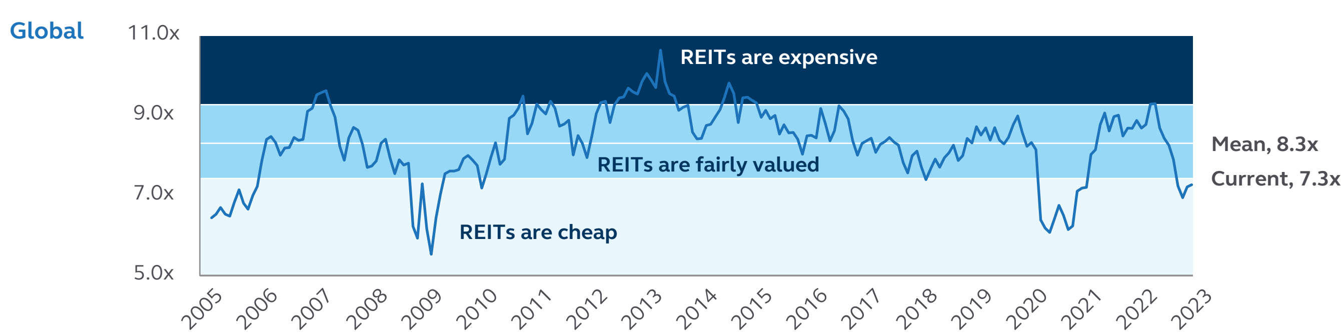
Listed REITs are trading at a bargain compared to general equities

In 2022, public REIT share prices repriced lower for higher yields and tighter financial conditions. Given the underperformance for the past year, REITs are looking historically cheap relative to equities, with price multiple spreads over one standard deviation away from the mean (in other words, historically REITs have been this cheap relative to equities only 16% of the time). Combined with fading rate headwinds and steady cash flows in a slowing environment, we believe the time is now to overweight REITs relative to equities.

EXHIBIT 5: REITs are in "cheap" territory relative to equities

Difference (spread) in EV/EBITDA multiples: REITs minus equities





As of 31 January 2023. Source: FactSet. Enterprise Value (EV) to EBITDA price multiples are used to measure valuations. The spread plotted is the EV/EBITDA of the MSCI US REIT index minus the EV/EBITDA of the S&P 500 Index (chart 1) and the FTSE EPRA/NAREIT Developed Index minus the EV/EBITDA of the MSCI World index (chart 2). Expensive and cheap valuations are represented by spreads higher or lower than one standard deviation from the mean, respectively. Fair value is represented by valuations between one standard deviation from the mean. See important information for index descriptions.

Risk Considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Potential investors should be aware of the many risks inherent to investing in real estate, including: value fluctuations, default risk, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. REIT securities are subject to risk factors associated with the real estate industry and tax factors of REIT registration.

International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards.

Important information

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Index descriptions: FTSE NAREIT Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. FTSE EPRA/NAREIT Developed Index is a free-float adjusted, market capitalization-weighted index designed to track the performance of listed real estate companies in both developed and emerging countries worldwide. S&P 500 Index tracks 500 publicly traded domestic companies. MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across all 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country.

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