VIEWPOINT

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For professional staff only

THE REIT CHOICE?

Investors often seek access to opportunities that, as the saying goes, are as safe as houses. Those looking to build a foundation in the property market could do worse than consider investing in Real Estate Investment Trusts (REITs), says Alan Supple, managing director, global real estate securities at BNY Mellon IM EMEA[1]

The arguments for investing in property are compelling. Across the world, but especially in emerging markets, urbanisation continues apace. In the next 15 years, the world is forecast to add another 1.1 billion city dwellers, nearly the equivalent of the population of India[2] and, as that population grows, so will demand for new offices, shops, homes and industrial and logistics facilities. In the developed world's more established markets, meanwhile, bricks and mortar have generated extremely good returns. In the UK, between 1999 and 2013, for example, average house prices in the UK rose from £93,000 to £247,000, a 166% increase. [3]

While commercial property and industrial real estate may have enjoyed less stellar returns, the asset class remains an important avenue for accessing growth in a wide variety of markets and industry sectors around the world. In London, the hiatus in new office development following the global financial crisis has led to a bottle-neck in supply as the wider economy recovers and demand increases. Office vacancy levels for London in September, 2014, were 8.2%, according to real estate company Savills. By 2019, this will have fallen to 4.4%, according to Knight Frank's *Global Cities Report*, making for one of the lowest office vacancy rates among the world's leading cities. The same story – of pent-up demand running into a shortage of supply – is a global one, though, with Shanghai, Tokyo, Paris and New York all experiencing the same predicament.

Against the recent backdrop of global economic recovery, says Supple, investing in a property fund seems a very good bet. Partly this is because of property's ability to generate predictable income returns. In effect, he says, investors get two bites of the cherry: potential capital appreciation if the value of the buildings in a fund increases, plus rental income from the tenants using those buildings.

DIRECT FUNDS OR REITS?

But what are the best strategies for gaining this kind of exposure? One option, says Supple, is to invest in a direct 'bricks and mortar' fund, a fund that buys and manages physical assets such as offices, shops, factories and warehouses. Each fund typically owns a range of buildings diversified by type and location and offers a degree of liquidity since, in the case of an open-ended fund, investors can buy and sell shares in the investment vehicle. However, in falling markets where there may be more sellers than buyers, the structure of these 'direct' funds may pose challenges for both the investor and the fund manager. First, to meet redemptions in a falling market, direct fund managers may be forced to sell underlying assets at the wrong time, thus potentially destroying value. If markets continue to fall, investors may then find their exit from the fund hindered by outflow constraints. This is what happened during the financial crisis, says Supple, when many holders of direct property funds found themselves in exit queues until markets picked up and managers were once more able to sell underlying assets at an acceptable price to meet redemption requests.

[1] BNY Mellon IM EMEA is the UK representative of CenterSquare Investment Management, a wholly owned investment boutique subsidiary of BNY Mellon, specialising in real assets investment management

[2] Knight Frank, *Global Cities, The 2015 Report*

[3] This is Money: *Historic inflation calculator: how the value of money has changed since 1900*; ONS data

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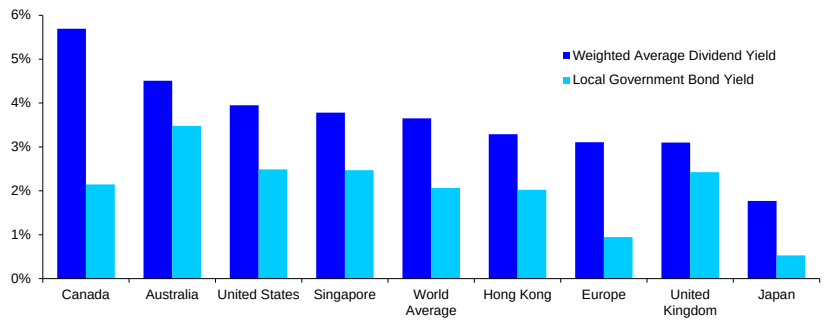
Figure1: Dividend yields vs. Government bond yields in regions of the FTSE EPRA/NAREIT developed index



Source: Bloomberg, FTSE, September 30, 2014. Data represents the weighted average dividend yield of the stocks in each region of the FTSE EPRA/NAREIT Developed Index vs. the local government bond yield in that region.

Direct funds are also exposed to the so-called 'cash drag'; that is, the time lag between flows into a fund and the time it takes to buy physical assets. Supple explains: "It is difficult to deploy capital at speed to buy physical assets. It can take six months or more to buy a property and, in the meantime, those flows into the fund may be sitting idle, with investors potentially missing out on any real estate exposure."

REITS: DIVIDEND INCOME; HIGHER LIQUIDITY

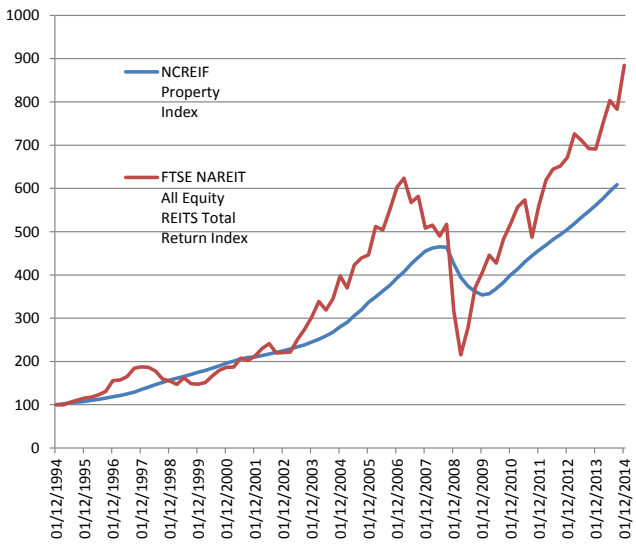
An alternative to direct funds is to invest indirectly in property via real estate investment trusts (REITs) – companies listed on major stock exchanges that enjoy corporation tax exemptions in return for an obligation to pay a high proportion (typically 90%) of profits to shareholders. These vehicles have tended to produce competitive dividend yields, says Supple, (see Figure 1) and a steady stream of income through a variety of market conditions. The legal requirement to pay dividends also encourages management to maintain capital discipline to safeguard these pay-outs.

More importantly, though, REITs offer vastly improved liquidity compared to direct funds, especially if investors choose a REITs fund. These funds are highly liquid since they invest in companies whose shares can be bought and sold freely, with pricing that is more transparent. This means investors can redeploy capital relatively rapidly should they wish to adjust their exposure to a particular sector or geography. It also means an absence of exit 'gates' in times of difficulty – as well as very limited time lag relative to direct funds in deploying inflows and thus gaining exposure to the property market.

The investment universe is further broadened, says Supple, if investors consider listed real estate securities; that is, companies that do not enjoy the tax benefits of the REIT structure, but offer exposure to returns from real estate development, as well as significant geographic and sector diversity. From Brazilian shopping malls, to Canadian care homes; from Indonesian infrastructure, to prime office space in New York, listed real estate spans the depth and breadth of the market, enabling investors to access niche opportunities around the world and benefit from the specialist, boots-on-the-ground knowledge of locally based management teams who are experts in their field. This is not always true for direct property funds, which tend to specialise in developed market situations.

Meanwhile, the REITs universe is growing. Although US REITs have been around since 1960, the asset class is a relatively new one in other countries. In the UK, for example, REIT legislation was only introduced in 2007. Inevitably, then, there has been an element of 'catch-up' as property companies around the world begin to apply for REIT status – but the momentum is

US REITs have outperformed US direct property



Source: Bloomberg data Jan 2015. Price performance rebased to 100. The NCREIF index is calculated to reflect the quarterly total returns % on a compounded basis of the underlying NCREIF Property Index, a quarterly time series composite total rate of return measure of investment performance of a large pool of individual US commercial real estate properties acquired in the private market for investment purposes only. The FTSE NAREIT All Equity REITS Total Return Index is a free-float adjusted market capitalization weighted index that includes all tax qualified US REITs listed in the NYSE, AMEX, and NASDAQ National Market.

Figure 3: Listed real estate has outperformed other asset classes over the long term

	Total return (USD) annualised as at 31 Dec 2014			20-year[1] annualised daily volatility
	3 years	10 years	20 years	
FTSE EPRA/NAREIT Developed Index[2]	+15.9%	+6.9%	+9.5%	16.3%
MSCI Global Index	+16.1%	+6.6%	+7.6%	15.3%
S&P Global SmallCap Index	+16.0%	+8.0%	+9.0%	15.2%
JP Morgan Global Aggregate Bond Index	+1.0%	+3.9%	+5.8%	5.4%

Source: Bloomberg. Past performance is not a guide to future performance.
[1] MSCI Global based on monthly return data; all other indices based on daily returns.
[2] European Public Real Estate Association/National Association of Real Estate Investment Trusts.

now increasing. The size of the developed market listed real estate universe continues to build, with a global market capitalisation in 2006 of US$905bn growing to US$1,254bn by the end of 2014. [4] By the same token, global developed market real estate IPOs totalled US$23bn in 2013, in line with the pre-financial crisis peak in 2006 and more than double the total seen in 2012. Although the pace slowed to US$17.5bn in 2014, the market for high quality new issues remains robust.[5]

A further compelling argument in favour of REITs is their relative outperformance versus direct funds (see Figure 3 above). Supple says: "Despite inflows into direct property, the reality is that REITs have high quality assets and proven management teams and they've been the ones that have best capitalised on the market conditions since the tail end of the global financial crisis."

Yet despite these advantages, direct property funds remain by far the most popular destination for investors. Data from FE Analytics reveals the top-five UK direct property funds have seen combined inflows of c.£3.35bn over the past year. Despite comparable or better performance over the same period, the top-five listed real estate securities funds, which predominantly focus on REITs, experienced outflows of c.£449m. [6] "There's been a love affair with direct property," says Supple. "Certainly, in recent years if investors have wanted to express a view on property they've put their capital into a direct fund."

This may be because REITs have tended to trade at a discount to their net asset value, or it may be because of the perceived lower volatility of direct funds. Unlike REITs, the argument goes, direct funds are slightly removed from the vagaries of the capital markets and so tend not to react to the short-term peaks and troughs of day-to-day macroeconomic newsflow and investor sentiment. But, says Supple, this is largely an illusion. The values of direct property funds are appraised periodically, rather than daily, like stocks, so they only appear more stable. Research shows while REITs are correlated to equity markets in the short term, in the long-term, once this 'smoothing' effect has been removed, returns from REIT and direct property funds converge. [7]

OUTLOOK

Perhaps, though, there is space for a range of approaches in an investor's portfolio. Supple notes that direct funds operate in some specialist niche areas where REITs have no presence. There is also evidence to suggest that highly leveraged, high risk direct funds may outperform REITs on an annualised basis during bull markets. [8] But even here, he notes, many of these funds are typically private equity vehicles which are not available to retail investors.

[4] FTSE/EPRA NAREIT Developed Index Series (Source: EPRA, 2015)
[5] Source: Bloomberg data 30 Jan 2015
[6] FE Analytics, 19 Jan 2015

[7] Hoesli, M. & Oikarinen, E., *Are public and private real estate returns and risks the same?,* EPRA Research, 2014
[8] National Association of Real Investment Trusts, *REITs: Real Estate with a return premium,* May 2010

Says Supple: “A lot of the data shows that it’s not necessarily a bad thing to mix your REIT exposure with some direct fund and listed real estate company exposure too. We believe each investment type may offer a different short-term benefit or strategic strength depending on the market cycle. REITs’ strong income profile, lower transaction costs and higher liquidity make them a valuable complement to a more opportunistically focused private real estate market allocation,” he adds.

INVESTING IN DIRECT PROPERTY FUNDS V. REITS

Direct (open) property funds

Rental income plus possible capital appreciation

Index-linked rental increases may provide inflation protection

Limited diversification across geographies, industrial sectors and property types

But:

Limited liquidity: it may take time for a fund to sell the properties it owns directly and to pass on those gains to investors

No obligation to pass on profits as dividends

High costs associated with buying buildings directly (stamp duty, land tax etc)

REITs

Rental income plus possible capital appreciation

Index-linked rental increases may provide inflation protection

Highly diversified across geographies, industrial sectors and property types

Legally obliged to pay out 90% of profits as dividends

Highly liquid: investors can buy and sell shares at short notice

As publicly traded companies, provide a high level of transparency and disclosure

But:

Often trade at a discount to market capitalisation

Highly correlated to equity markets in the short term (although less so in the long term)

Short-term correlation with equities equates to higher volatility

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