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REIT Performance: A New Definition (RUC211)

By Richard Wollack, Dan O'Connor, Dionisio Meneses, and David Siopack

Investment Myopia

For much of the latter half of the 1990s, investors in stocks reaped a bonanza seldom paralleled in history. For instance, in the years 1997-99, investors who owned the stocks contained in the S&P 500 achieved average annual total returns (almost entirely from share price appreciation) exceeding 26% a year. Investors holding the Nasdaq 100 (which includes many of the biggest names in technology) did even better; their investment skyrocketed an average of nearly 47% annually in the same period.

Shrewd investors likened this share price appreciation (and unprecedented expansion in earnings multiples) to the mythical Icarus flying too close to the sun with his waxen wings and, consequently, did not overinvest in these highflying stocks and indices. Many (perhaps most) investors, however, continued to pour money into those stocks, some even after the inevitable decline in share prices had begun. What caused this "irrational exuberance," to quote a now-famous phrase?

Quite simply, too many investors focused exclusively on absolute return potential and ignored the other yardsticks that must be taken into account in evaluating investment performance. In other words, performance was encapsulated in a single (and all-too-often exaggerated) return (i.e., share price appreciation) number without an understanding of the underlying risk (and risk/return relationship) required to achieve it.

Focusing on average annual return, as most investors do, is a myopic perspective of performance. An investor's measure of performance—his definition—must consider not only return, but also other factors, particularly the risk inherent in the return potential. Such additional factors incorporate both practical insights as well as some of the risk measures used in Modern Portfolio Theory (MPT).

A New Definition

Five key measures of performance—viewed together—help alleviate investment myopia: (1) annual return; (2) dividend yield; (3) dividend contribution to total return; (4) correlation with other asset classes; and (5) the Sharpe ratio.

This course analyzes these five performance metrics in the context of how three major asset classes—stocks, bonds, and real estate (with real estate investment trusts, or REITs, constituting the last category)—have performed, both recently and over the long term. In short, as documented by the last two of these metrics—correlation and the less widely utilized Sharpe ratio—this course demonstrates that the inclusion of REITs optimizes the risk-adjusted return in virtually all investment portfolios. Hence, REITs' performance must be redefined when compared with other asset classes, incorporating a diverse group of measures rather than simple annual return.