Real Estate Sector Report

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Investment Management Program 2024 Spring Semester

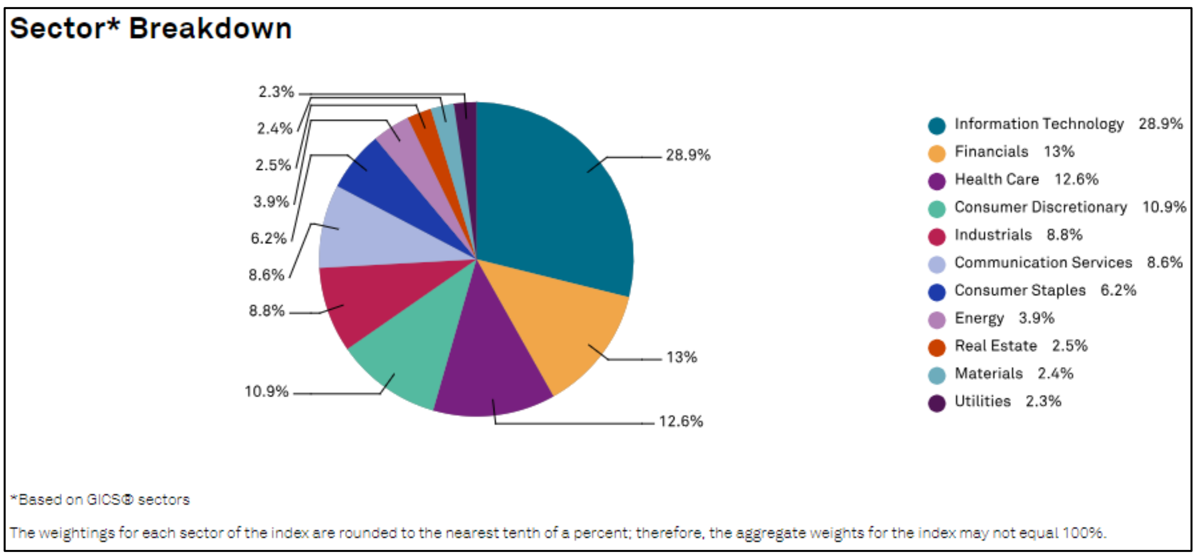
Introduction

The Real Estate sector stands as a pillar within the broader financial market, encompassing a diverse range of industries, including Equity Real Estate Investment Trusts (REITs), real estate management and development, and operating companies that provide an array of services related to the real estate domain. In this equity sector report, we delve into a thorough examination of the Real Estate sector, including its inherent dynamics, historical performance, and offer insightful recommendations for portfolio allocation within this sector for the 2024 Spring semester of the Investment Management Program.

Wisman Fund Current Holdings

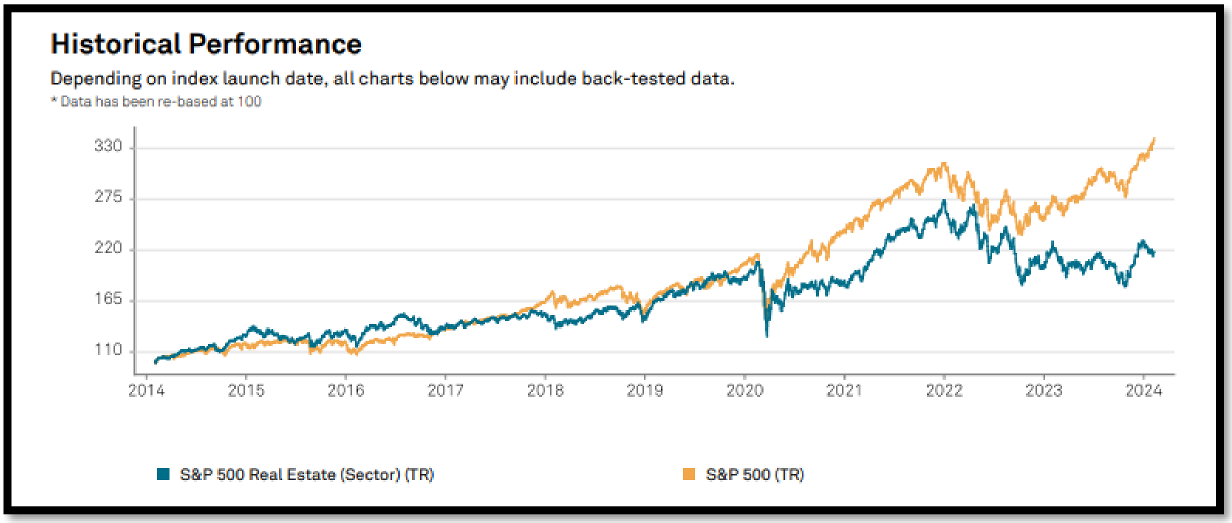
American Tower Corp. (AMT), Digital Realty Trust (DLR)

Size and Comparison



As of December 29th, 2023, the Real Estate sector accounts for 2.5% of the S&P 500 index's market capitalization (see the figure above), 31 different companies. The Wisman Fund currently weighs the Real Estate sector at 1.6%. The current market cap of the Real Estate sector is $1.47 Trillion.

Historical Performance



This graph shows the cyclical nature of this sector and the sector's historical underperformance compared to the S&P 500 index.

Composition of Real Estate Sector

The Real Estate sector is made up of 9 different industries: Diversified REITs, Health Care REITs, Hotel & Resort REITs, Industrial REITs, Office REITs, Real Estate Management & Development, Resident REITs, Retail REITs, and Specialized REITs, but industry-specific results in the Real Estate Sector are not generally reported as frequently as other sectors. The top ten weighted companies in the S&P 500 index are seen in the list below. These constituents make up approximately 62% of the Real Estate sector. The Wisman Fund contains two of the top weighted Real Estate sector stocks; American Tower Corp A (AMT) and Digital Realty Trust (DLR). All numbers shown as of February 19, 2024.

Ticker	Name	Sector Weight	Mkt. Cap
PLD	ProLogis Inc	12.68%	$124.52 B
AMT	American Tower Corp A	8.98%	$87.23 B
EQIX	Equinix Inc	8.27%	$80.39 B
WELL	Welltower Inc	5.30%	$52.98 B
SPG	Simon Property Group A	5.03%	$48.92 B
CCI	Crown Castle Inc	4.83%	$46.97 B
PSA	Public Storage	4.58%	$49.50 B
O	Realty Income Corp	4.48%	$37.88 B
DLR	Digital Realty Trust	4.25%	$41.25 B
CSGP	Costar Group Inc	3.42%	$33.24 B

FY23 Nominal Price Returns

As of December 29th, 2023, 1-year returns for the Real Estate sector in the S&P 500 saw growth at 6.92%, from December 29th, 2022. Whereas the S&P 500 saw a staggering 23.21% increase over the past year. The Real Estate sector in the Wisman Fund accounts for 1.6% of the portfolio and has provided an overall weighted 1-year return of 9.94%. The graph below shows the overall performance data from Dec. 29th, 2022, to Dec. 29th, 2023. This illustrates the vast underperformance of the sector in terms of 1-year returns compared to the S&P 500 index. (*^GSPC is the S&P 500 index ticker symbol, ^SP500-60 is the Real Estate sector ticker symbol*)

YTD Nominal Price Returns

Real Estate has continued to underperform the S&P500 since the beginning of 2024. YTD returns for the Real Estate sector in the S&P 500 saw growth of -3.9%, whereas the S&P 500 itself has achieved growth of 4.2% since the beginning of 2024.

Industry-Specific Returns

The information listed below provides a snapshot of the one year returns of the industries listed under the Real Estate Sector, including the largest company in the particular industry for any who are interested in looking into those. It should be noted that Diversified REITs underperformed the most at a -22.59%. Real Estate Development, on the other hand, achieved a year return of 46.77%.

	1Y Industry Returns	Largest Company in Industry
Specialty REITs	-1.46%	American Tower Corp (AMT)
Industrial REITs	4.30%	Prologis, Inc (PLD)
Retail REITs	5.73 %	Simon Property Group Inc (SPG)
Residential REITs	-10.46%	AvalonBay Communities, Inc (AVB)
Healthcare REITs	2.42%	Welltower Inc (WELL)
Office REITs	-17.74%	Alexandria Real Estate Equities, Inc (ARE)
Diversified REITs	-22.59%	VICI Properties Inc (VICI)
Mortgage REITS	-7.56%	Annaly Capital Management, Inc (NLY)
Hotel & Motel REITs	10.37%	Host Hotels & Resorts, Inc (HST)
Real Estate Development	46.77%	Forestar Group Inc (FOR)
Real Estate Services	2.95%	CoStar Group, Inc (CSGP)

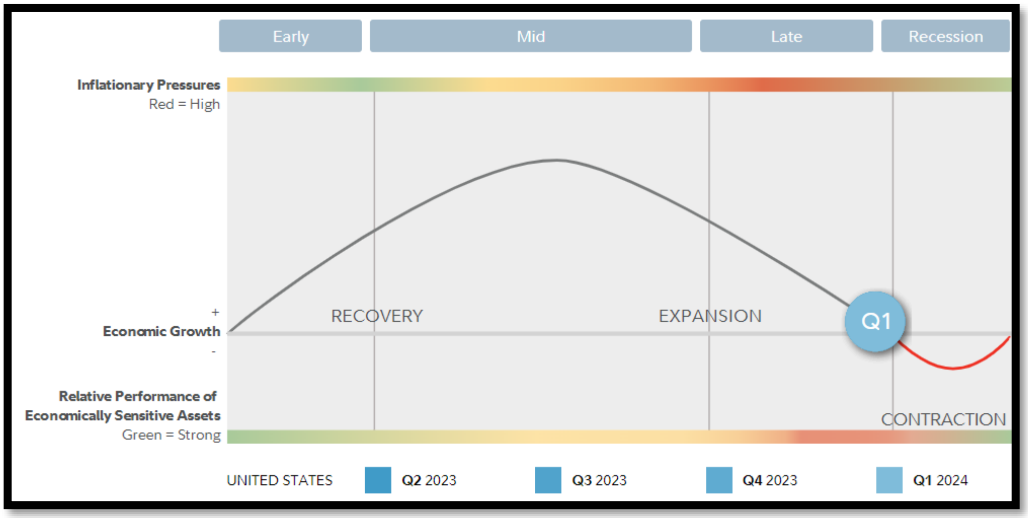
The Wisman Fund

The securities from the Real Estate sector in The Wisman Fund through FY2023 have both underperformed (AMT) and overperformed (DLR). The graph on the right shows the 1-year fluctuations and growth for the current holdings.

Business Analysis

Economic Cycle

Fidelity indicates that the US economy is in the very late expansion stage of the economic cycle, as seen in the graphic below.



The late expansion stage of the economic cycle marks a mature phase of growth, where economic expansion persists but at a more moderate rate. Key features include reduced unemployment, increasing inflation, higher interest rates, potential stock market turbulence, and a concentration on readiness for the next economic contraction. These aspects are explored in the economic analysis section. A thorough grasp of this phase is vital for businesses and investors to ensure informed decision-making and adept navigation through the economic environment.

Business cycle

Historical performance of sectors during business cycle phases.

Sector	Early	Mid	Late	Recession
Financials	+			−
Real Estate	+ +	−	+	− −
Cons. Disc.	+ +		− −	
Info Tech.	+	+	−	− −
Industrials	+ +			− −
Materials	+	− −		−
Cons. Stap.	− −	−	+	+ +
Health Care	− −			+ +
Energy	− −		+ +	− −
Comm. Serv.		+		−
Utilities	− −	−	+	+ +

Business Cycle

As seen on the left, the performance of the Real Estate sector is pessimistic during recessionary periods. The Real Estate sector - considered a Bond-proxy sector - is intrinsically linked to economic cycles and tends to overperform during the late expansion stage as a result of interest rate hikes set by the Federal Reserve. While demand for Real Estate services remains stable and is a necessary industry for society, the securities in the Real Estate sector behave as investors see them; diversification with passive income. The valuation of Real Estate securities will naturally be more pessimistic if an investor's dollar sees greater reward in bonds or other bond-proxy sectors with less risk, as we have seen in the recent year.

The Real Estate Sector in the Economy

The Real Estate sector is essential to the global economy due to its role in managing Real Estate – in its products, services, and management of the asset class itself. The sector's historical use in the securities market is to provide dividends and income for investors - both retail and institutional – and is often a sign of defensiveness and a want for non-cyclical asset diversification.

Macroeconomic Factors: The Real Estate sector's success is closely tied to the broader macroeconomic environment. It relies on factors such as economic growth, monetary and fiscal policy, and government regulations.

- *Economic Growth:* The overall health of the economy is a primary driver of demand for Real Estate. During periods of strong economic growth, there is increased activity in construction, money is easier to borrow for infrastructure, and asset AFFO (Adjusted Funds from Operations) generally increases, which in turn provides companies more flexibility in payouts for investors.
- *Monetary Policy*: Real Estate tends to be an inflation-hedge as it's uses are inelastic. Regardless of economic cycle, brick and mortar is the life-blood of a populous and

business to thrive and succeed. As for the securities, more commonly being Real Estate Investment Trusts, they are actively affected by the rest of the market's risk/reward ratios of depreciation/reliable incomes. In monetary policy, Real Estate Investment Trusts (REITs) can behave as bond proxies. This is because REITs are often seen as a stable source of income, like bonds. REITs typically pay out a significant portion of their income as dividends, making them attractive to income-seeking investors, much like bonds do. When interest rates rise, the yields on bonds also rise, making them more attractive compared to REITs. This can lead to a decrease in demand for REITs and a subsequent decrease in their prices.

- *Fiscal Policy*: REITs can behave as touchpoints for investors who want exposure to infrastructure spending by a government. This is because REITs often invest in real estate assets, which can include infrastructure assets such as airports, toll roads, and other public works. When the government increases spending on infrastructure, it can lead to an increase in demand for these assets, which can in turn lead to an increase in the value of REITs that hold them.
- *Government Regulations:* Regulations related to environmental sustainability and emissions can affect REIT values. Compliance with environmental standards may require investments in cleaner technologies.

SWOT Analysis: Real Estate Sector

- **S**trengths (Internal):
  - *High Dividend Yields*: REITs are required to distribute at least 90% of their taxable income to shareholders in the form of dividends, making them attractive for income-seeking investors.
  - *Diversification:* REITs often have diversified portfolios of real estate assets across various sectors, such as residential, commercial, industrial, and healthcare, which can reduce risk.
  - *Access to Capital:* REITs can raise capital by issuing new shares, debt, or through joint ventures, allowing for growth and investment in new properties.
  - *Tax Advantages:* REITs are not subject to corporate income taxes if they meet certain criteria, making them more tax-efficient than traditional corporations.
- **W**eaknesses (Internal):
  - *Interest Rate Sensitivity:* REITs can be sensitive to changes in interest rates as higher rates can increase borrowing costs and reduce the present value of future cash flows, impacting stock prices.
  - *Economic Downturns:* Economic downturns can lead to decreased demand for real estate, lower property values, and increased vacancies, negatively impacting REITs.
  - *Regulatory Risks:* Changes in government regulations, such as tax laws and zoning regulations, can impact the real estate sector and REITs.

- *High Leverage:* REITs often use debt to finance their acquisitions and operations, which can increase financial risk, especially during economic downturns.

- **O**pportunities (External):
    - *Technological Advancements*: REITs can leverage technology to improve property management, increase efficiency, and enhance the tenant experience.
    - *Demographic Trends:* Changing demographics, such as an aging population and increased urbanization, can create new opportunities for REITs in sectors like senior living facilities and urban multifamily properties.
    - *Sustainable Investing:* The growing focus on environmental, social, and governance (ESG) factors can create opportunities for REITs that focus on sustainability and energy-efficient properties.
    - *Mergers and Acquisitions:* REITs can pursue strategic acquisitions and mergers to expand their portfolios and enter new markets.
- **T**hreats (External):
    - *Competition:* REITs face competition from other real estate institutions, private equity firms, and traditional corporations, which can impact property valuations and market share.
    - *Market Volatility:* REITs can be subject to market volatility, which can impact stock prices and investor sentiment.
    - *Technological Disruption:* Disruptive technologies, such as online real estate platforms and virtual reality tours, can impact traditional real estate business models and REITs.
    - *Geopolitical Risks:* Geopolitical events, such as trade disputes and political instability, can impact global markets and affect REITs with international exposure.

Economic Analysis

The economic analysis will consider important factors like PCE Inflation, Unemployment, the FED interest rate and monetary policy.

- *Inflation:* The PCE (Personal Consumption Expenditures) inflation rate is at 2.8%, which is above the Federal Reserve's target of 2%, but lower than the 3.3% projection. This indicates that there is currently elevated inflation in the economy. The FED acknowledges this and expresses its commitment to returning inflation to its 2% objective.
- *Unemployment:* The unemployment rate is at 3.8%. This suggests a very tight labor market with low levels of unemployment, which is typically associated with a strong job market.
- *Economic Activity:* The Federal Reserve indicates that economic activity has been expanding at a solid pace. This is a positive sign for the overall health of the economy, although it mentions that job gains have slowed in recent months. Despite this slowdown,

the job market remains strong. 2023 percent change in GDP was well above the September projection.

- *Monetary Policy:* The Federal Reserve has decided to maintain the target range for the federal funds rate at 5-1/4 to 5-1/2 percent. This suggests that the FED is holding interest rates steady at a relatively high level, likely to combat inflation. The Fed also mentions its commitment to reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, which is a part of its strategy to normalize its balance sheet.
- *Uncertainty:* The FED acknowledges uncertainty regarding the effects of tighter credit conditions on economic activity, hiring, and inflation. This uncertainty suggests that the central bank is closely monitoring economic developments and may adjust its monetary policy as needed.

The table below acknowledges changes, and projections in real GDP, unemployment, PCE inflation and core PCE inflation.

Percent														
Variable	Median[1]					Central Tendency[2]					Range[3]				
	2023	2024	2025	2026	Longer run	2023	2024	2025	2026	Longer run	2023	2024	2025	2026	Longer run
Change in real GDP	2.6	1.4	1.8	1.9	1.8	2.5–2.7	1.2–1.7	1.5–2.0	1.8–2.0	1.7–2.0	2.5–2.7	0.8–2.5	1.4–2.5	1.6–2.5	1.6–2.5
September projection	2.1	1.5	1.8	1.8	1.8	1.9–2.2	1.2–1.8	1.6–2.0	1.7–2.0	1.7–2.0	1.8–2.6	0.4–2.5	1.4–2.5	1.6–2.5	1.6–2.5
Unemployment rate	3.8	4.1	4.1	4.1	4.1	3.8	4.0–4.2	4.0–4.2	3.9–4.3	3.8–4.3	3.7–4.0	3.9–4.5	3.8–4.7	3.8–4.7	3.5–4.3
September projection	3.8	4.1	4.1	4.0	4.0	3.7–3.9	3.9–4.4	3.9–4.3	3.8–4.3	3.8–4.3	3.7–4.0	3.7–4.5	3.7–4.7	3.7–4.5	3.5–4.3
PCE inflation	2.8	2.4	2.1	2.0	2.0	2.7–2.9	2.2–2.5	2.0–2.2	2.0	2.0	2.7–3.2	2.1–2.7	2.0–2.5	2.0–2.3	2.0
September projection	3.3	2.5	2.2	2.0	2.0	3.2–3.4	2.3–2.7	2.0–2.3	2.0–2.2	2.0	3.1–3.8	2.1–3.5	2.0–2.9	2.0–2.7	2.0
Core PCE inflation[4]	3.2	2.4	2.2	2.0		3.2–3.3	2.4–2.7	2.0–2.2	2.0–2.1		3.2–3.7	2.3–3.0	2.0–2.6	2.0–2.3	
September projection	3.7	2.6	2.3	2.0		3.6–3.9	2.5–2.8	2.0–2.4	2.0–2.3		3.5–4.2	2.3–3.6	2.0–3.0	2.0–2.9	
Memo: Projected appropriate policy path															
Federal funds rate	5.4	4.6	3.6	2.9	2.5	5.4	4.4–4.9	3.1–3.9	2.5–3.1	2.5–3.0	5.4	3.9–5.4	2.4–5.4	2.4–4.9	2.4–3.8
September projection	5.6	5.1	3.9	2.9	2.5	5.4–5.6	4.6–5.4	3.4–4.9	2.5–4.1	2.5–3.3	5.4–5.6	4.4–6.1	2.6–5.6	2.4–4.9	2.4–3.8

Financial Analysis

These financial fundamentals are used together to assess the financial health and performance of a company. Analysts often consider them alongside other metrics, industry benchmarks, and qualitative factors to form a comprehensive view of a company's financial situation and prospects. It's important to note that the interpretation of these metrics can vary depending on the industry, company size, and economic conditions, so they should be analyzed in context.

Financial Fundamentals

Why these factors?

- *ROE:* a financial ratio that shows how much net income a company generates per dollar of invested capital. It helps investors understand how efficiently a firm uses its money to generate profit.

- *EPS Growth Rate:* the net income generated in a given period as allocated to each common share outstanding.
- *ROA:* measures how efficient a company's management is in generating profit from their total assets on their balance sheet.
- *Profit Margin:* represents the portion of a company's sales revenue that it gets to keep as a profit, after subtracting all of its costs.

Through FY23	**S&P 500**	**Real Estate Sector**
ROE	23.24%	4.15% (REITs) -8.54% (Development) 9.11% (General) -8.27% (Operations)
EPS Growth Rate	3.20%	0.00%
ROA	4.44%	-
Net Profit Margin	10.70%	-

The S&P 500 outperforms the Real Estate sector in terms of ROE in all industries and EPS growth. These differences may be attributed to the specific performances of REIT's as a whole and challenges within the Real Estate sector, particularly in reference to the economy.

Major Companies

	ProLogis Inc (PLD)	**American Tower Corp (AMT)**	**Equinix (EQIX)**
ROE	3.94%	13.21%	8.08%
EPS Growth Rate	-	-	34.42%
ROA	4.44%	1.08%	3.08%
Net Profit Margin	38.17%	6.46%	11.84%

These major companies in the S&P 500 index Real Estate sector tend to underperform or equally perform the sector.

Valuation Analysis

Valuation ratios, including metrics like the P/E ratio, P/B ratio, P/S ratio and DY play a crucial role in evaluating a company's worth. These ratios are evaluated in conjunction with other financial indicators, industry benchmarks, and qualitative factors to develop a comprehensive understanding of a company's financial standing and future potential.

Why these ratios?

- *P/E:* a way to value a company by comparing the price of a stock to its earnings.
- *P/B:* measures the market's valuation of a company relative to its book value.

- *P/S:* an investment valuation ratio that shows a company's market capitalization divided by the company's sales for the previous 12 months.
- *DY:* a financial ratio that tells you the percentage of a company's share price that it pays out in dividends each year.

	S&P 500	**Real Estate Sector**
P/E	23.27	38.27
P/B	4.04	2.05
P/S	2.33	6.71
DY	1.51%	4.01%

The Real Estate sector has a lower P/B ratio, indicating potentially more attractive valuations based on book value. In the terms of P/E and P/S ratios, the Real Estate Sector has substantially higher, which could be used to conform to the argument that the Real Estate Sector tends to be overvalued. However, the Real Estate sector offers a higher average dividend yield, implying a potentially better income generation for investors.

Major Companies

	ProLogis Inc (PLD)	**American Tower Corp (AMT)**	**Equinix (EQIX)**
P/E	40.54	124.75	86.69
P/B	2.32	19.24	6.36
P/S	15.82	7.90	9.48
Dividend Yield	2.61%	3.45%	1.69%

Current Holdings Trialing Returns

Why Trailing Returns?

Trailing returns, when analyzed in absolute terms, offer insight into the nominal growth of an investment, which can then be compared to a benchmark. Relative trailing returns, on the other hand, serve to indicate whether an investment has surpassed or fallen short of the benchmark's performance during the measured period.

American Tower Corp (AMT)

Total Return %	15-Year	10-Year	5-Year	3-Year	1-Year	YTD	3-Month	1-Month	1-Week	1-Day
AMT	14.72	10.42	3.67	-3.11	-8.69	-13.32	-5.16	-10.06	-3.76	-1.23
Industry	16.41	10.16	7.59	1.27	0.34	-5.31	2.42	-1.38	-1.47	0.00
Index	14.89	12.13	13.78	8.24	23.37	4.89	12.02	5.25	-0.24	-0.51

AMT has consistently underperformed both the industry and the index across all time trials dating back 15 years. Its 1-year return of -8.69% is particularly noteworthy, further suggesting that this stock should be scrutinized for potential divestment from the Wisman Portfolio once additional financial analysis is concluded.

Digital Realty Trust (DLR)

Total Return %	15-Year	10-Year	5-Year	3-Year	1-Year	YTD	3-Month	1-Month	1-Week	1-Day
DLR	12.85	12.76	6.74	3.16	25.00	1.22	1.69	-1.77	-7.45	-8.34
Industry	16.41	10.16	7.59	1.27	0.34	-5.31	2.42	-1.38	-1.47	0.00
Index	14.89	12.13	13.78	8.24	23.37	4.89	12.02	5.25	-0.24	-0.51

DLR has demonstrated both favorable and unfavorable performance over the years. In the most recent year, it boasted a notable ROI that surpassed both industry standards and the index. However, it is important to note that over a 15-year span, it has consistently underperformed. Given these factors, DLR's inclusion in the Wisman Portfolio will be reevaluated pending further financial analysis.

Recommendation

Based on the current market conditions and historical performance, we recommend the following actions regarding the Wisman Fund's allocation within the Real Estate sector:

> *Underweight Real Estate Sector:* Considering its bond-proxy nature, the current economic outlook, historical data, current financial data, and the SWOT analysis, the Real Estate sector should be **underweighted**. The weight of the Real Estate sector in the

S&P 500 Index as of December 29th, 2023, was 1.6%. It is recommended that the fund find a target weight around 1.5%. Underweighting this sector will help mitigate potential risks associated with the sector's underperformance in the current high-interest rate environment.

The Wisman Fund Current Holdings: Considering the underweighting recommendation, it is crucial to look at the current holdings to determine what the fund should sell or replace.

	American Tower Corp (AMT)	**Digital Realty Trust (DLR)**
YTD Return	-13.3%	-.04%
Holding Return	82.5%	-7.4%
Portfolio Weight	0.94%	0.47%
Sector Weight	66.6%	33.4%
Market Cap	$87.10B	$41.83B

The Wisman Fund's holdings in American Tower Corp. and Digital Realty Trust are considered mixed positions within the Real Estate Sector. Given AMT's consistent underperformance over the past fifteen years, it should be a candidate for liquidation. While DLR's growth is moderate, it should also be considered for liquidation if a better stock (or stocks) can be found to replace it. The current Spring 2024 semester IMP cohort should consider underweighting this sector through the sale of AMT and potentially cutting or selling DLR. The fund has experienced a significant loss of purchasing power due to the performance of these two stocks.

Sources

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