

Understanding the benefits of REITs in the US market

The FTSE NAREIT US Real Estate Index Series

Real Estate Investment Trusts (REITs) have enabled investors of all types to gain access to a regular income stream, a diversified portfolio of underlying properties and a link to the capital values of the portfolio holdings by means of companies with securities listed on a public stock exchange.

The FTSE NAREIT US Real Estate Index Series is designed to represent the performance of qualifying REITs listed on the New York Stock Exchange (NYSE) or NASDAQ.

FTSE launched the index series in 2006 in partnership with the National Association of Real Estate Investment Trusts (NAREIT®). NAREIT is the US-based association for REITs and publicly traded real estate companies.

What are REITs?

A REIT is a company that owns or finances income-producing real estate. Unlike real estate companies that focus on developing properties in order to resell them, REITs buy and develop properties primarily with a view to holding them within their own investment portfolios. REITs thereby aim to provide investors with a regular income stream, a diversified portfolio of underlying properties and a link to the capital values of the portfolio holdings. A REIT's shareholders thus earn a share of the income produced through real estate investment, without actually having to go out and buy or finance property.

The US REIT market dates from 1960, when Congress passed the REIT Act to make real estate investment available to all investors and to encourage the development of a broader investor base for commercial properties.

Under US law, to qualify as a REIT a company has to invest at least 75 percent of its total assets in real estate and derive at least 75 percent of its gross income from rents from real property, interest from mortgages secured by real property or from sales of real estate. US law also requires REITs to distribute each

year at least 90 percent of their taxable income to shareholders, who then pay income tax on the dividends they receive. REITs are allowed to deduct dividend payments from their taxable income.

REIT or “REIT-like” legislation now exists in 36 countries around the world, covering the majority of the major developed investment markets.¹ In the US market, REITs fall into three principal categories:

- Stock exchange-listed REITs are registered with the SEC and their shares are listed and traded on public stock exchanges and face the financial disclosure and corporate governance obligations required under US law for public companies.
- Public, non-listed REITs are registered with the SEC but their shares are not listed or traded on stock exchanges and investors may face restrictions on their redemption rights, such as a minimum holding period, often a number of years.
- Private REITs are not registered with the SEC, do not have their securities listed and are therefore not subject to disclosure or corporate governance requirements of the SEC or any stock exchange, while investors’ redemption rights vary from REIT to REIT.

The FTSE NAREIT US Real Estate Index Series focuses on listed REITs, which had a total equity market capitalization of \$1 trillion, as of September 30, 2016.² Via their stock exchange listings, REITs offer their investors a way of reducing the risk of illiquidity that has traditionally been associated with direct investments in real estate. According to NAREIT, daily average dollar trading volume in REITs rose from about \$100 million in 1994 to \$7.1 billion in July 2016.

Types of REITs

REITs fall into one of two categories: equity and mortgage.

Equity REITs own and operate commercial and residential properties. Mortgage REITs provide financing for real estate through investments in mortgages and mortgage-backed securities. They may originate commercial mortgage loans, securitize mortgage loans and engage in other activities that support the financing of commercial real estate. Equity REITs thereby offer investors the opportunity to gain exposure to the returns available from equity ownership of real estate, while mortgage REITs offer the opportunity to gain exposure to the returns from the debt financing of real estate.

The FTSE NAREIT US Real Estate Index Series includes both composite indexes (covering all REITs) and sub-indexes for equity and mortgage REITs.

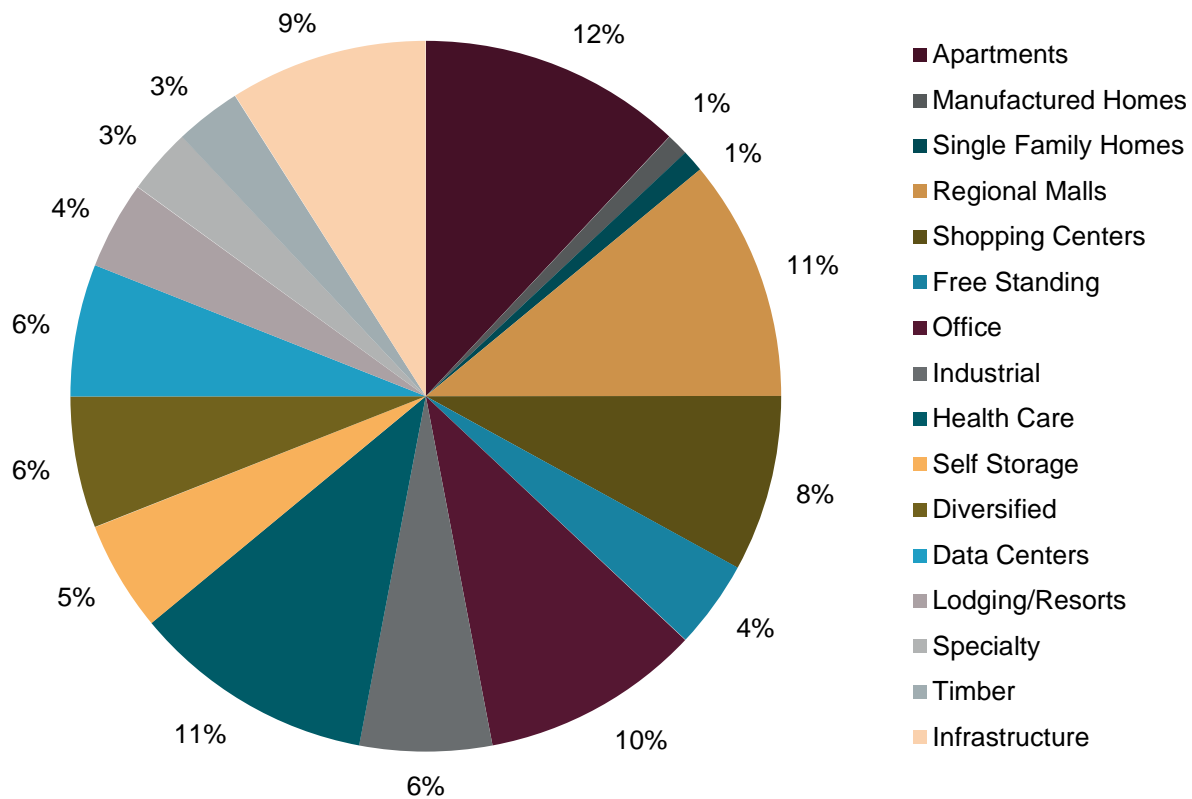
According to NAREIT, equity REITs represented 95% of the US REIT market by value in September 2016, with mortgage REITs constituting the remaining 5% of the REIT market’s overall capitalization.

Equity REITs own and manage properties in a variety of economic sectors, including malls and shopping centers, apartments, health care facilities, data centers, hotels, offices, industrial premises, telecommunication towers and others (see Exhibit 1). Most REITs, however, tend to specialize in one property type only.

¹ Source: EPRA Global REIT Survey 2015.

² According to NAREIT, listed REITs paid out approximately \$46.5 billion in dividends during 2015, while public non-listed REITs paid out approximately \$4.5 billion in dividends.

Exhibit 1. Subsector Exposure of the FTSE NAREIT All Equity REITs Index



Source: FTSE Russell, NAREIT, as of September 30, 2016.

REITs as an inflation-protecting investment

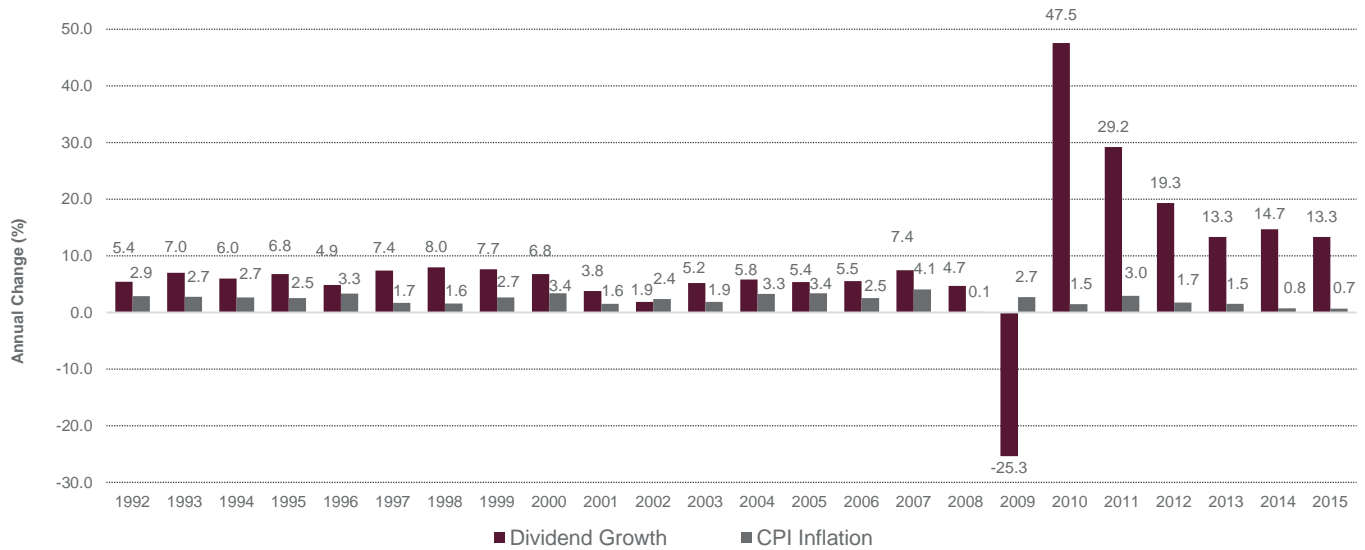
Investments in commercial real estate are often viewed by many as offering a natural protection against inflation. In real estate leases in the US and many other economies there is a strong link between rents and the annual change in consumer price inflation, resulting in an inflation-protecting income stream for property owners.

This relationship is visible in Exhibit 2, which shows the annual change in dividends paid by US listed equity REITs and the annual change in the US Consumer Price Index (CPI). Over the 24 years from 1992 to 2015, inclusive, annual REIT dividend growth exceeded the annual change in the CPI in every year except 2002 and 2009.

On an annualized basis, equity REIT dividends grew at a compound rate of 8.2 percent per annum over the period, compared with a growth of 2.3 percent per annum for the CPI.

The divergence between REIT dividends and inflation in 2009 reflected the severity of the financial crisis. In aggregate, REIT managers reduced dividend payments in response to or in anticipation of a drop in cash flows from their underlying investments. In some cases, a reduction in per-share dividends also occurred as a result of the REITs' issuance of new equity. REIT dividends rebounded strongly from the 2009 decline in the succeeding six years.

Exhibit 2. REIT Dividend Growth vs. US CPI



Source: NAREIT, data from December 31, 1991 to December 31, 2015. The chart shows the average annual change in dividends of all US listed equity REITs. Past performance is no guarantee of future returns. Please see the end for important legal disclosures.

REIT income

By law, US REITs are required to distribute at least 90% of their taxable income to shareholders in the form of dividends.

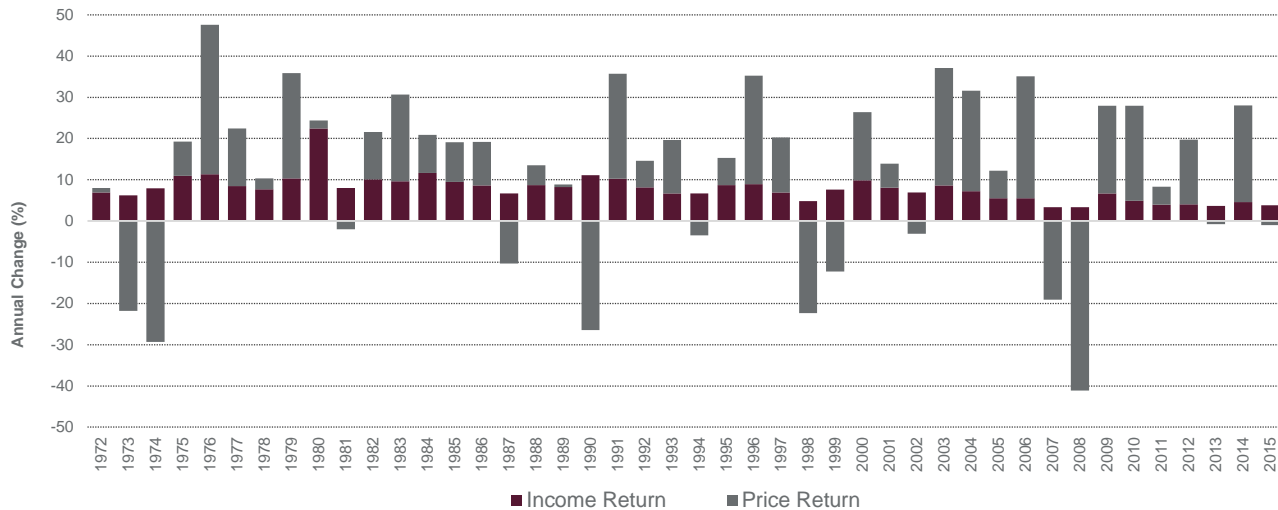
As a result, REITs have tended to be among the sectors of the equity market offering a higher-than-average dividend yield. For example, at the end of September 2016, the FTSE NAREIT All Equity REITs Index recorded a dividend yield of 3.7 percent, while the Russell 3000® Index recorded a dividend yield of 2.0 percent.

At the same time, the effect of dividend income (including reinvested income) on REITs' long-term returns has also been significant.

Exhibit 3 illustrates the income and price (capital) components of the annual total returns of the FTSE NAREIT All Equity REITs Index (and its predecessor the Equity REITs Index) between 1972 and 2015, inclusive.

Over the 44-year period, 43% of the average annual total return on the index over the period came from income in the form of REIT dividends, with the remainder coming from REIT price appreciation.

Exhibit 3. FTSE NAREIT All Equity REITs Index and Equity REITs Index: Return Components 1972-2015 (%)



Source: FTSE Russell, NAREIT, data from December 31, 1971 to December 31, 2015. The FTSE NAREIT All Equity REITs index was launched on March 6, 2006, with an index start date (based on a retroactive application of the index rules) of December 31, 1999. For the years 1972-2010, inclusive, the index history is that of the Equity REITs index. Past performance is not a guide to future returns. Please see the end for important legal disclosures.

The FTSE NAREIT US Real Estate Index Series

The FTSE NAREIT US Real Estate Index Series consists of six headline indexes and a number of sector and sub-sector indexes:

- FTSE NAREIT All REITs Index:** consists of all REITs listed on the New York Stock Exchange (NYSE) or NASDAQ and compliant with the relevant provisions of the US Internal Revenue Code³. The index is not free float-adjusted and constituents are not required to meet minimum size and liquidity criteria.
- FTSE NAREIT Composite Index:** consists of all the REITs from the FTSE NAREIT All REITs Index that meet minimum size and liquidity criteria. Only companies with a full market capitalization in excess of \$100 million are eligible for the index. Non-constituents must turn over at least 0.05% of their shares in issue, based upon the median daily trade per month, in at least ten of the twelve months prior to a full market review in order to gain eligibility. Constituents' weightings are also adjusted for free float.
- FTSE NAREIT Real Estate 50 Index:** consists of the largest 50 eligible REITs from the FTSE NAREIT Composite Index, ranked by market capitalization.
- FTSE NAREIT All Equity REITs Index:** consists of all equity REITs from the FTSE NAREIT Composite Index.
- FTSE NAREIT Equity REITs Index:** consists of all equity REITs from the FTSE NAREIT Composite Index not designated as timberland or infrastructure REITs.
- FTSE NAREIT Mortgage REITs Index:** consists of all mortgage REITs from the FTSE NAREIT Composite Index.

Indexes are calculated on both a price and total return basis. For total return indexes, REITs' dividends are reinvested on the respective ex-dividend dates.

³ For further detail, see rule 1.1.1. of the [index rules](#).

Index reviews

The FTSE NAREIT US Real Estate Index Series is reviewed on a quarterly basis. Any resulting changes in index constituents are implemented after the close of business on the third Friday of March, June, September and December, effective from the start of business on the following Monday. Reviews are based on data at the close of business on the Monday four weeks earlier.

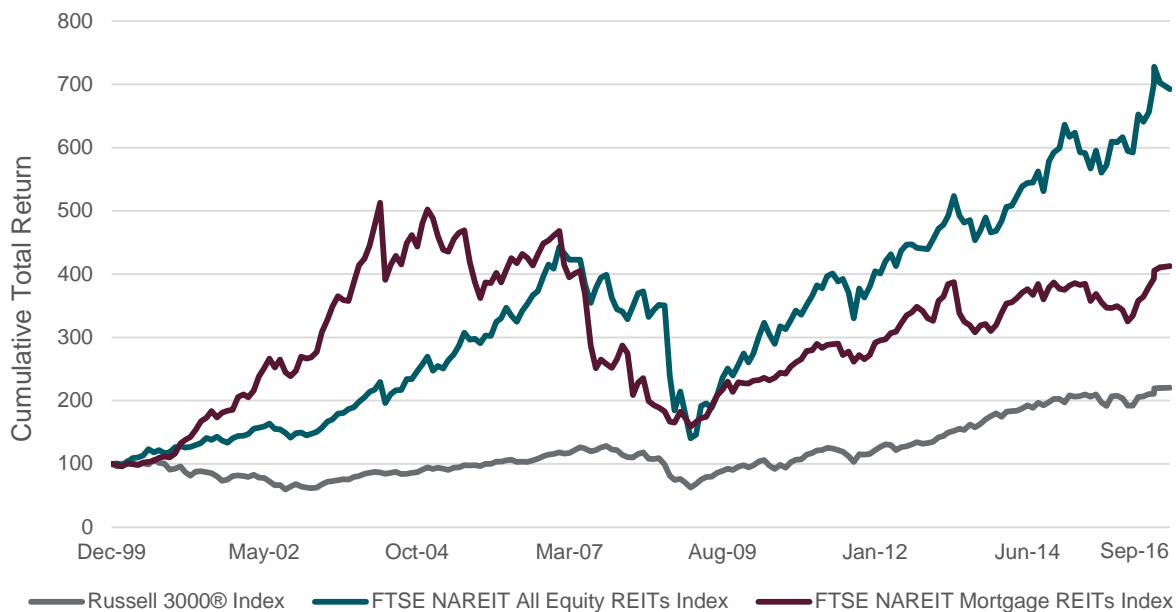
Equity and mortgage REITs—relative performance

The actual total return performance of the FTSE NAREIT All Equity REITs and FTSE NAREIT Mortgage REITs Indexes from December 1999 to September 2016 is shown in Exhibit 4.

Over the whole period, the FTSE NAREIT All Equity Index gave a higher total return (+11.2 percent per annum) than the FTSE NAREIT Mortgage REITs Index (+7.0 percent per annum), although with modestly higher levels of volatility: the annualized standard deviation of return of the FTSE NAREIT All Equity REITs Index was 21.5 percent over the period, compared with 19.6 percent for the FTSE NAREIT Mortgage REITs Index.

There was a noticeable difference in the performance of the two REIT categories, however, in the periods before and after the 2008/09 financial crisis: in aggregate, the FTSE NAREIT Mortgage REITs produced higher returns than the FTSE NAREIT Equity REITs Index during the first half of the last decade, while the reverse has been true over the period since the financial crisis.⁴

Exhibit 4. Total Return Performance: FTSE NAREIT All Equity REITs Index and FTSE NAREIT Mortgage REITs Index



Source: FTSE Russell, NAREIT, data from December 31, 1999 to September 30, 2016. The chart shows the total returns of the FTSE NAREIT All Equity REITs Index and the FTSE NAREIT Mortgage REITs index, rebased to 100 on December 31, 1999. Both indexes were launched on March 6, 2006 and index values prior that date are based on a retroactive application of the index rules. Past performance is no guarantee of future returns. Please see the end for important legal disclosures.

⁴ One should use caution interpreting the FTSE NAREIT Mortgage REIT Index as there has been significant turnover in composition since prior to the crisis.

Reflecting a global decline in yields from all financial instruments, dividend yields on equity REITs have more than halved over the same period, despite a spike during the 2008/09 financial crisis. As shown in Exhibit 5, in December 1999 the yield on the FTSE NAREIT All Equity REITs index was 8.7% but by September 2016 the yield had fallen to 3.7%. However, in February 2009, the index yield temporarily exceeded 10% per annum.

Exhibit 5. FTSE NAREIT All Equity REITs Index: Dividend Yield (%)



Source: FTSE Russell, NAREIT, December 31, 1999 to September 30, 2016. The FTSE NAREIT All Equity REITs Index was launched on March 6, 2006 and index values prior that date are based on a retroactive application of the index rules. Accordingly, prior to March 6, 2006, returns reflect hypothetical historical performance. Past performance is no guarantee of future returns. Please see the end for important legal disclosures.

Listed real estate exposure via REITs

The FTSE NAREIT US Real Estate Index Series offers market participants a comprehensive set of benchmarking solutions for the US REIT market, covering all the major market sectors and sub-sectors.

REITs enable investors of all types to gain access to a regular income stream, a diversified portfolio of underlying properties and a link to the capital values of the portfolio holdings by means of securities listed on a public stock exchange. Dividend income has always represented a major part of REITs’ total returns and, despite recent absolute declines in yields, US equity REITs have continued to offer a premium in income terms to the broader US equity market. At the same time, REITs offer an alternative to direct real estate investment with its high transaction costs, complexity and relative lack of liquidity. With such advantages, it is not hard to see why the REIT universe has expanded so rapidly and why market participants need index tools to help them towards a deeper understanding of this continually growing market.

For more information about our indexes, please visit ftserussell.com.

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