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Real Estate Investment Trusts (REITs): Considerations for the Federal Employees Thrift Savings Plan (TSP)

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Real Estate Investment Trusts (REIT): Considerations for the Federal Employees Thrift Savings Plan (TSP)

Summary

Real Estate Investment Trusts (REITs) are mutual funds made up of real estate and mortgage assets. In recent years, their performance has been stronger than broader market indicators, leading to calls for inclusion of an REIT alternative in the Thrift Savings Plan (TSP) for federal workers. At present, the TSP is limited to five savings vehicles, three of which are broad-based stock indexes. Proponents of inclusion cite greater diversification and participant choice in the TSP as well as potentially higher returns as benefits of the proposal. The TSP board, while studying the matter, has argued that changes should only occur as part of a comprehensive program, should not encourage "return chasing" by participants, and should maintain the current very low cost structure of the TSP.

H.R. 1578, the Real Estate Investment Thrift Savings Act, was introduced April 12, 2005, to provide for an REIT option in the TSP. Hearings were held on the legislation April 19, 2005, by the House Government Reform Subcommittee on the Federal Workforce and Agency Organization. Further hearings are scheduled for April 26, 2006. A companion bill, S. 2490, was introduced in the Senate on April 13, 2006.

This report summarizes the legal and economic history of REITs and the factors that have contributed to recent strong performances of REITs as investment vehicles. It then addresses the arguments behind their possible inclusion as an investment alternative in the TSP.

This report will be updated as events warrant.

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Introduction[1]

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This report summarizes the legal and economic history of REITs and the factors that have contributed to recent strong performances of REITs as investment vehicles. It then addresses the arguments behind their possible inclusion as an investment alternative in the TSP.

Background on REITs

Introduced in the 1960s, Real Estate Investment Trusts (REITs) applied the mutual fund concept to real estate. By buying an interest in a REIT, an investor could own a share of a number of real estate assets, reducing the risks and transaction costs that accompany investment in a single piece of real estate. Congress made the REIT concept financially viable by enacting the Real Estate Investment Trust Act of 1960, which exempted REITs from double taxation of shareholder dividends. That is, REIT income is not taxed at the trust level, but only after it has been distributed to shareholders. (Stock and bond mutual funds receive similar tax treatment.) To qualify for this tax exemption, REITs are required to distribute at least 90% of their income in the form of dividends.

A second piece of legislation critical to the development of the REIT market was the Tax Reform Act of 1986, which permitted REITs to operate and manage property themselves. (Previously, they were permitted to be only passive investors.)

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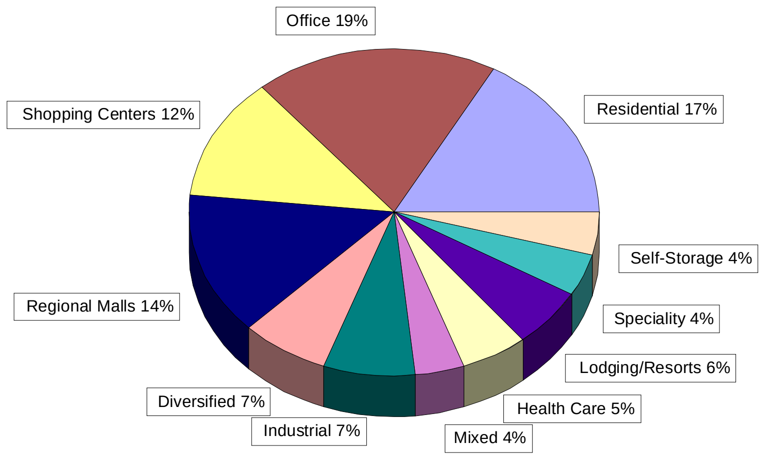
[1] Barbara Miles, former Specialist in Financial Institutions, contributed to this report.

The Tax Reform Act also channeled investment funds into REITs by restricting the use of limited real estate partnerships as tax shelters.

Individual REITs tend to specialize in certain kinds of real estate, but taken as a whole, the REIT industry invests in the broad range of commercial and residential (primarily multi-family) properties. **Figure1** shows the distribution of REIT assets at the end of 2005.

Figure 1. REIT Assets by Type, December 31, 2005



Source: National Association of REITs.

There are two basic types of REITs: equity and mortgage. Equity REITs develop, own, and operate income-producing real estate and provide tenant services, whereas mortgage REITs lend money to real estate owners and operators or acquire loans or mortgage-backed securities.

A few hybrid REITs operate in both modes. The investment characteristics of the two types differ: mortgage REITs are highly sensitive to interest rates because their profits depend on the spread between the income from their loans and other debt assets and their own cost of funds. As interest rates have risen since 2004, the returns on investment in (and share prices of) mortgage REITs have fallen sharply.

Equity REITs, on the other hand, are affected by a range of economic fundamentals besides interest rates. For example, REITs that invest in hotels are sensitive to corporate profits and other factors that affect business travel. Similarly, returns on investment in hospitals, office buildings, and shopping malls depend on a host of sector-specific, uncorrelated trends.

REITs may be either private or publicly held companies.[2] Shares of publicly held REITs are traded on the stock markets like shares of any other corporation. As of the end of February 2006, there were 202 REITs listed on the stock exchanges,

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[2] Figures in this report reflect only publicly traded REITs.

with a total market value of $368 billion. (Of the 202, 156 were equity REITs, 40 were mortgage REITs, and the remaining 6 were hybrids. Market capitalization of the classes was $335 billion, $27 billion, and $5 billion, respectively.)[3] **Table 1** summarizes the growth of the publicly traded REIT market since 1975.

Table 1. Number and Market Capitalization of Publicly Traded REITs, 1975-2005

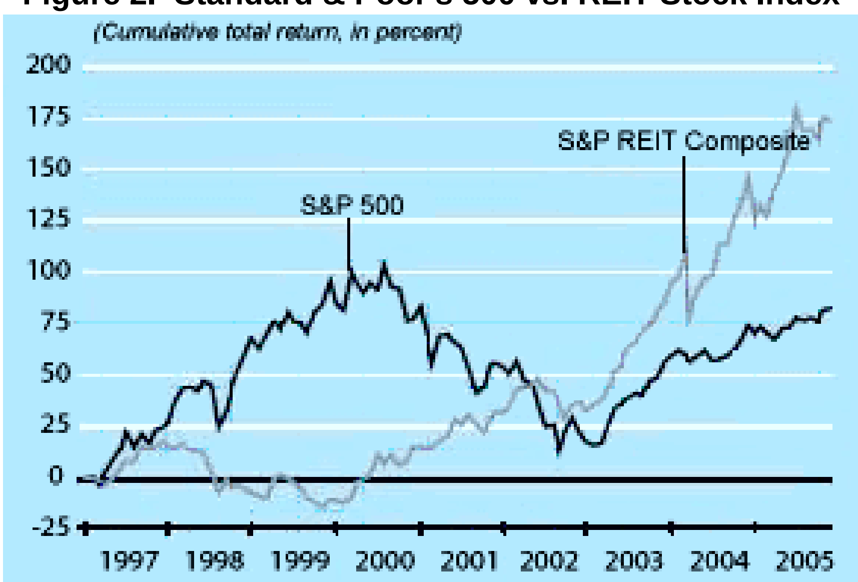
Year	Number of Firms at Year-End	Market Capitalization ($ in billions)
1975	62	0.9
1980	75	2.3
1985	82	7.7
1990	119	8.7
1995	219	57.5
2000	189	138.7
2005	197	330.7

Source: National Association of REITs.

Recent Investment Performance

Indices of REIT stocks have outperformed broad market indicators such as the Standard & Poor's 500 since 2000. **Figure 2** compares the two indices since 1997.

Figure 2. Standard & Poor's 500 vs. REIT Stock Index



Source: Standard & Poor's.

3 Available at Dow Jones & Co., [http://www.djindexes.com/mdsidx/index.cfm?event=showReitStats].

What accounts for the recent performance of REIT stocks? First, the economic fundamentals have been favorable. Following the stock market crash in 2000 and the September 11, 2001 attacks, the Federal Reserve lowered short-term interest rates to the lowest levels since the 1950s, greatly reducing the cost of borrowed funds. Longer term rates, partly in response to the Fed moves and partly because of a fall in post-9/11 investment demand, continued their decade-long decline, lowering the cost of funds most important to real estate funding considerably. Long rates, in particular, have remained low by historical standards in 2006. In addition, consumer spending has been strong since the end of the last recession in November 2001, which is good news for REITs that invest in resorts and retail structures, including shopping malls. Economic growth has been good for the industrial real estate sector, and improving business conditions have buoyed the hotel and lodging sectors, and are beginning to drive down the office vacancy rate in many parts of the country.

A second factor has been a wave of mergers and going-private transactions in the industry. When a publicly traded REIT is acquired by another or taken private, shareholders receive a premium above the current market price for their stock. The prospect of a merger or buyout usually adds to the attraction of REIT shares, and drives prices up.

A third — and perhaps the most important — factor behind rising REIT share prices has been the relatively poor performance of other investments. Since the market peak in 2000, stock yields have been much lower than during the 1990s. At the same time, low interest rates have meant that returns to fixed-income investments like corporate bonds, bank certificates of deposit, and U.S. Treasury notes have been meager by historical standards. The combination, according to a Standard & Poor's analysis, "has sent investor dollars surging into U.S. REITs in recent years."[4]

Thus, performance of REIT shares is affected not only by the fundamentals of the real estate business, but also by the quality of other investment opportunities. **Figure 2** shows that the REIT index was negative during several periods in the late 1990s, not just because of problems in real estate markets and earnings,[5] but also because investors shifted funds to Nasdaq technology stocks and other "hot" sectors, where returns of 30% per year were considered sluggish.

Future Prospects

Future returns on any stock market investment are, of course, uncertain. Several factors make predictions about REITs even more uncertain than most. As **Table 1** shows, the market value of REIT stocks has grown explosively since 1990. Since 2000 alone, market capitalization has more than doubled. This suggests two things:

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[4] Raymond Matthis, Robert McMillan, and Joe Niezielski, "Real Estate Investment Trusts," *Standard & Poor's Industry Surveys*, Feb. 16, 2006, p. 6.

[5] For an account of this difficult period for REITs, see Steve Bergsman, "After an Awful Year in the Real Estate Investment Trust Market..." *Investment Dealers' Digest*, June 28, 1999, p. 1.

(1) that publicly traded REITs have become much larger, though mergers, external debt and equity financings, as well as internally-generated growth, and

(2) that investor perceptions of REITs have changed.

The first point means that an investment fund that attempted to capture the aggregate return of the full range of publicly traded REITs, as a TSP fund would presumably do, would in fact be investing in a shifting pool of firms and assets. As public REITs buy private funds or assets, or as they are taken private, the volume and composition of the real estate assets that generate REIT income will not be constant, which implies that past behavior of REIT stocks may not be a reliable guide to future performance.

On the second point, if investors move in and out of REITs in response to factors unrelated to the state of the underlying commercial real estate market, the behavior of REIT stocks under any given set of market conditions can be expected to change. In 2000, a *Wall Street Journal*[6] article noted that "[h]istorically, REITs have behaved like stocks. But in the last two years, they have seemed more like bonds, diving as interest rates rose." A recent Ibbotson Associates study found that the historical correlation between REITs and small-capitalization stocks has broken down:

> Early in the 1990s, however, the market's perception of these securities began to shift as the REIT market grew along with investor understanding of the sector. In turn, shifts in the market began to alter the behavior patterns of this asset class. Since 1992 the REIT market has more than quadrupled, and investors have begun to view these investments more as real estate investments and less as simply domestic equity investments. Over the last 10 years, correlations between REITs and more traditional asset classes have been declining, making them a significant source of portfolio diversification.[7]

Together, these trends suggest that the investment characteristics of the present set of publicly traded REITs may not hold constant over the years to come.

In the short-term, the fact that REITs have outperformed the S&P 500 for several years running suggests that REIT stocks may be overvalued and due for a correction. Standard & Poor's analysis notes that the "cap rate," a measure of commercial property returns, was low in early 2006, suggesting that stock prices were higher than the fundamentals of the commercial real estate market would

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[6] Jonathan Clements, "REITs: Awakening from a Slumber?" *Wall Street Journal*, Feb. 15, 2000, p. C1.

[7] Ibbotson Associates, "Ask Ibbotson." [http://www.ibbotson.com]. See also testimony of Roger G. Ibbotson, Hearing of the House Government Reform Subcommittee on the Federal Workforce and Agency Organization, April 19, 2005.

support.[8] Nevertheless, REIT stocks have risen by 13% since the beginning of 2006, seemingly in "defiance of common sense," according to the *Wall Street Journal*.[9]

A REIT Fund for the TSP?

The Thrift Savings Plan (TSP) is a tax-deferred retirement savings vehicle for federal workers, akin to "401(k)" plans for private sector employees. Although available to all federal employees, it is particularly important to those covered by the Federal Employees Retirement System (FERS), whose contributions are partially matched by their federal agency. At present, the TSP has five investment vehicles, three of which are broad stock indexes. One of the stock funds tracks the S&P 500 index of major U.S.-listed companies (the C fund). The I fund tracks international stocks and the S fund invests in stocks not included in the S&P 500, including shares of small and mid-size companies. The remaining two funds invest in bonds (the F fund) and government securities (the G fund).

In addition, the TSP has five automatic "lifecycle" arrangements of investing among the five vehicles, each geared toward a projected time frame over which accounts will remain in the TSP. At this time, the TSP does not allow for investment in individual stocks, nor in funds made up of particular economic sectors or industries (such as biotech, or aeronautics). The TSP has approximately 3.5 million participants and more than $180 billion in assets.

On April 12, 2005, Chairman Jon Porter of the House Government Reform Subcommittee on the Federal Workforce and Agency Organization introduced H.R. 1578, the Real Estate Investment Thrift Savings Act, which would provide for a real estate stock index investment option under the TSP. The subcommittee held a hearing on April 19, 2005. Chairman Porter made the case for the legislation as follows:

> What we are talking about today is a simple concept: DIVERSIFICATION. Basic economic principles dictate that investors should not place all of their eggs in one basket, but must spread their money and risk among different types of assets. A few years ago — during the tech bubble collapse — many Federal employees experienced setbacks in their investment portfolio and did not have the option to invest substantially in REITs. Federal employees should not be left out in the cold. Adding a REIT fund option to the TSP is the next logical step. With its resilient earnings and lower volatility, real estate provides a sound investment over the long haul. Such an investment is a valuable diversification tool, providing the possibility of strong returns and risk reduction.[10]

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[8] "Real Estate Investment Trusts," *Standard & Poor's Industry Surveys*, p. 7.

[9] Jennifer Forsythe, "REITs Rally Again, Defying Predictions," *Wall Street Journal*, Mar. 22, 2006, p. D1. (The article cites speculation on mergers as a principal reason for the continued rise.)

[10] Opening Statement of Chairman Jon Porter, Hearing of the House Government Reform Subcommittee on the Federal Workforce and Agency Organization, Apr. 19, 2005.

Chairman Porter also noted that the TSP offered five investment options, versus 16 for the average corporate 401(k) plan. Investment diversification is the cornerstone of modern portfolio theory, which holds that the inclusion of highly risky assets in a portfolio can enhance overall returns and does not imply a high level of risk to the portfolio, as long as the risks are not positively correlated. If the correlation between REITs and the stock market has declined, as the Ibbotson study cited above finds, a REIT fund would offer TSP participants a way to hedge their investments in stock funds: if the stock funds fell, the REITs would rise (or at least not fall as far), easing the pain of stock market episodes such as the bear market of 2000-2002. At the same time, based on their expectations of future REIT performance, participants could move funds into REITs in search of higher yields. Thus, as Chairman Porter stated, a REIT fund may offer both "the possibility of strong returns and risk reduction."[11]

The TSP governing board and CEO, however, have recommended against the addition of a REIT fund. Their arguments, as set out at the 2005 hearing mentioned above,[12] may be summarized as follows.

The view of REITs as a hedge against stock market declines is complicated by the fact that REIT stocks are already included in both the large and small stock funds currently offered by the TSP. (For example, nine REIT stocks are included in the S&P 500, which the TSP's C fund tracks.) Gary Amelio, the TSP executive director, noted in his 2005 testimony that the C and S stock funds held over a billion dollars in REIT shares, making TSP the thirteenth-largest holder of REITs in the United States. Thus, the hedging value of REITs is to an extent already built into the TSP: if REITs rise when other stocks fall, the aggregate indexes mirrored by the TSP funds will fall less than they would have otherwise. Similarly, superior returns earned by REITs over any period are captured in the aggregate return to the TSP stock funds.

What the creation of a REIT fund would do is allow TSP participants to increase the proportion of REIT stocks in their portfolios beyond their weighting in broad indices such as the S&P 500. If their timing were right, TSP participants who chose the REIT option could outperform their peers who remained in the stock funds. But **Figure 2** suggests that they would be choosing a volatile investment option that could lead to losses as well as gains.

By offering only a few investment alternatives, the TSP is structured in a way that discourages "return chasing." Conventional wisdom in financial theory is that many investors — particularly small investors — tend to buy the stocks or mutual funds that did well in the last reporting period and that this is generally an unsuccessful strategy, for two reasons: return chasers are always paying top-of-the-market prices and, by frequently reallocating their investments, they incur high

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[11] Ibid.

[12] Statements of Andrew M. Saul, chairman of the Federal Retirement Thrift Investment Board, and Gary A. Amelio, executive director, before the House Government Reform Subcommittee on the Federal Workforce and Agency Organization, Apr. 19, 2005.

transaction costs. Gary Amelio noted that educational programs to discourage such counterproductive investment behavior would be expensive.[13]

Another argument regarding the hedging and diversification benefits offered by new TSP funds is that such alternatives ought to be offered (if they are needed) as part of a comprehensive, considered program, rather than piecemeal. If TSP investors would be better off with a REIT choice, observers ask why not add funds based on emerging markets, hedge funds, commodities, junk bonds, and so on?

Two general arguments against such multiplication of investment options are made. One deals with fund expenses. Current TSP expenses are extremely low by industry standards — "off the charts," according to Andrew Saul[14] — partly because the number of funds is limited. If annual expenses go up by even a fraction of a percentage point, the effect on total investment returns over a 20- or 30-year time frame can be dramatic. Testimony from Barclays Global Investors, which serves as a TSP investment manager, indicated that administration of a REIT fund, while desirable from a "pure investment perspective," would likely incur management and transaction costs considerably above present levels.[15]

Second, there is some question whether a wide menu of investment choices is in the interest of TSP participants, many of whom are not (and do not care to become) expert in financial markets. Presenting unsophisticated investors with many choices may result in less-than-optimal behavior, including the chasing of returns (discussed above) or the selection of an unsuitable initial investment allocation, which the participant may not correct later because the perceived costs of obtaining expertise are too high. These arguments can be countered by the charge of "paternalism," and the case for investor choice and self-direction is intuitively attractive. If, as neoclassical economics assumes, individuals act rationally in their own self-interest, why should the government, or its designees, decide where TSP participants can put their funds?

However, a growing body of empirical and theoretical research, called "behavioral finance," throws doubt on the notion that individual investors can be expected to make the decisions that are best for themselves.[16] Behavioral finance identifies mistakes that investors make consistently, such as reliance upon inaccurate rules of thumb and being influenced by the form in which an investment opportunity is presented, rather than the substance. These bad habits appear to be deeply rooted and not easily corrected by education programs.

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[13] Ibid.

[14] Ibid.

[15] Testimony of Amy Schioldager, head of U.S. Equity Indexing Products, before the House Government Reform Subcommittee on the Federal Workforce and Agency Organization, Apr. 19, 2005.

[16] For an overview of the field, see Hersh Shefrin, *Beyond Fear and Greed*, (New York, Oxford University Press, 2002), 368 p., or, for a very brief account, John J. Bowen, "The Enemy Within," *Financial Planning*, Apr. 1, 2006.

A recent study of investment returns by defined-contribution plan participants found that individuals who chose an asset allocation or balanced fund (such as the TSP lifestyle options) achieved better returns than participants who make allocation decisions themselves.[17] Results like these suggest that the neoclassical assumption that individuals can be relied upon to act rationally in their own self-interest may be overly simplistic. This line of analysis seems to support the contention of the TSP directors that the current plan design, based on a few broad choices and low costs, "has been recognized by many impartial observers as an optimum approach."[18]

Recent Events

S. 2490, a companion bill to H.R. 1578, was introduced by Senator Norm Coleman April 3, 2006, thus bringing the issue to the Senate as well as the House. The House Government Reform Committee has scheduled new hearings on the subject for April 26, 2006.

In March 2006, the Employee Thrift Advisory Council, an advisory panel made up of labor, management, and other federal employees, adopted a resolution opposing the addition of a REIT option to the TSP. Finally, a study has been commissioned by the Federal Retirement Thrift Investment Board to review the existing TSP investment policy and consider the addition of more options (including a REIT option), but publication is not expected until later in 2006

[17] Jenna Gottlieb, "Asset Allocation Funds Benefit Participants; Study Shows 401(k) Performance Shines for Those Who Let Others Make Decisions," *Pensions and Investments*, Mar. 20, 2006, p. 6.

[18] Statement of Gary Amelio, ibid.