JULY 2016
www.bdo.com

AN ALERT FROM THE BDO REAL ESTATE AND CONSTRUCTION PRACTICE

BDO KNOWS:
REAL ESTATE

REITS SPLIT OFF INTO NEW S&P SECTOR

BACKGROUND

REITs will soon have a new home on Wall Street.

On September 1, publicly traded equity REITs will be spun off from other financial stocks under the Financials sector into a newly created 11th sector in the Global Industry Classification Standard (GICS); the first addition of a new sector since its introduction in 1999. This will result in changes to the manner in which REITs are classified in a number of indexes, such as the Standard & Poor's (S&P) 500.

IMPACT

Questions remain as to how this reclassification could impact the industry. REITs have flown under the radar in recent years, perhaps due to lingering fears from the Great Recession. Now, however, there is a notable shift in the investment community toward viewing real estate as a core asset to include in portfolios. Real estate's low correlation to stocks and bonds can help lower a portfolio's overall risk.

As the low interest rate environment continues to hinder bank profits, Morningstar reports that investors pulled out approximately $4.8 billion from mutual funds and exchange-traded funds that focus on financial stocks during the first quarter of this year. The new sector distinction will separate REITs from other financial stocks that experience bigger performance swings. This could heighten awareness of REITs' advantages, stability and performance among investors and fund managers.

Index changes generally spur an uptick in trading activity. Some analysts have suggested this change could prompt a significant increase in demand for REITs. Forty percent of core mutual funds don't own any REITs. And those that do hold only 2 percent of their assets in REITs, according to Goldman Sachs. As a result, many funds will be underweight in REITs and might opt to purchase. Analysts suggest that inflow would come primarily from existing investors increasing their allocations in an effort to ensure their portfolios cover all sectors.

On the flip side, some purely financial sector-focused funds might look to sell off their REITs to remain aligned with the financial sector index. This movement of money away from REITs could be offset, however, by new funds targeting the real estate sector as well as allocations by general funds into the new REIT sector.

BDO INSIGHTS

REITs have been listed in the S&P 500 alongside financial stocks, including banks and insurers, since 1999 when these sectors were formed. Because REITs make up about

Read more

HOW DO I GET MORE INFORMATION?

BDO's Real Estate and Construction practice consists of multidisciplined professionals, well-versed in compliance and consulting matters. For more information, contact:

STUART EISENBERG
National Real Estate & Construction Industry Practice Leader
212-885-8431 / seisenberg@bdo.com

IAN SHAPIRO
Real Estate and Construction Practice Co-Leader
305-420-8052 / ishapiro@bdo.com

BRIAN BADER
Assurance Partner, New York
212-885-8203 / bbader@bdo.com

BRENT HORAK
Assurance Partner, Dallas
214-665-0661 / bhorak@bdo.com

EDWARD PLUNKETT
Assurance Partner, Greater Washington, D.C.
703-770-6353 / eplunkett@bdo.com

KEVIN RILEY
Assurance Partner, Orlando
407-841-6930 / kriley@bdo.com

CHRISTOPHER TOWER
Regional Managing Partner, Assurance, Orange County
714-668-7320 / ctower@bdo.com

20 percent of stocks in the financial sector, this change may impact significantly the allocation of and availability of investor dollars to REITs.

The tides could shift even before the new sector division goes into effect. REITs have been outperforming other asset classes consistently in recent years, but there has been concern expressed that REITs should be prepared for the possibility of the big gains experienced over the past 15 years leveling out as the current economic cycle progresses.

While the Fed eyes a potential rate hike as soon as September, market fundamentals could shift away from the current mix, which has been favorable. REITs should remain cautiously optimistic as they look to deploy capital. REITs that lease space on a longer-term basis, such as healthcare or office REITs, may be more shielded from the economic ripple effects a rate hike could create. Other sectors that are more exposed to the turbulence of the broader economy and consumer confidence, like mall REITs, could face greater risk with the added exposure the sector distinction might bring.

The heightened awareness of REITs and their performance could sustain or even escalate the recent uptick in investor activism. Current reporting requirements for REITs result in the availability of a large amount of property-level information. This allows investors, including activists, to derive their own opinions of a company's value, and trade or act on that information. In the last year, more activists have engaged in public struggles with REITs in an effort to push them to unlock more value from their assets. Activist shareholders launched 26 campaigns against REITs in 2015 alone, according to SharkRepellent.Net. If demand for REITs increases, the sector will draw more attention from all investors, including activists. Contingency planning will be important for REITs responding to the threat of rising shareholder activism.