Is now the right time to invest in REITs despite major headwinds?

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Many clients are unlikely to shed their REITs because the asset class is foundational to most portfolios, says an advisor.

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Real estate has been making headlines lately for all the wrong reasons. Amid inflation and rising interest rates, virtually all types have fallen in value.

In turn, many client portfolios with exposure to real estate investment trusts (REITs) have seen the generally steady, income-producing asset class drop in value since the start of the year.

Illustrating this descent is the S&P Global REIT index down more than 20 per cent, year-to-date (YTD), while Canada's publicly traded REITs have fared much the same, with the S&P/TSX Capped REIT index down 20 per cent.

"It's a very challenging environment so far this year," says Terri Szego, senior portfolio manager and senior investment advisor at Szego Jones Szego Lawrence Wealth Management at BMO Nesbitt Burns Inc. in Toronto, whose client portfolios typically have about five to 10 per cent allocated to REITs.

She notes three headwinds. Capitalization rates, also known as cap rates, have risen as the values of many holdings within REIT portfolios have been downgraded.

"The second issue is REITs have a lot of debt on the books; they borrow money to buy real estate, so they have to refinance debt at higher rates," she adds. "Then, inflation is increasing their operating costs."

Of course, many clients are unlikely to shed their REITs because the asset class is foundational to most portfolios, says Darren Coleman, senior vice president, private client group, and portfolio manager with Coleman Wealth at Raymond James Ltd. in Toronto.

"We pretty much always maintain exposure to that sector," he says, adding it provides diversification from stocks and bonds. "There has been a lot of talk in the past few years about adding alternatives to the portfolio."

And real estate – along with infrastructure – are accessible alternative classes for most investors, often providing slightly different return profiles than most equities and bonds.

"Plus, there's so much variation within real estate that people can really tune into types that match their risk profile and their outlook on conditions," he says.

How parts of the sector have performed

Indeed, REITs come in a wide variety from multi-family and office to industrial, even broken into subsectors covering data centres, health care facilities and cell phone towers.

However, since the pandemic hit, some areas have done better than others, Mr. Coleman says.

For example, industrial has been in high demand, driven by the growth of e-commerce that peaked during COVID-19 lockdowns. The S&P 500 Industrial REITs Sub-Industry Index was up 106 per cent at the start of 2022 from early summer 2019.

In contrast, office properties have suffered as workers stayed home. They continue to struggle as many companies have moved to hybrid work models, slowing demand for office space, Mr. Coleman says.

At the start of the year, the S&P 500 Office REITs Sub-Industry Index had almost recovered to its pre-pandemic 2020 high, but the index is now down about 31 per cent YTD.

Yet, many who follow REITs closely are seeing light at the end of the long tunnel of interest rate hikes.

"Sometimes, market sentiment swings to extremes more than it should," says Michel Massaad, founder of REIT Report in Montreal, which aggregates online news focused on the Canadian market.

Recent challenges aside, Canada's market has many upsides with strong immigration amid a housing shortage, which should bode well for multi-family real estate, he says.

"There will be a lot of bargains later this year as the interest rate and inflation picture becomes clearer," he says.

The case for investment

A portfolio manager for a multi-billion-dollar global REIT mutual fund has a similar view.

Corrado Russo, managing partner and head of global securities at Hazelview Investments in Toronto, contends most current anxieties about real estate have already been priced into the market. He further notes that, historically, and contrary to popular perception, real estate fares well during most periods of rising interest rates even outperforming broader equities.

Mr. Corrado cites one such instance that spanned from 2004 to 2006, in which the U.S. Federal Reserve Board increased interest rates 17 times, or 425 basis points in total.

"Over those 27 months, REITs were up 30.8 per cent and equities were up 8.5 per cent," he says.

One advantage of REITs is their steady distributions. Although bond-like given that their income streams become less attractive as interest rates rise, REITs differ because "their income can grow and often does so faster than inflation," he adds.

In fact, most leases for tenants in the underlying properties are long term and have built-in inflation protection. Those that do not generally are shorter leases that can then be renewed at higher rates once expired, Mr. Corrado says.

Another consideration is that bad news – like the recent interest rate hikes and future ones – is already priced into most REITs, and the worst may be over. In a recent Reuters poll, most economists predicted the Fed's overnight rate will reach 3.5 per cent by the end of the year.

"So, the market then extrapolates that impact on property prices, or the cap rate, for example," says Mr. Corrado, who runs Hazelview's Global Real Estate Fund, which invests in publicly-traded REITs mostly outside of Canada.

Given the current conditions, a buying opportunity may be at hand for those with a long-term horizon and an ability to withstand short-term volatility.

"If there are a lot more rate hikes to come than expected and we go into recession, yes, that changes that premise," he says, noting most asset classes – not only real estate – would be affected negatively.

Yet, even if a recession emerges, central bankers are likely to lower interest rates.

"Then, you get into a situation where bad news for the economy is actually good news" for REITs, boosting the attractiveness of their income streams, Mr. Corrado says.

"While I can't say things won't get worse [for REITs], I am confident that when you look back in three to five years from now, you will be happy with your entry price today," he says.

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