You should probably own more Real Estate.

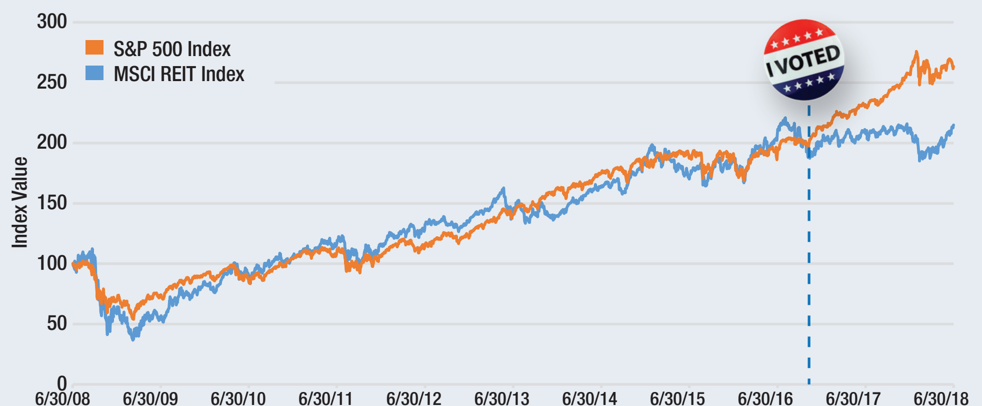
– Michael Mack, Portfolio Manager

Recently, investors have been weary of investing in Real Estate Investment Trusts (REITs). Memories of last decade's real estate bubble still haunt them, but investors should remember that sentiment doesn't always match fundamentals.

These investors perceive real estate as a nonproductive segment of the economy where bubbles are fueled by ultra-low interest rates. The recent scandals in the non-traded REIT space of high fees and no performance or downright fraud may have also soured their taste for real estate. This negative understanding of real estate can also be seen driving across any town in America passing empty shopping centers that used to house widely known retailers.

This timeline from CBI Insights summarizes the demise of what were once known as major retail chains.

The negative sentiment of investors has been reflected in recent performance. REITs have missed the entire rally since the Presidential election.



Source: Bloomberg
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

Beyond the lack of interest because of negative past experiences, the end of quantitative easing and the beginning of the Fed's path to normalizing interest rates have also led investors to flee real estate stocks.

It may be time to reconsider REITs

With all the bad news surrounding the sector, it's easy to see why investors would be hesitant to invest in real estate. However, now may be a good time to add exposure to real estate in an investment portfolio. The fact is that real estate is not going anywhere. It is the life blood of the economy. Without real estate there is no economy, so it makes sense for investors to have a portion of their portfolio in real estate. The question they must ask is, how should they invest in real estate?

Investors who rely solely on broad based indexes for their sector diversification should consider evaluating their risk tolerance and time horizon to ensure their portfolios are properly diversified. Several studies recommend investors have a 5-15% allocation[1] to real estate. Broad based indexes may not give investors the recommended exposure. The S&P 500® for example only has a 2.9% allocation to real estate.

Let's take a look at four reasons now might be a good time to invest in real estate:

1) Publicly traded REITs are trading at attractive valuations relative to private real estate.

Investors can get exposure to real estate in their investment portfolio through private real estate and non-traded REITs or public REITs and C-corps that focus on real estate. Public real estate companies are more likely to have avoided scandals because of the restrictions imposed and the standards they are held to as public companies. In addition, publicly traded REITs are currently trading at significant discounts to their private counterparts. A recent analysis by FTSE NAREIT estimates that property values of public REITs are trading at a 20% discount to private properties. If these estimates are correct, investors can purchase a public REIT for a price 20% lower than a similar property they would buy directly. This huge gap creates greater upside potential for public REITs if it narrows. Possible positive outcomes include:

- The gap closes and buyers emerge pushing the prices of publicly traded REITs higher.
- The valuation gap remains causing public REITs to become merger and acquisition targets.

Alternatively, it is possible for real estate prices to decline or the valuation differential to widen.

2) REITs hold up better in rising rates than widely believed.

Contrary to popular opinion, REITs have actually outperformed during previous Fed hiking cycles. While higher interest rates may increase borrowing costs and make the dividends less attractive, they also tend to be associated with economic growth. Higher economic growth allows these companies to charge higher prices for real estate leases, driving rental income higher.

This chart shows the performance of the FTSE NAREIT Index vs Russell 1000 during periods when the fed hiked rates.

Fed Hiking Cycle	FTSE NAREIT	Russell 1000
12/29/1978 to 6/30/1981	84.56%	60.33%
1/31/1983 to 7/31/1984	28.17%	8.76%
9/30/1986 to 2/28/1989	11.09%	32.11%
11/30/1993 to 3/31/1995	2.82%	11.93%
4/30/1999 to 6/30/2000	3.59%	12.33%
4/30/2004 to 7/31/2006	80.04%	21.84%
10/30/2015 to 6/29/2018	20.91%	38.18%
Average	33.03%	26.50%

Source: FTSE Nareit, Pacer Advisors, Bloomberg

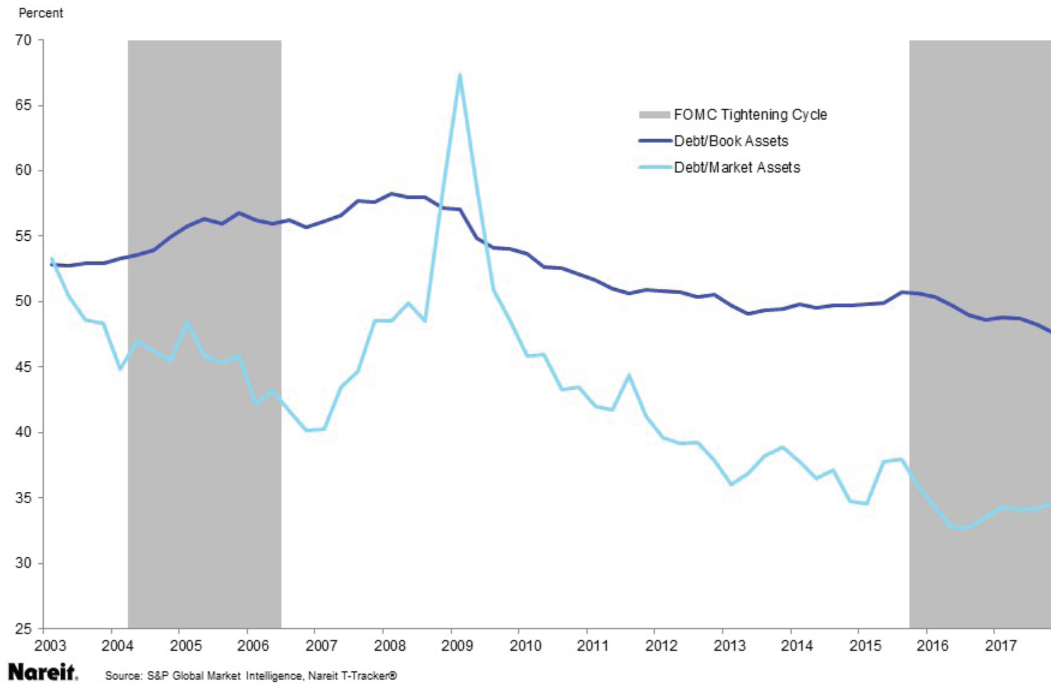
(1)Nareit 2018-2019 REIT Quick Facts

3) REITs are the least leveraged they have been in 15 years.

Going into 2008, REITs were carrying record high debt levels, but ever since 2008 the industry has made a concerted effort to improve operations, eliminate underperforming properties, and reduce debt. This has resulted in REITs carrying the lowest debt levels in 15 years.

Debt to Total Assets

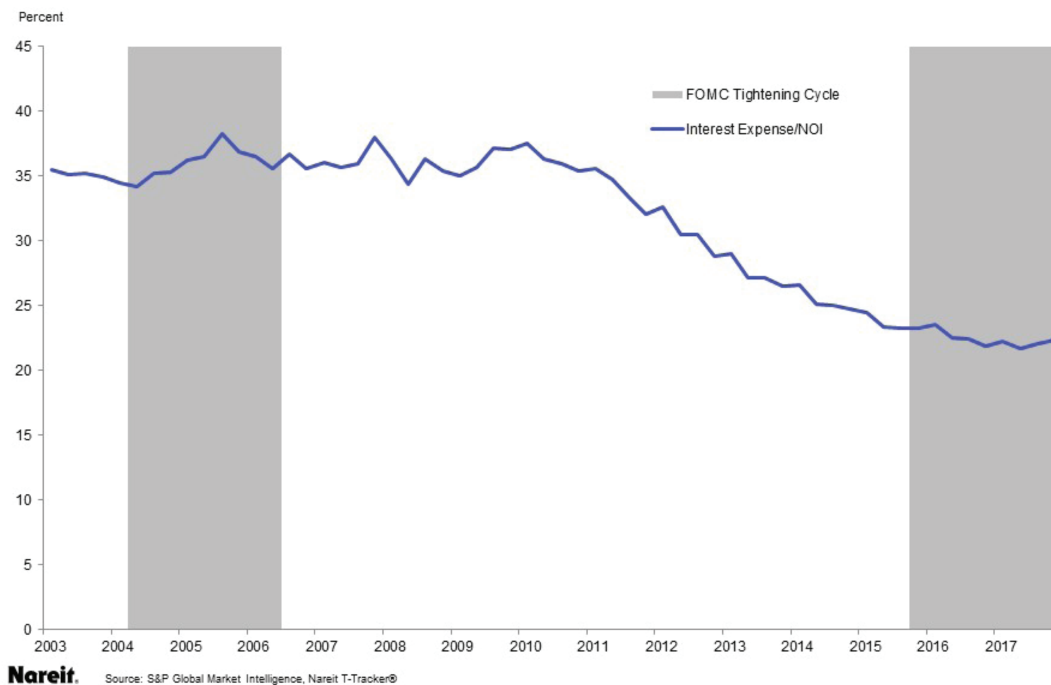
All listed U.S. equity REITs



In addition, lower interest rates have allowed REITs to lower interest expenses. Despite three interest rate hikes in 2017, interest expense relative to operating income has declined. There's no guarantee there won't be another 2008, but post-crisis REITs are in much better shape than they were pre-crisis.

Interest Expense to Net Operating Income

All listed U.S. equity REITs

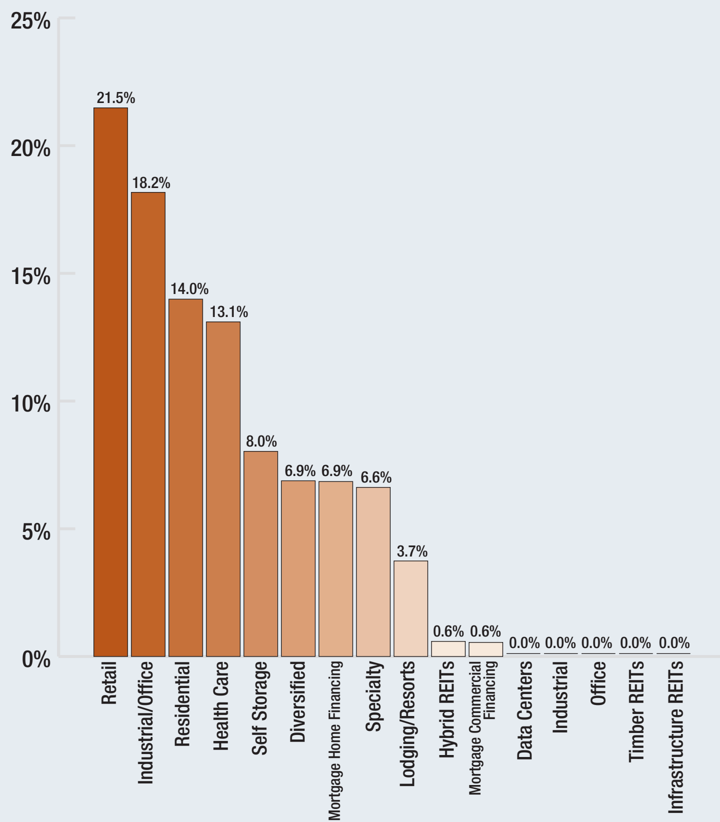


4) The REIT sector is the most diversified it has ever been.

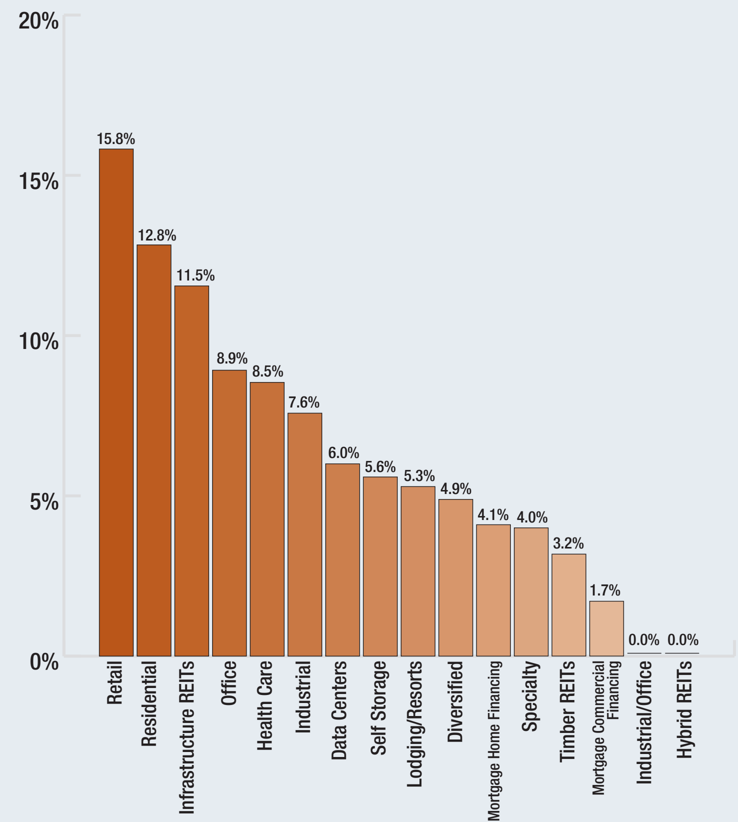
Once a concentrated play on the retail, residential, and office sectors, the REIT universe has expanded into the technology sector with the rise of data centers and cell towers. This has allowed REIT investors to tap into a massive pool of growth opportunities. The expansion of e-commerce and internet/mobile streaming has sparked a high demand for data centers and cell towers.

In 2008, retail, residential, and office spaces made up over 50% of the REIT universe. Now, they only make up 37%. Many argue e-commerce growth is signaling the demise of retail real estate, but it still remains the largest sector of REITs. Retail has definitely seen a shift since the growth of e-commerce, but going foward it may become a partnership of brick and mortar and e-commerce as consumers change the way they shop.

FTSE NAREIT Index Sector Breakdown
(2008)



FTSE NAREIT Index Sector Breakdown
(2018)



Source: FactSet

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Despite the change in landscape of the real estate sector, some investors are still timid about using REITs. Pacer offers sector based REIT ETFs that allow them to invest in the sectors they believe in without owning the ones they don't. Our current line-up focuses on the e-commerce cycle:

- **Pacer Benchmark Data & Infrastructure Real Estate SCTR ETF (SRVR)** offers exposure to data and infrastructure REITs and C-Corps (ex. cell towers and data centers) that are crucial to the data processing of online ordering.
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- **Pacer Benchmark Retail Real Estate SCTR ETF (RTL)** aims to offer exposure to the quality REITs that have embraced the changing retail landscape.

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P/E ratio is a fundamental measure commonly used to determine if an investment is valued appropriately. Each holding's P/E is the latest closing price divided by the latest fiscal year's earnings per share. Negative P/E ratios are excluded from this calculation.
Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. Return on Equity = Net Income/ Shareholder's Equity
The FTSE Nareit US Real Estate Index Series is a comprehensive family of REIT-focused indexes that span the commercial real estate industry, providing market participants with a range of tools to benchmark and analyse exposure to real estate across the US economy at both a broad industry-wide level and on a sector-by-sector basis.
Russell 1000 Index is a market-capitalization weighted index representing the top 1000 large-cap stocks in the Russell 3000 Index.

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