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Principal Real Estate

Principal Asset Management℠

THE CASE FOR ACTIVE REITS

Capitalizing on an inefficient market

> “When it comes to choosing **active** versus **passive** management in REITs, the proof of “why active” is in the results.”

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The debate between active management supporters and those who champion a passive investing style has become more animated since the global financial crisis. Passive investing is the consensus trade in several areas of the equity markets, and strategies investing in listed real estate investment trusts (REITs) are not immune from the trend. Undoubtedly, a passive investment approach—one that mirrors a market-capitalization-weighted index, for example—can provide low-cost market beta, but sacrifices the potential for alpha or a portfolio that actively manages risk. We think investors are overlooking the fact that many REIT strategy managers have consistently generated alpha over the short- and long-term. We believe that investing in public REITs is ideally suited for active management. Sector specialists, such as dedicated active REIT managers, often have the necessary knowledge and REIT-centric investment approach to potentially exploit the market's inefficiencies. But much like picking a winning stock, due diligence by investors to find winning REIT managers is crucial. We believe an experienced and stable team, large breadth and depth of real estate resources, and a diversified approach to alpha generation is a successful combination for prolonged alpha generation in the market.

Why choose **active management** for your REIT allocation

A quick study of Exhibit 1 shows that more than half of the active U.S. and global REIT strategies have outperformed their benchmarks over the past five, 10, and 15 years on a net of fee basis. While passive funds have continued to take share in recent years,[1] it hasn't been the consequence of REIT managers yielding poor results. Relative to U.S. and global equities, the preponderance of REIT strategies outperforming has been higher even for the median actively-managed U.S. and global REIT strategies as shown in Exhibit 2.

When it comes to choosing active versus passive management in REITs, the proof of "why active" is in the results. We believe the surge in popularity of passive funds is a misguided attempt to lower costs in an effort to improve outcomes in client portfolios instead of focusing on enhancing returns. It's our belief that you get what you pay for; the value of hiring an active manager for REITs is arguably one of the best choices an investor can make.

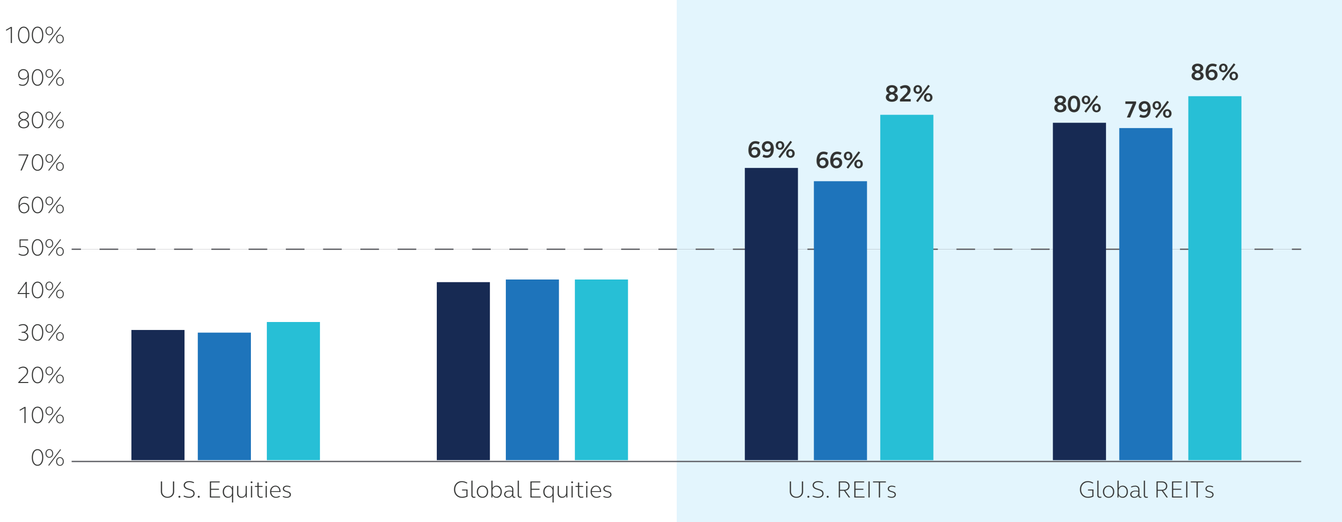
[1] Source: Green Street Advisors, LLC, Flowtracker November 29, 2022.

Over the last nine years, actively managed REIT funds/accounts have seen their market share erode from 49% to approximately 22%, though recently this has stabilized due to improved performance. Somewhat surprisingly, the preponderance of this share has been picked up by generalist passive vehicles (e.g., S&P index funds), as opposed to REIT index funds/ETFs.

EXHIBIT 1: Where active matters most

% of active managers outperforming their benchmark, net of fees

5 Year | 10 Year | 15 Year



Compared to their U.S. and global equity counterparts, active U.S. and global REIT managers have demonstrated consistent alpha generation over a five, 10, and 15-year time frame, with over half the managers outperforming their benchmarks.

Source: eVestment as of 06/30/2023. Percent of active managers that outperform benchmark was calculated as the number of actively managed composite strategies that had positive excess returns (net of ADV fees) when compared to their preferred benchmark divided by the total number of actively managed composite strategies in the category. For more details please see disclosures on page 6.

EXHIBIT 2: Achieve potential alpha with an active REIT Manager

% excess returns using median strategy

Global REITs | U.S. REITs | Global Equities | U.S. Equities

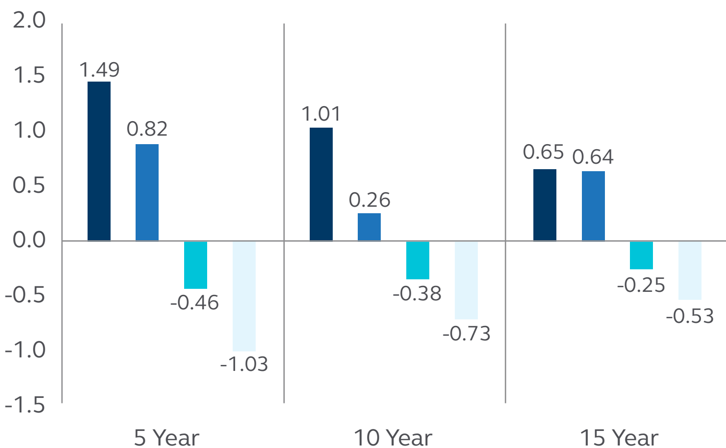


Exhibit 2 illustrates that even the median actively-managed U.S. and global REIT strategies have delivered much stronger excess returns than their U.S. and global equity counterparts over five,10, and 15 year time periods. We believe choosing the right active manager, that has demonstrated the skills necessary to exploit mispricing opportunities in the public REIT markets, provides an opportunity for even further outperformance.

Median strategy refers to the manager at the median and 50th percentile.

Source: eVestment as of 06/30/2023. Excess return (net of ADV fees) when compared to manager preferred benchmark. For more detail please see disclosures on page 6.

Inefficient markets create **opportunities**

Beating the market requires mispriced investment opportunities and manager skill. Market mispricings require inefficiencies in market behavior. Outperforming the market is difficult, of course, as we believe that equity markets and public REIT markets are inherently efficient to a certain degree. Broadly, the costs and barriers to information have decreased, thanks to a maturing investment industry and technological advances. However, the modern public REIT market is relatively young (it started in the mid-90s) and the nuances of investing in REITs are not well understood by all market participants. We believe there are several informational inefficiencies that create opportunities for skilled active REIT managers to exploit. Some of these inefficiencies aren't unique to REITs, but can create ample opportunities when combined with the unique factors impacting REITs.

The thirst for yield

Historically, many investors buy REITs for income. REITs must distribute the majority of their taxable income to shareholders. As such, they often provide higher dividend yields than other equity sectors. However, a specialized active REIT manager often invests to produce attractive, favorable total returns with the largest contribution sourced from capital appreciation, not income. Avoiding richly priced REITs, for which investors are overpaying for yield or overestimating the durability of that yield, can be a winning strategy for active REIT managers, under certain market conditions. Our research reveals that the total return of lower-yielding stocks has outperformed higher-yielding stocks on a more frequent basis, as they tend to generate higher capital appreciation.[2]

Accounting distortion

Depreciation is a factor with an outsized impact that is unique to real estate—and other asset-heavy businesses—that can distort certain financial ratios and metrics in a unique way compared to companies in most other industries. The U.S. GAAP accounting rules require property owners to record depreciation (a non-cash expense). If assets are in real estate, a high level of depreciation expense is shown on the income statement and assets recorded on the balance sheet are recorded at a "depreciated" book value, not market value. This can misrepresent or heavily skew valuation and earnings metrics, like price-to-book value, for example, since book value is "depreciated down" when market value actually may have increased. Similarly, price-to-funds from operations (P/FFO), which adds back non-cash depreciation expense to earnings, is the REIT equivalent of an ordinary stock's P/E ratio.

Without adjusting for real estate's unique accounting treatment, an investor is likely to reach the wrong conclusion about a stock's value. Investors' quantitative screens that seek to use consistent metrics across all equities can easily fail for REITs. We believe it is essential to focus on metrics unique to real estate that consider these accounting distortions. The REIT investing lexicon is full of terminology unique to REITs (FFO, NAV, implied cap rate, etc.) that is well-understood by active REIT managers, but may be overlooked by general equity investors.

Other key reasons why active management should be favored for REITs

- Active managers can invest beyond the index to seek alpha from a broader investment universe.
- Passive index funds are typically comprised of the largest companies in an asset class—not necessarily the ones positioned for growth in shareholder value. Active managers will buy more of companies they believe offer the most promising returns in the future, not always chasing past winners. Passive market-cap based funds will indiscriminately buy more of stocks whose market caps have grown the most.
- The size, complexity, and local nature of the asset class demands a high level of expertise to navigate.
- Active managers can potentially construct portfolios with better risk-adjusted outcomes—taking into consideration risk management, style tilts, and long-term structural changes impacting real estate.

[2] Source: As of 12/31/22. Principal Real Estate, MSCI, FactSet. Our analysis divided MSCI U.S. REIT Index constituents into quintiles (equal number of securities) based on dividend yield and measured the six month returns of each quintile on a quarterly frequency. Since 06/30/03, the lower yielding stocks (quintile 4 and 5) outperformed higher yield stocks (quintile 1 and 2) 78% of the time (61 out of 78 periods).

Underestimating capital needs

REIT stock mispricings can also originate from underestimating a property's capital expenditures (capex) —that is, the investment needed to ensure the property remains competitive or is maintained properly. Capital might be needed to improve a hotel lobby, add amenities to a high-end residential tower, or invest in the best IT infrastructure for an office building. Estimating the future capex needs of a property is not easy and is often underestimated by many real estate investors. Capex is a burden on company cash flows; consequently, REIT buildings with more modest capex needs typically generate higher returns. Research by Green Street Advisors, LLC. has demonstrated that the lowest capex REIT sectors have consistently outperformed over rolling five-year periods, while the highest capex sectors have nearly always trailed (see exhibits 3 & 4).

Essentially, low capex stocks tend to be undervalued because investors underestimate the cash flow growth of the properties and, therefore, the potential shareholder value increase. If markets were priced more efficiently, a company with a lower capex burden would be priced higher and the persistent return differentials noted in the charts wouldn't exist. On the other hand, high capex sectors, like hotels, frequently tend to be overvalued and disappoint in terms of their total returns.

A glaring inefficiency

There is one key differentiator of sector returns that has long been underappreciated by many market participants, and, as a result, appears to have been the source of consistent and predictable mispricing. Though we have been banging the "capex is important" drum for over two decades, property-market participants continue to understate the long-term magnitude of the expense… The phenomenon has translated into large and persistent return differentials across REIT sectors.

Yes, the broad market may indeed be too efficient for most active managers to add much value, but there is good reason to believe that the REIT sector is an exception.

Source: Heard on the Beach, "The Most Important Thing," June 10, 2019, Green Street Advisors, LLC.

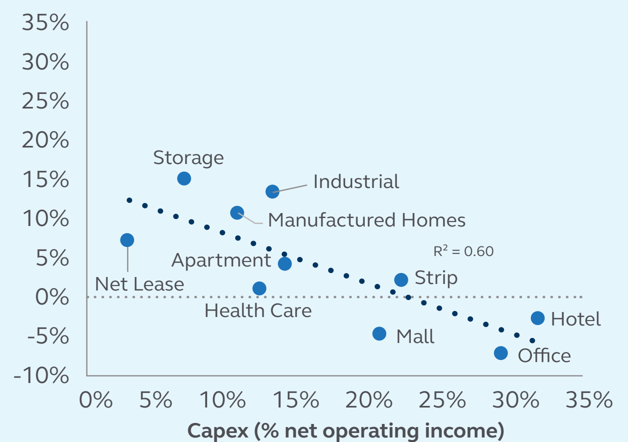
These capex differentials can exist in a large way when comparing sectors but also amongst REITs within a sector. When choosing a stock, it is necessary to adjust capex appropriately when performing valuations in order to ascertain the intrinsic value of a particular REIT. This adjustment of capex can be quite complex and requires a deep understanding of real estate markets, the specific subsectors of the industry, and qualitative attributes of the real estate portfolio.

EXHIBIT 3:

Annualized outperformance vs. REIT Index: 5 year rolling

EXHIBIT 4:

Capex and 5 year public market total return



Real estate investors have long understated the high costs of keeping commercial properties competitive. High capex real estate properties, like hotels and office properties, have been overpriced relative to those with small capital requirements such as storage and net lease properties.

Source: Green Street Advisors, LLC, 12/31/22. Reproduced with permission. Utilizes FTSE NAREIT All REIT index and property sector indexes available to facilitate more narrowly focused exposure to commercial real estate. Does not reflect the performance of any investment product.

Adjusting for capex: Imagine analyzing a company that owns a beautiful mid-century modern 80-story office building in New York City. Over the years, the wear and tear has required constant maintenance and upgrades to the building's façade, HVAC system, elevators, and interior finishes. While it's beautiful, the 60-year-old building now has to compete for tenants with a new office building next door that features all the latest in technology, open-architecture design style, efficiency, and green space. As active managers, we believe there's a way to add value in this example by digging deep to analyze the company financials and its specific properties. The key is to accurately adjust for those capex needs.

The nuances of REIT property sectors

On the surface many REIT companies may look alike, but they can behave quite differently. Each property sector has its own profile and responds distinctly to different economic and market factors. Lease duration, demand drivers, construction cycles, and submarket locations (urban vs. suburban) really matter. The following are some of the examples that illustrate how a dedicated REIT manager can actively adjust portfolio holdings to account for unique circumstances.

Economic factors

Specific economic measures can have varying effects on different types of real estate sectors. For example, exports and changes in e-commerce relate more to industrial properties than they do residential or healthcare-related properties. Job growth, on the other hand, has a greater impact on office and apartment real estate sectors. Hotel properties would likely be more affected by an economic downturn than a self-storage building, while shopping center and mall REITs are driven more by discretionary consumer spending.

Construction factors

The construction cycles for various types of real estate also differ. Building a warehouse or a self-storage facility is dramatically different than building a high-profile hotel in a large metropolitan market. The former can be completed within six months, while the latter may take two years or longer to complete.

Lease factors

How real estate properties are leased varies from sector to sector. Renting a hotel room for one or two days, for example, is the equivalent of a very short-term lease. In contrast, a lease for retail space in a shopping center might range from five to seven years. Other types of property command even longer leases. As a general rule, real estate is, on average, considered a long duration asset, but the duration of those fixed cash flows from leases can vary considerably from one sector to another.

Exploiting inefficient markets

Capitalizing on these inefficiencies, of course, is what generates alpha. An investor must have the skill and information necessary to position the portfolio accordingly before opportunities disappear. A dedicated, active REIT manager is a sector specialist. The manager has a narrow, but very deep focus on real estate markets and the public real estate stocks they invest in. Such a manager should have the resources to dig deeper, beyond what's readily available, to scrutinize REIT companies both large and small. Dedicated REIT specialists should also be well-equipped to make appropriate adjustments to valuation metrics that are unique to the asset class, taking into account factors like depreciation and capital expenditures. These adjustments require expertise to derive intrinsic values that may differ from consensus views and market values.

Exploiting information inefficiencies can be enhanced further with access to private real estate expertise and first-hand insights of real estate market conditions. Successful REIT managers can identify and capitalize on small inefficiencies that arise on a frequent basis when the market overreacts to good or bad news about a stock, sector, or at the market level.

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Risk Warnings

Past performance is no guarantee of future results and should not be relied upon to make an investment decision. Investing involves risk, including possible loss of principal. Potential investors should be aware of the risks inherent to owning and investing in real estate, including: value fluctuations, capital market pricing volatility, 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.

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For exhibits 1 and 2: The peer groups included the actively managed strategies within eVestment's U.S. Large Cap Equity, Global Core Equity, U.S. REIT, and Global REIT categories. Excess return was calculated as the strategy's net return less their preferred benchmark's return. If there was no manager preferred benchmark provided – U.S. Large Cap was defaulted to the S&P 500; Global REIT was defaulted to the FTSE EPRA/NAREIT Developed Net; U.S. REIT was defaulted to MSCI U.S. REIT; Global Equity was defaulted to MSCI ACWI Net. Individual strategies' portfolio construction, philosophy, processes and other characteristics are available upon request.

eVestment is the source of information for the above noted exhibits. eVestmentAlliance, LLC and its affiliated entities (collectively, "eVestment") collect information directly from investment management firms and other sources believed to be reliable, however, eVestment does not guarantee or warrant the accuracy, timeliness, or completeness of the information provided and is not responsible for any errors or omissions. Peer group comparisons are based upon available data provided by third parties and are for informational purposes only and should not be used as the sole basis for an investment decision. Past performance is not a reliable indicator of future performance. Third party rankings are no guarantee of future investment success and do not ensure that a client or prospective client will experience a higher level of performance or results. The comparisons provided above have been prepared as a guide and they are not intended to be exhaustive. Comparisons are based on the available information and Principal Global Investors disclaims any and all express or implied warranties of reliability or accuracy arising out of any for error or omission attributable to any third-party representation, example, or data provided herein.

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