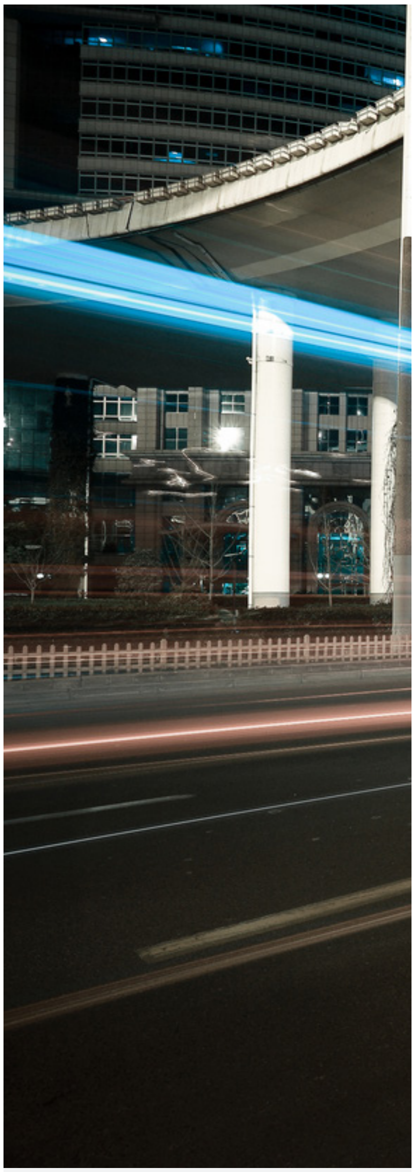
Listed Real Estate vs. Inflation

Whether inflation becomes "sticky" or transitory, listed real estate has the potential to hedge investors' portfolios.



DUFF & PHELPS
INVESTMENT MANAGEMENT CO.
A VIRTUS INVESTMENT PARTNER

Key Points:

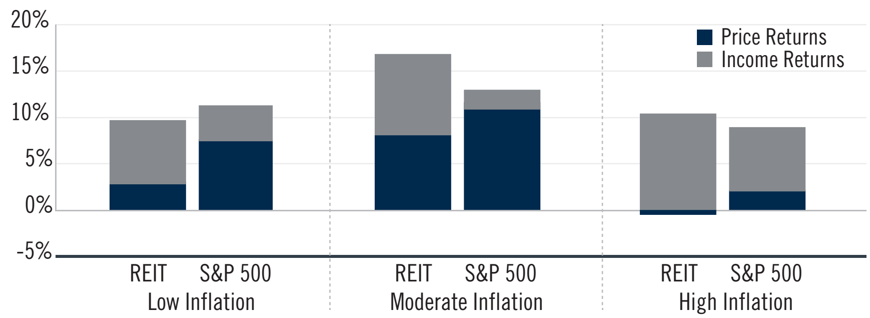
- In its various forms, real estate historically has provided a hedge against inflation and rising interest rates.
- Since 1972, for example, REITs have delivered attractive returns in a wide range of inflationary environments.
- REITs can offset increased costs by pushing rents higher as demand for space grows.
- With the dramatic expansion of the REIT universe, increased investment opportunity exists across a number of sectors benefiting from secular growth.

The Relationship Between Global Real Estate and Inflation

Duff & Phelps has long recognized real estate's qualities as an inflation hedge and has considered real estate as a preferred investment during periods of rising interest rates and inflation. We evaluate two attractive attributes real estate has as hedges against inflation: first, the ability to raise rents and, in turn, cash flows; and second, the increase in replacement costs of the real estate itself.

During historical periods of rising interest rates and medium-to-high inflation, REITs have generated positive total returns and outperformed equities. As shown in the chart, which incorporates several different inflation regimes since Nareit began tracking data for REITs in 1972, REITs have delivered attractive returns during periods of low, moderate, and high inflation.

REIT RETURNS HAVE COMPARED FAVORABLY TO S&P 500 RETURNS DURING DIFFERENT INFLATION PERIODS

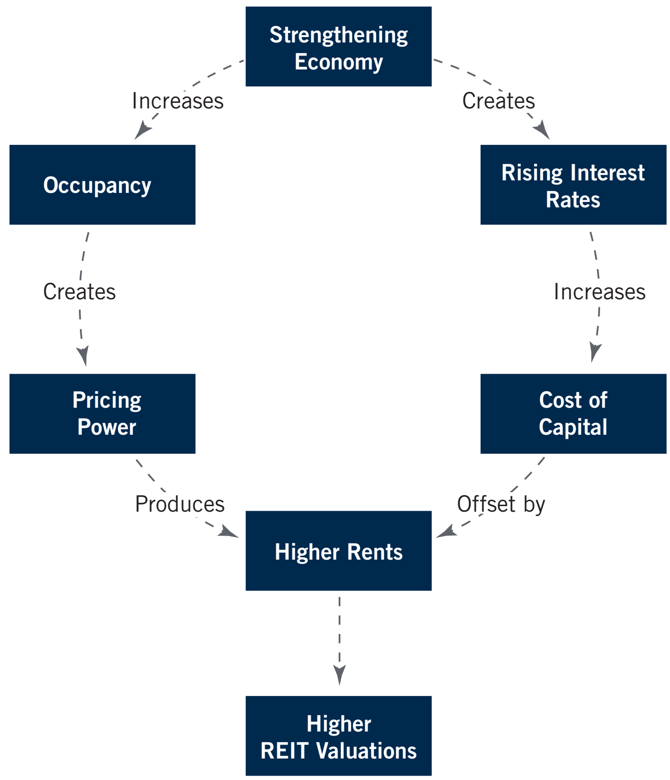


Past performance is not indicative of future results. Source: Nareit analysis of prices for the FTSE Nareit All Equity REIT Index and S&P 500® Index; 1972-2020; inflation measured for all items, all urban consumers.

Generally speaking, rising interest rates and inflation occur in the midst of a rebounding or strengthening economy, which in turn leads to increasing demand for commercial real estate space. While capital costs typically rise with an increase in interest rates, REITs are able to offset increases in costs by pushing rents higher as the demand for space grows (see the following diagram). This dynamic can result in faster revenue growth, which may more than offset an increase in expenses due to higher inflation.

Thus, investors who seek out real estate during these periods recognize that REITs can increase their cash flow and dividends at a pace that may more than offset higher borrowing costs from rising interest rates and the negative effects of higher inflation. Additionally, the replacement value of investors' underlying real estate should increase as land values and input costs rise. Input costs include materials such as steel, concrete, lumber, and architectural and contractor services.

DEMAND LEADS TO PRICING POWER, WHICH CAN OUTWEIGH HIGHER CAPITAL COSTS

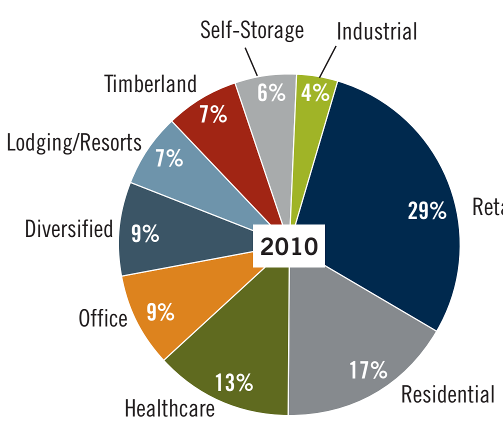


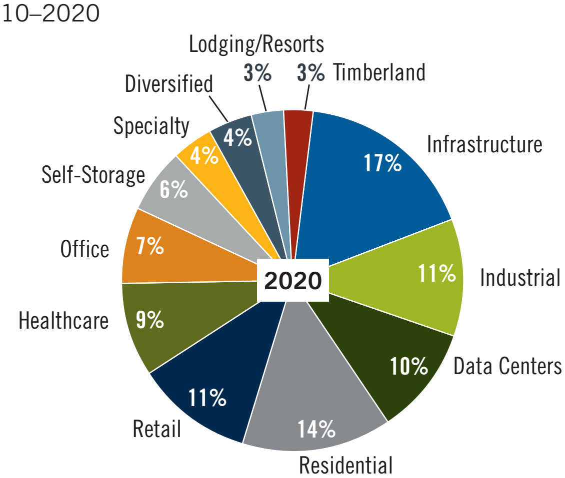
Source: Duff & Phelps Investment Management Co.

While real estate as a whole may prove to be a positive alternative during a period of rising interest rates and inflation, it is important to note how the listed market for real estate has evolved over time and that some real estate property sectors may perform better than others in this type of market environment. The following charts show how the REIT sectors have changed in the last 10 years. During this time, the number of REIT sectors has grown from nine to 12 and currently includes 17 when looking through to the retail and residential subsectors. Increased investment opportunity exists across a number of sectors benefiting from secular growth including data centers, infrastructure including wireless towers, logistics a/k/a industrial, and single-family home rentals.

In 2010, the largest property sectors were traditional property types which included retail centers, residential, healthcare, and office. If you fast forward 10 years, the industry has significantly expanded and now reflects the evolution of the changing U.S. economy, providing investors with a broader opportunity set.

COMPARISON OF SECTOR MARKET CAPITALIZATION SHARES, 2010–2020

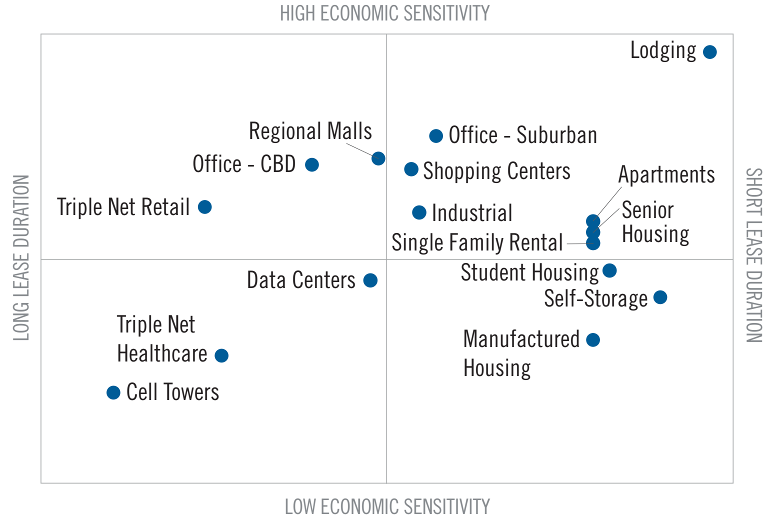




Source: FTSE Russell, Nareit. Data as of December 31, 2010 and December 31, 2020.

One way to differentiate among the different REIT property sectors and their sensitivities to changes in inflation and interest rates is to understand the average underlying duration of the leases across their real estate assets, where an increased frequency of rent repricing is provided by shorter leases. Another way is to evaluate to what extent longer leases have built-in rental rate increases (both fixed increases in rents and variable increases in rents linked to an inflation index are possibilities). Given the wide variety of property sectors available in the listed real estate market today, lease durations can range from as short as a day to over a decade. Just as bond portfolio managers can adjust the effective duration of their portfolios, active managers of listed real estate can do the same through a selection of listed real estate securities with a shorter or longer average lease duration.

REITS LEASE DURATION VS. ECONOMIC SENSITIVITY



Source: Duff & Phelps Investment Management Co. as of August 2021.

When pricing power rises for landlords, having the ability to reprice leases more frequently is a significant advantage, particularly for those property sectors with typical lease durations of one year or less, which include the lodging, apartments, single-family home rentals, manufactured home communities, student housing, senior living, and self storage sectors. This pool of property sectors represents a significant opportunity set that has grown over time. It has historically offered even more repricing benefits in the midst of a strengthening economy than alternative fixed increases in rents during lease terms or variable increases in rents – linked to an inflation index such as CPI – during lease terms.

REITs can perform well in a rising interest rate and inflationary environment due to the two attractive attributes we have demonstrated: first, the ability to raise rents and, in turn, cash flows; and second, the increase in replacement costs of the real estate itself.

Our outlook is particularly favorable for REITs that will benefit from an increase in economic and employment growth and are best positioned to grow their businesses in this post-COVID recovery period. We expect the variance in global growth trajectories to create opportunities for active managers, such as Duff & Phelps, who are focused on high-quality owner/operators of enduring commercial real estate, with solid balance sheets and proven management teams. We believe our existing investment process remains well suited to identifying companies that will benefit from ongoing improvement in the economic backdrop.

Conclusion

If the pandemic has taught us one thing, it is that one cannot underestimate how quickly the world can change. While we do not know if the current inflation will be transitory or permanent, we do know that uncertainty surrounding inflation is top of mind for many investors. For the reasons discussed in this article, we are confident that Global Listed Real Estate has unique characteristics that position them as an inflation hedge in this new season of investing.

Duff & Phelps is not a pure value or growth investor, but rather emphasizes relative valuations within each sector. We invest in companies with strong balance sheets and management teams that can drive continued success and have demonstrated their ability to efficiently allocate capital and create economic value over time. We believe the firm's investment philosophy positions us well to successfully invest our clients' capital though the current environment, as we have been doing for decades.

About Virtus Investment Partners

Virtus Investment Partners (NASDAQ: VRTS) is a distinctive partnership of boutique investment managers singularly committed to the long-term success of individual and institutional investors. The company provides investment management products and services through its affiliated managers and select subadvisers, each with a distinct investment style, autonomous investment process, and individual brand.

Duff & Phelps Investment Management

Duff & Phelps Investment Management pursues specialized investment strategies with exceptional depth of resources and expertise. Since its earliest beginnings, providing research and analysis of income producing securities to Depression-era investors, the firm's attention has been set on identifying attractive opportunities through active management and fundamental research, while managing the associated risks. Today, building on a distinguished legacy, Duff & Phelps has earned a reputation as a leader in investing in Global Listed Real Estate, Global Listed Infrastructure, Clean Energy, and Diversified Real Assets.
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Nareit – National Association of Real Estate Investment Trusts.

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