Green Street

Heard on the Beach

Swim With the Tide

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Executive Summary

Momentum can be a powerful force in investing. The recent return of the Covid-era meme stock craze, if ever briefly, highlights the impact on stock returns that herd-like behavior can have. Many investors, particularly those with a contrarian bent, may see the mania and decide to avoid these bandwagons.

However, momentum effects are nothing to scoff at in commercial real estate. A simple strategy of overweighting recent winners and underweighting recent losers proves to be a surprisingly profitable one. Investors taking this approach would have generated meaningful alpha in their property sector allocation in both the public and private market, as well as in city selection in the private market.

Where momentum breaks down is in individual REIT security selection. Buying recently outperforming REITs relative to intrasector peers has been a historically poor trading strategy. The opposite – buying recent losers – has worked better.

Momentum can serve as a simple but helpful supplement to fundamental analysis. A far better approach, however, is a relative value assessment of sectors, markets, and REITs on their real estate fundamentals as this generally proves superior to only following the crowd.

RMZ: **1,203** | DJIA: **38,712** | 10-Year T-Note: **4.32%** | Baa Yield: **5.87%**

Heard on the Beach
June 12, 2024

Swim With the Tide: A beginner's lesson in swimming safety inevitably includes an introduction to riptides. Green Street's Newport Beach headquarters most likely has a higher proportion of surfers than the typical company, and all are aware of what to do when caught in one of these currents. The worst plan of action is to swim against the tide as going head-to-head with ocean currents is a losing proposition. Investors with a contrarian bent should take heed to this advice in commercial real estate, as similar themes play out across property sectors and cities. Swimming with the tide – or betting on recent winners – is a historically winning strategy in property investing.

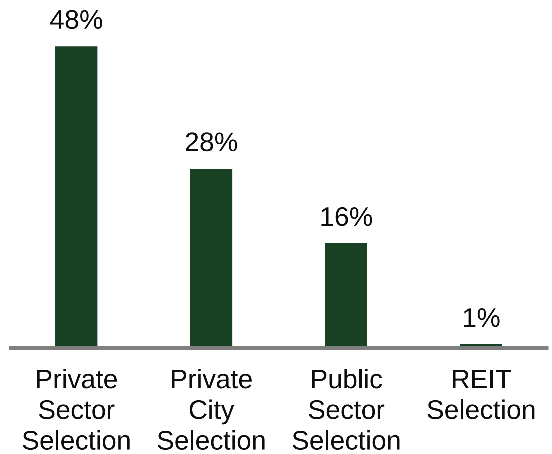
Betting on past winners feels intuitively wrong as an investor given the reasonable assumption that the good news is already priced in. Market efficiency suggests the low-hanging fruit is readily plucked, and any outperformance opportunities – particularly on such a simple premise – quickly removed. However, momentum effects are a longstanding and well-accepted anomaly in the stock market with entire strategies benchmarked against the "momentum factor". There is strong evidence of similar momentum effects in commercial real estate with the notable exception of REIT securities.

Momentum in investing refers to the concept that prior relative price performance provides predictive power over future relative returns. While anathema to all compliance officers, past has been found to be prologue across finance, including investment returns. Private commercial real estate is a prime area in which to examine momentum effects as the transmission of "new" news to values can take longer given less liquidity and higher transaction costs than marketable securities.

Underlying momentum is the idea that investors tend to underreact to new information. There is truth to this in private commercial real estate. Real estate valuations both in the form of Green Street's Commercial Property Price Index and appraisals tend to lag inflection points reflected in public REIT pricing. Green Street's CPPI moves materially faster than appraisal-based indices, but it still lags the public market's reaction to news by several months. This implies that pricing changes in the private real estate market can take several more months to manifest themselves than in the public market as our CPPI is designed to capture the 'real-time' bid for assets. Prior analysis has found that while full cycle moves in CPPI prices and appraisal-based indices are of the same magnitude, it can take over a year for the changes to materialize in appraisals – the optimal setup for momentum-based strategies to take hold.

Further, Green Street analysts tend to be surprised by changes in real estate fundamentals relative to prior expectations for consecutive quarters. In other words, there is momentum in forecast changes by Green Street: increases in rent/occupancy forecasts tend to be followed by more increases, and vice versa. This suggests both a reluctance to fully bake in new information and an under appreciation of lasting trend changes in a slow-moving real estate industry. In this regard, Green Street analysts are likely representative of many other market participants.

Long-term Alpha Capture of Momentum Strategies*



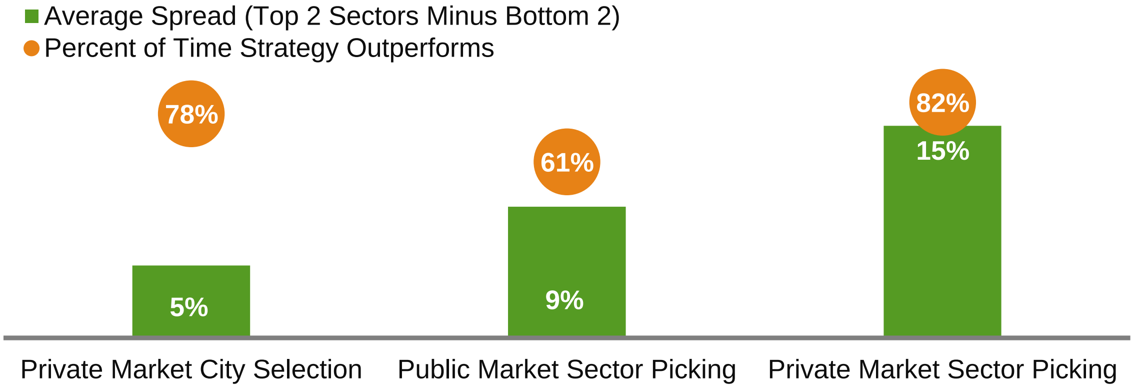
As a real estate investor, there are several different avenues to add value: public and private sector selection, REIT security selection, and private city selection. Momentum effects have been found to generate positive alpha across each one of these areas, barring REIT security selection. Simply overweighting the recently best performing sectors or cities and underweighting the worst performers would have generated meaningful outperformance over the past several decades. These findings reinforce prior analysis which found similar sector-level momentum effects in the public real estate market, but not in individual REITs.

The amount of outperformance generated relative to the potential outperformance – the so-called "alpha capture*" of a strategy – is high for these momentum strategies, particularly in the slower-moving private market. Buying recent winners is particularly useful for direct real estate investors at the sector and city selection level, as it tends to take much longer for news to filter to prices on Main Street than Wall Street. Momentum strategies perform better across sectors in the private market, where demand spikes take longer to translate into rent increases, and consequent development starts, resulting in outperformance for a long period of time and vice versa. One could also argue that private investors have had a visible tendency to follow recent trends and follow certain flagship investors, which likely further amplifies momentum investing. This can be seen in intention surveys in which investors usually promise to allocate growing amounts of capital in the next year to sectors that have recently performed well. Sector momentum is therefore the most powerful trend in private real estate investing.

* Defined as the spread between buying recent outperforming sectors and underweighting underperforming sectors on a quarterly basis divided by the maximum potential spread. The calculation of performance and the time periods used are described on page 4.

Momentum Alpha: Momentum effects in commercial real estate have been strong over the last twenty years. Sectors and cities that have outperformed over the last quarter tend to outperform in the next quarter. Three months is an admittedly unrealistic timeframe for changing direct real estate portfolios, but longer-term measures of recent performance (six and twelve months) suggest ample opportunities on the private side for this strategy.

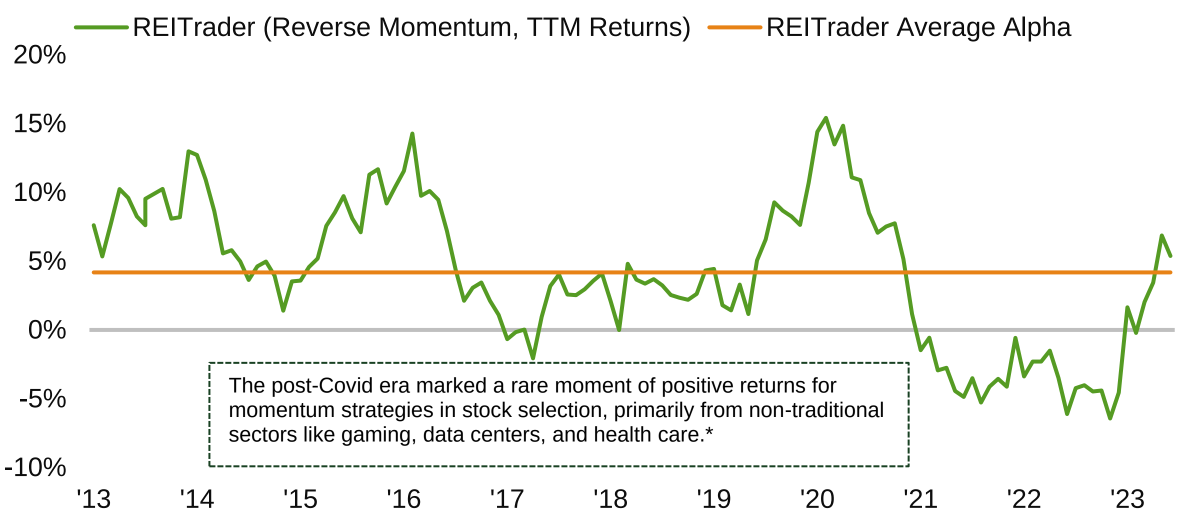
Prior Best Sector Performers vs. Prior Worst Performers (Rolling 12-Month Returns)*



* Rebalancing/ranking based on returns over prior three months. Public market sector averages use sector-specific REIT indices, while private market sector averages use Green Street's private sector-level historical returns. Private market city selection utilizes Green Street's market-level CPRIs intrasector to assess momentum at the city level. Private market sectors include apartment, industrial, office, self-storage, strip center, and single-family rental, while public market average also includes mall, net lease, health care, lodging, data center, and tower sectors. Data since '07 for private market, '97 for public market sector picking. The percentage of time of outperformance is defined as the number of quarters the strategy produced positive alpha versus the total number of quarters observed. CPRIs are available for download via Green Street's Excel Add-in. NCREIF data reveals similar results for sector and regional market selection.

The Odd One Out: Security selection within REIT sectors is the rare area where momentum-based strategies fizzle out. Selling winners is generally a better strategy in the public markets. This strategy tends to work better in sectors with more REITs than with fewer.

REIT Security Selection - Reverse Momentum Strategy*



*The health care sector represents the biggest outlier for reverse momentum strategies, as betting *against* recent winners would have resulted in a whopping negative 28%/yr. return over the last three years.
Source: Bloomberg, Green Street

Private city selection is another area where momentum shines noticeably bright. The simplicity in following the herd in city selection is hard to ignore: given less relative alpha in picking cities relative to sectors, the absolute outperformance and alpha capture is meaningful. More consideration in our private city selection will be given towards recently outperforming cities.

The one area where momentum falls apart is in REIT security selection. Generally, when REITs trade at unusually wide implied cap rates relative to sector peers, they tend to revert to the mean. Green Street has taken advantage of this market inefficiency via REITrader, which spots when REITs are trading meaningfully different from sector peers over sufficient timeframes. The post-Covid experience, however, has shown that alpha generating potential declined for anti-momentum strategies. This is a noticeable break from history, but not enough to call for a reversal of long-standing trends.

In sum, momentum strategies have a remarkably good track record outside of individual REITs. Fortunately for Green Street analysts and other real estate investors in need of gainful employment, fundamental analysis does offer demonstrable benefits. Green Street recently revisited its historical track record on sector, city, and REIT investing, and the scoreboard favors a relative valuation process based in rigorous underwriting.

Momentum denialists may cry foul at a few points in this analysis: turnover tends to be higher following momentum strategies, it therefore is more academic than real in its implementation in the private market, it ignores frictional costs of trading, and this analysis may be a quirk in the data rather than representing true valuation trends. The last point rings particularly true as the scope narrows from the daily pricing of public REIT securities down to the less frequently visited private marks in tertiary cities. Further, the performance track record presented herein represents a hypothetical track record. However, the consistency of alpha generation across various lines of commercial real estate investing – both public and private – suggests momentum-based strategies are worth their salt despite these criticisms.

It is best to think of momentum as a supplement to but not a replacement for fundamental analysis in commercial real estate. A thoughtful analysis of potential returns over a long-term time period, inclusive of cap-ex, cashflow growth assumptions, and others, has been a recipe for success for patient real estate investors. However, investors should be mindful of the area where the Venn diagram of fundamental analysis and momentum overlaps, as the odds are arguably – and historically – tilted towards outperformance.

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Green Street

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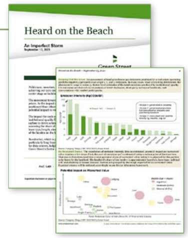

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