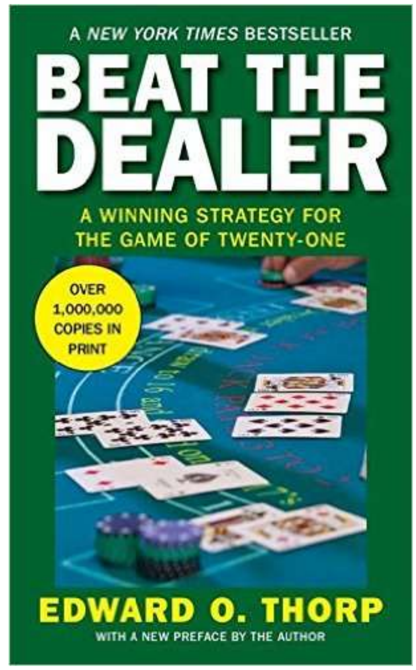
SERENITY
ALTERNATIVE INVESTMENTS

REIT Strategy I: Stacking the deck - Systematic Value and Momentum

"Chance can be thought of as the cards you are dealt in life. Choice is how you play them." Edward Thorp



So here is a question. If you could remove any single card in a deck before playing blackjack against a dealer, which card would you choose? It's not a trick question, there is an answer that maximizes your chances of winning. Take a minute to mull it over.

Which card would you pick? Did you pick an Ace? Queen? Lucky number seven? You didn't pick the number five did you? If you did then you are either lucky, a nerd, or possibly, you are a lucky nerd. Five is the correct answer to the question. Knowing that fewer fives gives the player better odds is also the first step towards a comprehensive system of card counting. It was this knowledge and eventual system that allowed a man named Ed Thorpe to legendarily beat the game of blackjack and consistently make money in Las Vegas casinos.

During the early 1960's Ed Thorpe developed one of the earliest mathematical models of the game of blackjack, and in the process discovered that by removing a single 5 from a deck of cards, the Casino's advantage decreased by 0.8% per hand. He also discovered that removing an Ace *increased* the casino's advantage by 0.58% per hand. While this 0.8% difference seems small, it's actually enough to flip the game in the player's favor, and, over long periods of time, makes it likely that you will beat the casino. At the time it was a pretty remarkable discovery.

Thorpe went on to develop a full system of card counting and used it to make real money playing blackjack in Reno and Vegas. His approach to the game rested on creating a small advantage that added up over a multitude of hands played. Thorpe's second act was in the stock market, as he again used a mathematical framework to gain a small edge over the seemingly un-beatable institutions that make up "the market". These strategies relied on historical edge, systematic implementation, and a huge amount of discipline. When employed correctly, the strategies were extremely profitable.

So how on earth is this relevant for REITs? Is there a five that we can remove from the REIT deck to help us make money? In this piece we will explore two strategies for picking REITs and see if these strategies give us a sustainable edge when applied systematically. *What we find is that common value and momentum strategies can shift the odds of beating the market in our favor.*

The REIT market: Real-Estate Blackjack

Let's start by approaching the REIT market in the same way we would approach a blackjack table. We know it's extremely difficult to beat the dealer or beat the market, so our best bet is to start with a basic system. In blackjack this is called basic strategy, and it consists of a set of rules a player must follow precisely, while playing, to maximize their odds of breaking even. By following a strategy designed around the known odds of the game, a player can increase his or her chance of winning, even if the dealer still has an edge. A player is always better off playing by the book in a disciplined fashion than by betting randomly or emotionally.

Similarly, in REITs or in the stock market generally, having a basic system in place can help us avoid making emotional mistakes. Investing biases almost always lead to pain. As human beings we are inclined to hang on to losers and sell winners; our natural instincts are not suited to beating the stock market. Establishing a simple system or strategy for buying REITs or stocks can be extremely beneficial for this reason.

Let's start with a simple set of rules commonly employed by "Quant" or "Systematic" investors to reduce or eliminate human biases. First, we will assume that our portfolio is always 100% invested. This keeps us from trying to time the market, which is notoriously difficult. Second, we will re-balance our portfolio once a month, and always into the top 10% of REITs, based on our chosen strategy. This keeps us from over-trading, rashly reacting to current news, holding losers too long, or selling winners too early; all of these behaviors, or emotional traps, are hard-wired in humans and lead to bad investing decisions. Lastly, we will equal weight each REIT in our portfolio. This assumption is perfectly realistic for most retail investors but may have to be relaxed for institutions looking to invest larger amounts of capital. For value-weighted results feel free to contact us.

With our basic rules in place it's time to look at some strategies. A good place to begin is by exploring the framework championed by arguably the most famous investor of all time, Warren Buffet. That framework is value investing.

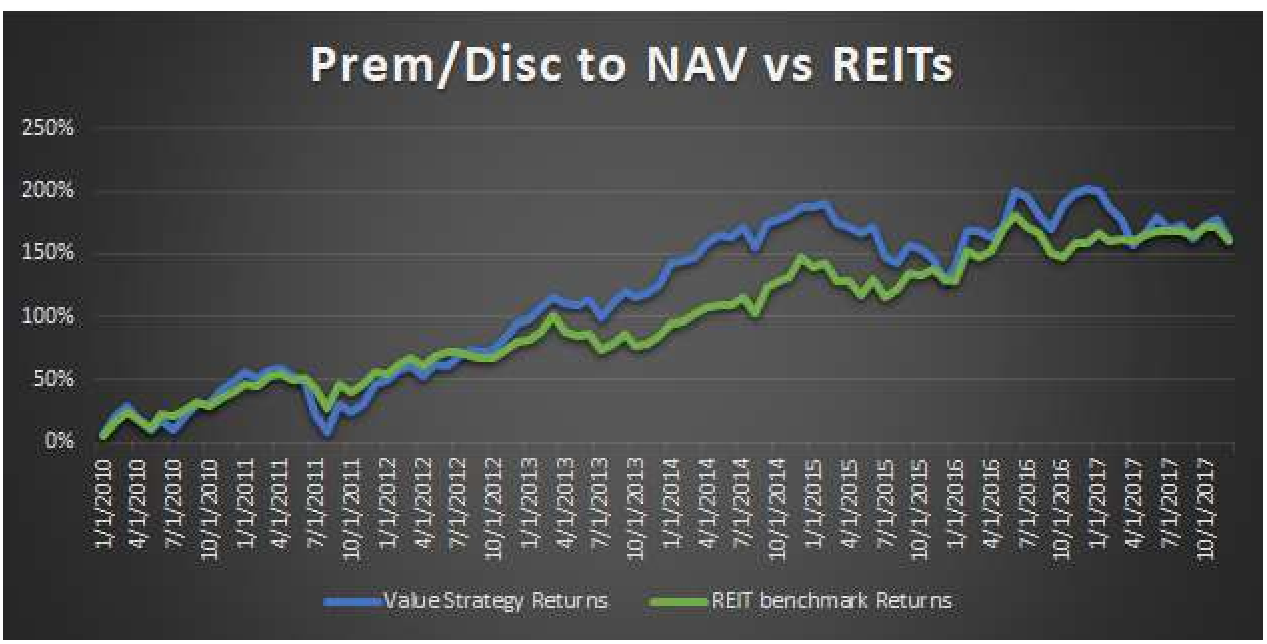
Value: What happens when you buy REITs that are on sale?

The Warren Buffet approach to investing focuses on buying businesses at a discount to their "intrinsic value", which is a fancy way of saying buying companies that are cheaper in the stock market than they should be. While it's a simple approach in theory, it's an incredibly difficult strategy to execute successfully, as evidenced by the fact that there is only one Warren Buffet, and countless less successful Warren Buffet wannabees. The trick is in defining intrinsic value. Get this value wrong, and your value investing strategy might simply invest in failing companies. Warren Buffet has proven uniquely talented at correctly recognizing intrinsic value and investing at a discount.

In REIT's however, the game is a bit different. Since REITs own commercial real estate assets, and commercial real estate assets routinely trade hands in the private market, we can usually get a pretty good idea of how much a given REIT portfolio is worth. We call this concept NAV, which stands for Net Asset Value. At the same time, REITs are publicly traded stocks, and their share prices change on a daily basis. This means that REITs are almost always trading at either a premium or discount to the value of their underlying real estate.

Taking this line of reasoning to its logical conclusion, we can use NAV as an anchor point to construct a simple value strategy that consistently invests in REITs that trade at a discount to their NAV. In other words, we are buying REITs whose stock prices are below the value of their underlying real estate.

The chart below is a visual representation of this strategy in action using the rules we defined above. What we can see is that from 2012 until 2015 this strategy worked extremely well. In fact, until the beginning of 2015, the strategy had out-performed the REIT index by almost 5% per year! That's a huge amount of out-performance. After this period, however, our value strategy seems to lose steam, and as of the end of 2017, this strategy has only done about as well as the benchmark since 2010. Remember we want to find strategies that do *better* than the benchmark.



Does the recent fall from grace mean we should abandon the value approach in REITs? Is value-investing dead? I would not be so hasty to make such a bold pronouncement. Like all strategies, value investing has historically undergone periods of under-performance. While the data isn't as prevalent for REITs, value investing in the broader stock market has been shown to add value over extremely long periods of time, in spite of periods of under-performance. While two years of weak returns for value-investing is unfortunate, let's not totally rule it out. We can set it to the side for now and explore our second strategy, which is value's evil twin (or vice-versa depending on your perspective) …momentum investing.

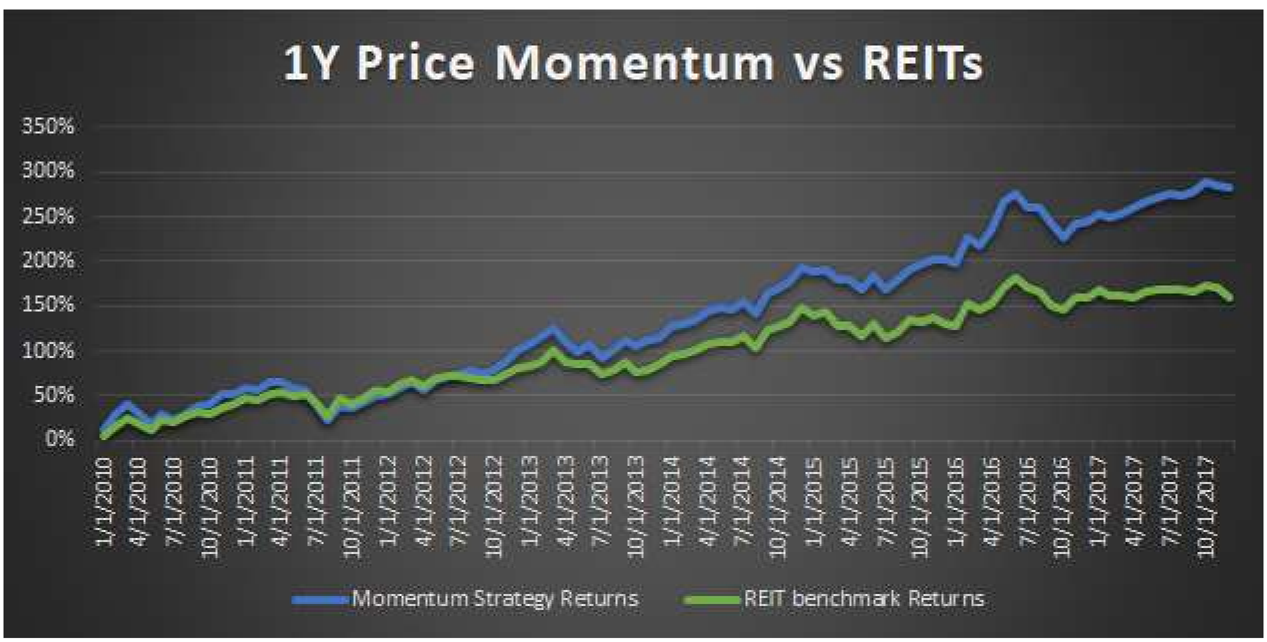
Momentum: Riding the Market's Hot Hand

Momentum investing is a newer discipline from an academic perspective but has been around in various forms for a long, long time. Momentum is often referred to as trend-following and is extremely simple and surprisingly powerful in almost all asset classes. It is based on the premise that what has worked in the past will continue to work in the future, which for many investors seems almost too easy. This may be part of the reason momentum continues to work, defying the skeptics and rewarding those willing to embrace it as a strategy.

In REITs, price momentum is rarely discussed, and I would argue not well understood. REIT investors are by and large real estate experts, and the thought of a stock going up, just because it's been going up, does not jive with their in-depth, fundamental, Buffett style approach. But does it work? As can be seen in the chart below, the answer is a resounding yes!

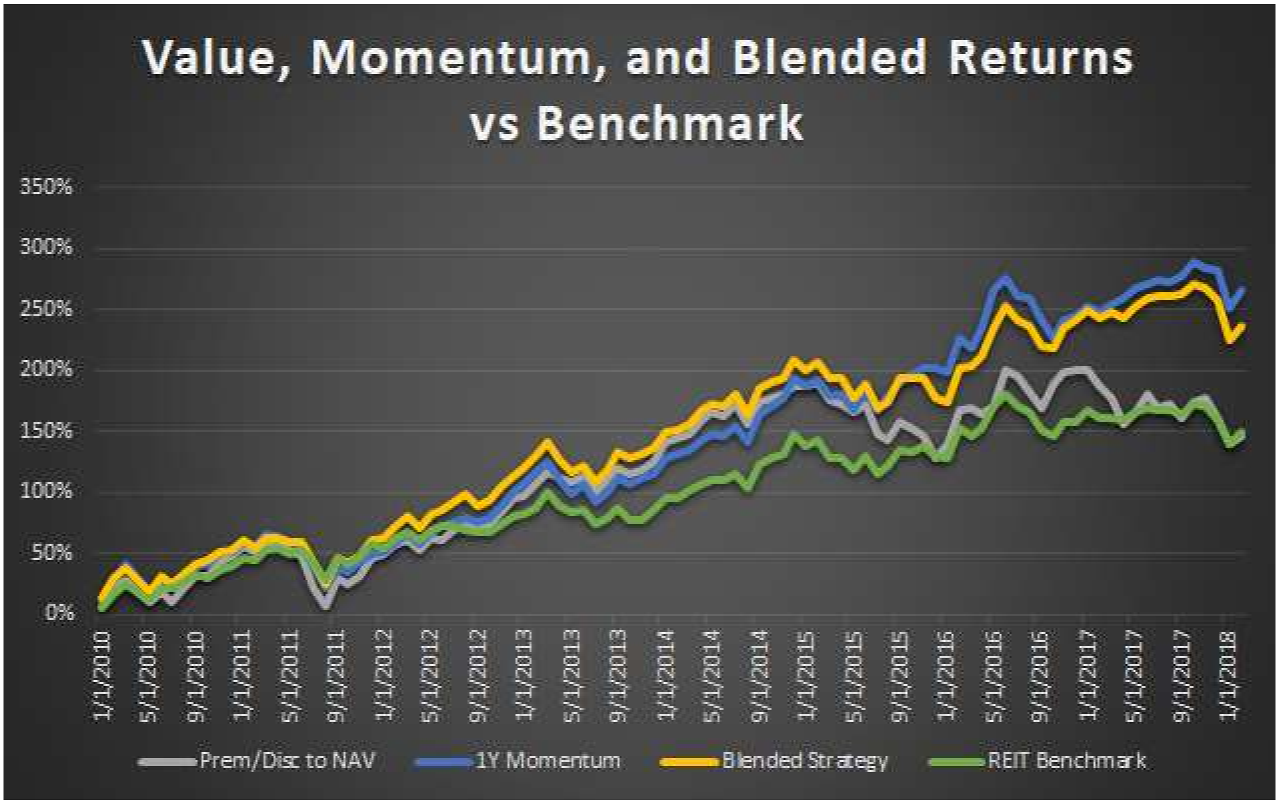
Since 2010, re-balancing into the top 10% of REITs based on 1-year price momentum has produced an annualized return of 18.52%. This is comparable to the REIT benchmark performance of 13.43% over the same period. That 5% per year gap is again a huge amount of outperformance. Momentum investing today looks just as good as value investing did going into 2015!

If that sounds a bit like a cautionary statement, you read it correctly. At this point in time momentum absolutely dominates value as a strategy for picking REITs, but how long this will be the case is anyone's guess. The emotional response to these two charts is to adopt a 1y price momentum strategy immediately, with often means it is the *wrong* response. It's just as hard to choose which strategy will outperform in any given year as it is to time the market, so which do we pick?



Why not both? Since the data is available, why not have our REIT cake and eat it too? Using a quantitative framework we can easily blend the two strategies together; effectively picking the best value REITs with the best momentum.

Value/Momentum Blend strategy: Balancing Risk and Return



What we get when we blend these two strategies together is a composite strategy that for a long period of time outperforms both individual strategies. While momentum has outperformed recently, our risk is lower over time using the blended strategy. This is the power of combing two unique ways of picking REITs into a composite model. When strategies are uncorrelated, you are better off owning some proportion of both consistently. Just like in a portfolio of individual stocks, diversification lowers your risk.

The Power of Quant

History makes it clear that there are simple strategies available to REIT investors (the Buffet strategy and the Momentum strategy) that can give them a slight edge in their quest for long-term performance. Value and Momentum are two quick and common examples of strategies that work well on their own and are uniquely powerful when combined. By following a basic set of rules, such as monthly re-balancing, a fully invested portfolio, and equal weights for each REIT, the average investor can construct a portfolio with a great chance of beating the REIT index over the long-term.

The power that these simple strategies unlock is especially impressive when considering that REITs returned 10.8% on an annualized basis from 1990 to the end of 2007. Those are returns that would make any card-counters mouth water. By following a disciplined process in a growing sector built on high quality real estate, investors stand a much better chance of making money than sitting across the table from even the friendliest blackjack dealer. While a similar approach can give you an edge in both, I'll take REITs any day of the week. I would imagine Dr. Thorpe would agree.

For more information on REITs, other REIT strategies, or REIT basics, feel free to reach out to Serenity Alternatives or see our REIT Primer.

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