Listed real estate: an unexpected buttress against rising rates?

After a strong year for listed real estate securities, many investors are wondering whether the sector can continue to grow in an economic environment which may see rising interest rates. We think it can. Indeed we think listed property can be a useful diversifier for investors looking for a way to gain exposure to real estate, traditionally seen as an illiquid asset class. Typically, real estate investors tend to allocate only to their domestic market and predominantly to physical assets. In fact, real estate securities give exposure to companies with high quality management teams around the world in a variety of sub-sectors, thereby reducing the risk to investors who do not have the knowledge to invest directly.

In 2014 the listed real estate sector (which includes REITs) delivered returns of over 15%, with the US alone rising by over 30%[1]. We believe that the continuation of a low growth environment will be supportive of the real estate sector as long as investors are selective in their approach. With bond yields at historically low levels and investors searching for income, real estate offers both income and the potential for capital growth.

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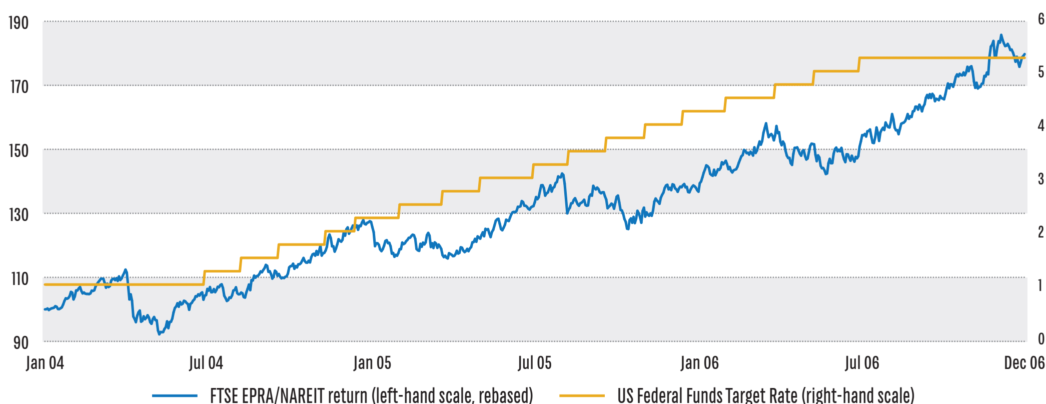
Will resurgent rates demolish returns?

There is a strong – and we believe misguided – belief that, as interest rates rise, the listed real estate sector will underperform. If increasing rates drag bond yields up, the expectation is that investors will move back into bonds from other higher yielding asset classes.

Figure 1: Interest rates and real estate can move up together



Source: FactSet, Thomson Reuters Datastream, Schroders as at 31 January 2015.

It is certainly true that the announcement of increases in interest rates, or indeed other measures designed to limit economic growth, can cause short-term volatility in the listed

1 FactSet, FTSE EPRA/NAREIT Developed, FTSE EPRA/NAREIT USA, in US dollar terms, gross, unhedged.

property sector. This happened in 2013 when the US Federal Reserve (Fed) announced that it would taper its bond buying programme. However, it is worth looking a bit further back in history to gain some clues as to how the market reacts over a slightly longer period. The period 2004 to 2006 saw a total of 17 US Fed rate increases against the background of an improving economic climate. Despite that, over these years the US listed real estate market still delivered returns of almost 80% (Figure 1). This does not suggest a negative relationship between tighter money and the real estate market.

There is no question that many investors are constantly on the lookout for more promising income propositions. However, with US 10-year Treasuries currently yielding less than 2% and 30-year Treasuries less than 2.6%[2], it will take a significant correction to make them attractive compared with higher yielding companies in the property sector. For instance, a number of Australian property companies are currently paying dividends of 5% or more, as are a number of Singapore REITs[3]. Even in the stronger markets, such as the US West Coast and London, bond yields will have to rise by a notable margin to be a threat.

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This suggests that those markets offering both strong fundamentals and higher yields are more protected from the impact of rate rises, at least in the short to medium term. Further out, the likelihood is that any tightening announcement by the Fed this year will be as a result of an improving economy. Even then, such a decision will not be taken lightly and any increases will probably be in small steps, as a sharp rise could imperil the recovery.

Rising rents should provide robust underpinning

If, as we suspect, economic growth and business sentiment are improving by the time rates start to go up, companies will want to expand their workforces and will need space to accommodate the growth of their businesses. In these circumstances, they will gravitate towards those locations that will give them a competitive edge. These places tend to be the major global cities as businesses seek to keep pace with their global customer base.

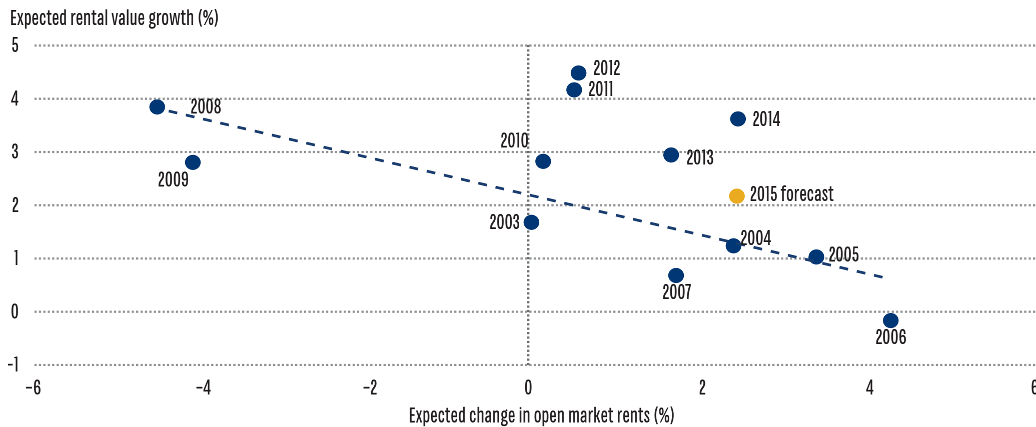
Times Square Tower, New York

As things stand, increasing occupier demand is already resulting in rental growth, particularly in prime areas in major cities. This is good news for the listed market, which tends to own the best assets in these locations, such as 20 Fenchurch Street (otherwise known as the Walkie Talkie) in London and Times Square Tower in New York (pictured). As long as there is sustained rental growth, then any modest increases in interest rates are unlikely to have any significant effect on the attraction of these assets for investors. This is borne out by history: if we take the UK market as an example, the short-term relationship between real estate yields and 10-year gilts has historically been very weak. The correlation over the last 15 years has been zero. This suggests that, while 10-year gilt yields are an important anchor, or reference point, for real estate yields over the long term, in the short term the main influence has been the outlook for the economy and investors' expectations for future income growth. By contrast, investment grade corporate bonds have tended to move with 10-year gilt yields and are quite highly correlated at 0.52[4].

Figure 2 (overleaf) plots the spread between property and bond yields against rental growth expectations over the last 10 years. In 2006, real estate looked expensive, with average yields below long-dated gilts, even though there was strong rental growth. Despite the rapid re-pricing (downwards) in 2007 and 2008, the spread over gilts was still not sufficient to tempt investors back, especially as rents began to tumble. The real estate sector only started to see investors return once rents stabilised and the spread over gilts grew.

2 FactSet, as at 24 March 2015.
3 FTSE EPRA/NAREIT.
4 IPD Annual Index to end 2014, Thomson Reuters Datastream.

Figure 2: Rental growth should temper the impact of rising gilt yields



The regression line is based on the decade up to 2010 and deliberately excludes the last few years to give a rough indication of rational pricing.
Source: Bloomberg, IPD Monthly Index and Schroders, as at March 2015.

Income is undoubtedly the core of real estate returns, but in many markets capital growth has also been a significant factor. This capital growth is being driven by the significant increase in the sums being allocated to real estate around the world. Investors are seeking high quality property in prime locations, property which has traditionally been owned by the listed sector. These property companies should therefore be able to cash in on the increasing values in these areas, redeploying the capital to new projects where they can create value and provide a growing and sustainable rental stream.

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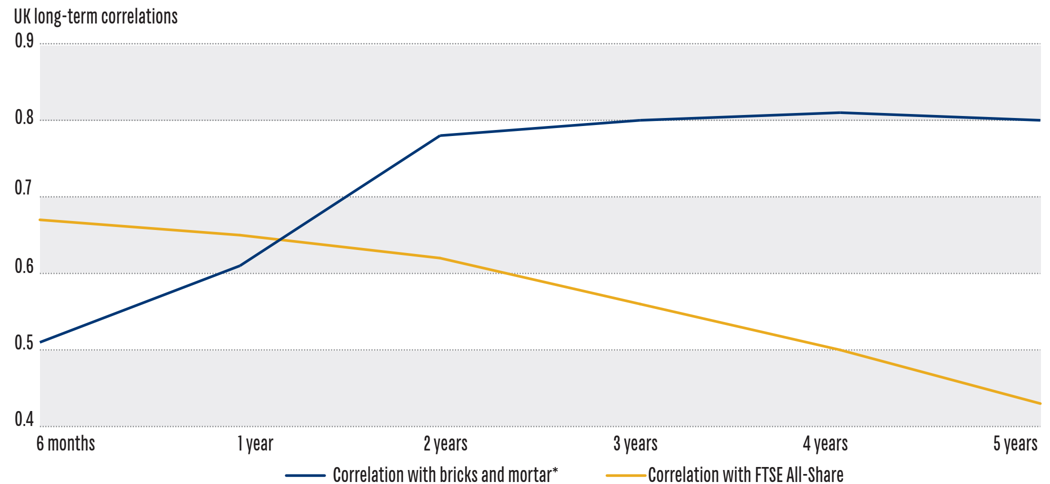
A well balanced supply

The final part of the jigsaw is supply. The biggest risk to the property sector is oversupply, particularly as economies recover and developers push ahead with construction. The good news is that in many locations new construction is being undertaken only on the back of space that has already been let. The low level of supply means that those companies owning property in the more desirable locations are seeing, not just capital appreciation, but rental growth too. This is providing them with another source of rising cashflow to take advantage of new opportunities as they arise.

Longer term, some markets are still woefully short of supply. For instance, in the Hong Kong market it will be some time before developers catch up. This means that investors in listed real estate should be able to anticipate any significant increase in supply well in advance and adjust their allocations accordingly. Investors will still need to be selective as to the companies in which they invest. We believe companies with experienced management teams, strong balance sheets and strategies that will be rewarded by long-term trends, such as technological advances or demographics, are likely to offer the strongest returns.

Evidence demonstrates that, over the longer term, the correlation of listed real estate securities is closer to “bricks and mortar” than equities. If we compare the correlation of UK listed securities against the equity market and physical property (Figure 3), after about 18 months listed real estate securities correlate more closely with “bricks and mortar” property than equity markets. This is also the case for the US market, which shows similar correlation with bricks and mortar. We recognise, however, that short-term volatility remains a challenge for some investors. We believe, however, that any short-term volatility in the equity market is a great opportunity for active real estate managers to increase positions in strong companies.

Figure 3: Correlations with equities diverge over longer periods



* IPD/AREF's PPFI All Property Funds
Analysis based on monthly data from second quarter 1990 to fourth quarter 2014. Source: FT, Investment Property Databank, Thomson Reuters Datastream, and Schroders, as at December 2014.

Technical enhancements

The attractions of listed property should be further enhanced from August 2016, when real estate will become the 11th sector in the Global Industry Classification Standard (GICS) and the first to be added since GICS was launched in 1999. GICS has stated that the reason for the addition of real estate was because feedback from investors had "confirmed that real estate is now viewed as a distinct asset class and is increasingly being incorporated separately into strategic asset allocation". The move will certainly give the sector its own status with MSCI, one of the major index providers. It should result in a reduction in the sector's volatility and enhance its ability to provide liquidity and diversification.

There is a significant quantity of research which suggests that investors should include both listed and unlisted exposure in their portfolios. Such a blend can enhance returns and provide liquidity. At the same time, the large amount of capital seeking real estate exposure is making it difficult for investors to find deals and is resulting in increasing capital values. The listed sector allows investors to gain immediate exposure, without investing in direct property portfolios which may have to hold high levels of cash while they try to gain access to physical assets.

> "Both the historical evidence and current fundamentals suggest that select real estate markets should continue to prosper if monetary policy tightens.

Conclusions

We do not believe rising interest rates should deter investors from investing in property. Both the historical evidence and current fundamentals suggest that select real estate markets should continue to prosper if monetary policy tightens. If, on the other hand, we remain in a low interest rate environment, then the growing income yield that the best real estate companies can offer will become increasingly attractive. The key to a successful strategy is the careful selection of stocks. Not all regions, countries and companies were created equal. However, a global fund allows the investor to invest in the strongest markets and sub-sectors, wherever they may be.

Andrew Robbens, Product Manager, Real Estate