Commercial real estate historically has shown low or negative correlations with other major financial and real asset classes, which provide investors with diversification. This has led to a view that real estate investment trusts (REIT) stock prices should not be affected by overall equity prices, and that REITs should have a low statistical relationship (covariance) with other assets, including other REIT sectors. However, the evidence in this study does not support that view.

The authors found a high percentage of synchronicity, or co-movement, in the equity REIT market, particularly when larger, more liquid REITs are compared. The research further shows that the level of synchronicity is highest among regional malls, office and industrial REITs, and much lower among apartment, health care and mixed (i.e., diversified) property REITs.

Normally, one would not expect movements in REIT stock prices to be highly correlated, particularly with specialized REITs defined by a single property type or a single geographic location. One would assume that specialized REITs would provide diversification benefits to a portfolio, as REIT stock prices should be largely independent of market changes, given that underlying real-estate assets have the benefit of being a “spatial monopoly.” However, because of a “herd effect” by types of buyers (in particular, the insurance companies and pension funds), REIT stock prices appear to move together more as investors tend to buy the same types of properties (high end, class A), in the same markets (major metropolitan areas), over the same time period. This impacts pricing, as buyers all pursue the same assets at the same time.

The authors used REIT return data from the University of Chicago’s Center for Research in Security Prices to investigate co-movements in REIT stock prices. This study analyzed a sample of 216 NYSE, ASE, or NASDAQ-listed equity REITs and real-estate companies, divided into eight REIT groups, plus a catch-all category for all real-estate operating companies. The eight REIT groups are divided by property type: apartments, health-care, hotels, industrial, mixed, office, regional malls and shopping centers. Three main issues were examined: the impact of asymmetric information about the value of assets in a REIT, the ability to signal REIT asset quality to investors, and the impact of short-sale constraints on REIT stock-price movement. This review will focus on the first two sets of results.

The asymmetric information problem states that all REITs want to signal their asset quality to investors, and that for larger REITs there are generally more informed traders, meaning that one should expect the larger REITs to have fewer similarities with each other and/or the general stock market. In addition, one should expect stock prices of larger REITs to have greater information content than stock prices of smaller REITs. Using hedge-fund ownership as a proxy for informed buyer or seller, the authors hypothesized that REIT stocks with a higher degree of such ownership should have a lower level of synchronicity with other REITs that had fewer hedge-fund investors.

The hypothesis that hedge-fund ownership would have a smaller amount of co-movement was found to hold true, and REITS with a higher degree of such ownership were indeed less synchronous. But the REITs that were heavily owned by pension funds and insurance companies tended to be much more synchronous.

In many respects, this finding is not that surprising. Institutional investors seek stable returns. Institutional investors seek stable returns in the same property types. So the level of positive co-movement was the highest among regional mall,
office and industrial REITs, while REITs made up of more diverse investments, such as open-air shopping centers, were less likely to move together. Given the similarity in tenants found in regional malls as well as the large capital needed to make these sorts of investments, these REITs tend to attract pension funds and insurance-company investors. The typical investment of a shopping center-REIT will be a grocery-anchored neighborhood shopping center whose tenants are more likely to depend on the local economy, and investments held by these REITs will be much smaller both in terms of square feet and value.

Next, the authors tested whether asymmetric information was the reason for the high synchronicity. The hypothesis was that with a high known risk, the synchronicity to REIT stock prices should be high, while with a low known risk, this co-movement should be lower. Results provide evidence that this is not the case, however. Again, regional shopping centers and industrial properties have much lower risks than the shopping-center investment, yet the pricing behavior for the former REIT types was much more similar than for the latter, more locally based shopping center. Another potential explanation was that the size of the REIT matters. The authors hypothesized that REIT stock-price synchronicity should decrease as the firm size grew. Again, the authors found the opposite to be true.

When REITs are compared to other REITs, rather than examined in a more common multiple-asset framework, they were found to be much more similar in performance, particularly for REITs that are larger and more liquid. The level of synchronicity was found to be highest among industrial and regional mall REITs, and lower among apartment, health care and mixed property REITs, making the asset-allocation decision into the types of REITs for diversification benefits extremely important. In short, not all REITs are the same, and investment strategy as well as ownership within the REIT matter.

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