Good Reasons to Invest in Global REITs

By **Mick O'Brien**
Invesco Australia

Mick O'Brien was appointed CEO of Invesco's Australian business in July 2006. He was previously director, retail sales & marketing, a position he had held since August 2004 where he led significant progress in Invesco's retail business.

Before joining Invesco, Mick was chief investment officer at AXA Australia and New Zealand, with overall responsibility for managing more than $30 billion of assets. Mick was previously a director of Alliance Capital Management's companies in Australia and New Zealand. Mick has 27 years' experience across a range of areas in wealth management and financial services. At AXA Asia Pacific Holdings (and its predecessor National Mutual), he held a variety of senior roles in marketing, funds management, product development, strategy, Asian development, actuarial management and superannuation consultancy.

Mick is qualified as a Fellow of the Institute of Actuaries of Australia and also holds the Chartered Financial Analyst designation.

Property is typically used in a portfolio to add diversification and to provide a stream of regular income. However, as direct property is an illiquid asset class, many investors prefer to gain their property exposure via listed property securities, which provide liquidity.

The Australian listed property securities market does provide exposure to high quality properties across most sectors. However, the market also exhibits a number of particular characteristics that investors should carefully consider. Firstly the market is highly concentrated by manager, with the top five securities representing more than 70 per cent of the market. Secondly, many of the larger REITs in Australia trade in the form of stapled securities, where an operating business is 'stapled' to the property vehicle. In these circumstances the nature of the investment is higher risk and the exposure isn't simply pure property exposure, lessening the diversification benefits.

So when investors are looking for property exposure and wanting that exposure to be liquid in the form of property securities, investors are increasingly looking to the global listed property market.

The global listed property:

- provides better diversification benefits than Australian REITs (AREITs) – and
- still provides significant liquidity benefits.

In this paper we look at the characteristics of global REITs.

WHY CONSIDER GLOBAL REITs?

The benefits of 'going global' in listed property investment are increasingly being embraced by Australian investors. By allocating a percentage of client assets in global real estate investment trusts (global REITs), investors can achieve far greater diversification by geography, sector, manager and stock than by simply investing in Australian REITs.

The global REITs universe, which includes Australian REITs, provides increased investible opportunities as a growing number of countries establish liquid markets in listed real estate securities.

There are a number of reasons why investors should consider investing in global REITs. The key reasons are:

- significant diversification benefits of global REITs
- the significant size of the global REIT market and the opportunities it provides
- the growth of the global REIT market
- other factors such as potentially improved prospects in some markets.

We discuss each of these reasons in more detail below.

1. SIZE OF THE GREIT MARKET

The global REIT market, represented by the FTSE EPRA/NAREIT Developed REIT Index, is currently capitalised at A$483 billion and contains around 280 listed securities (as at August 2010). This Index continues to grow strongly in 'organic' terms, driven by capital raisings, new issues, and more recently, market growth.

In contrast, the Australian REIT market has consolidated significantly in recent years. From 60 trusts in the early 1990s, the sector comprises only 22 trusts today. Of that, a large proportion of the sector's market cap comprises Westfield Group (see example below) and a handful of other trusts. So while the Australian REIT market is still a reasonable portion of the global REIT market, it is a highly concentrated sector.

Global REITs can provide investors with a deep, liquid and diverse market of tradeable real estate securities.

The sheer size and diversification of global REITs provides investors with a much greater source of value-adding (alpha) opportunities from active management. The opposite is true in Australian REITs, where the concentration levels of the sector provide little room for alpha generation. It's also worthwhile remembering that, although very large, the global REIT universe comprises just 10 per cent of the world's commercial real estate. Hence, there is still a very significant untapped growth potential for investors in REIT markets globally.

Example – Westfield Group

In June 2010 Westfield comprised 40 per cent of the ASX 300 A-REIT Index (from a high of 51 per cent in March 2009) and had a market cap of $25.8 billion. Westfield has had a return correlation of 89 per cent with the ASX 300 A-REIT Index. By placing a significant portion of asset allocation in A-REITs an investor is likely to have a very large exposure to Westfield. Hence true diversification (the prime reason for investing in property) is not possible. Figure 1 shows the close correlation of performance returns between Westfield and the S&P/ASX 300 A-REIT Index over more recent years.

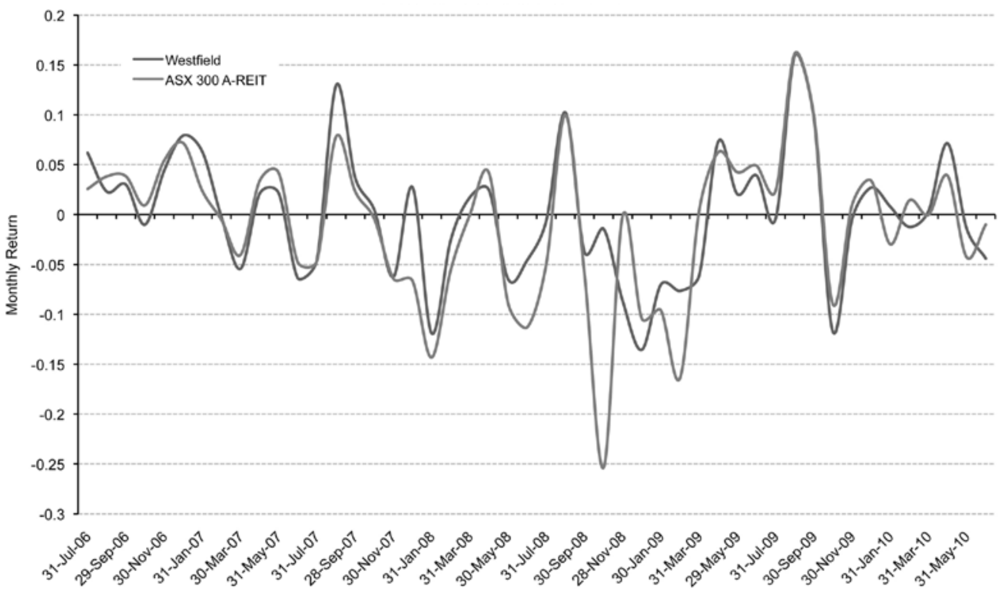
We can conclude that the key purpose of investing in A-REITs – to obtain added portfolio diversification – has been severely compromised given the high correlation of the Index to one (the largest) major stock.

2. GROWTH OF THE GLOBAL REIT MARKET

In our view, global REITs as an asset class will continue its longer term growth trend over the coming years. The European/Middle East region (EMEIA), particularly France and Germany, are expected to experience increased investor demand for REITs and will continue to be more highly biased to retail REIT structures.

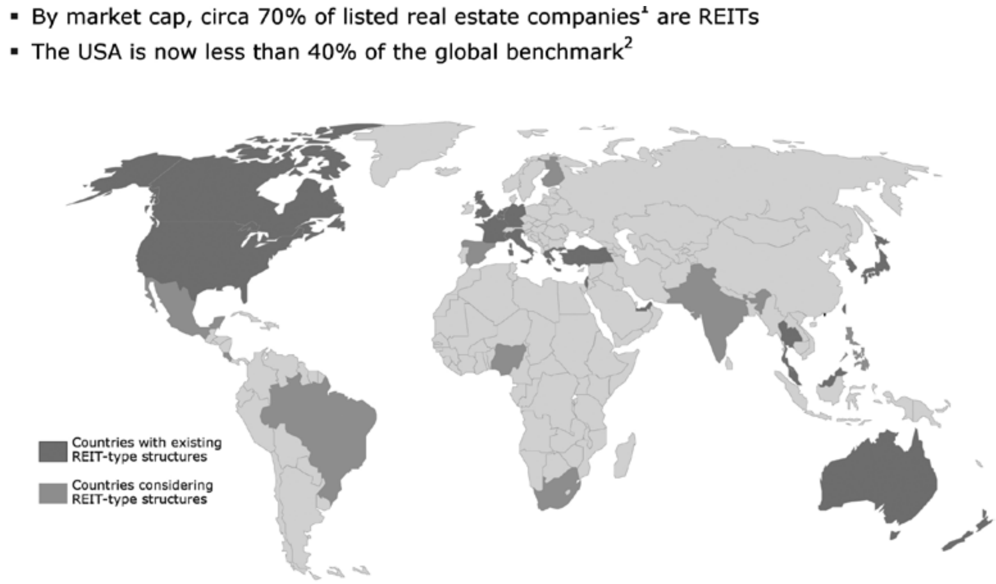
Asian REIT markets will continue to grow more strongly and we expect will be more heavily weighted to the office sector. China is a potentially huge REIT market, with developers and state-owned enterprises holding vast amounts of property on their books and with a large residential property sector. While legal, tax and trust regulations loom as short term challenges to the establishment of a deep and liquid REIT market in China, we expect that Chinese REITs will comprise an ever-increasing share of the Asian REIT market over the next 10 years.

Figure 1. Westfield tracks the S&P/ASX 300 A-REIT Index closely



Source: Invesco

Figure 2. **Evolution of global REIT structures**



Source: Invesco Real Estate based on date provided by UBS and other sources.
1. Invesco Real Estate estimates based on FTSE EPRA/NAREIT Global Index as at 31/12/09
2. Source: www.epra.com

In contrast, the size of the Australian REIT sector, as a portion of the global REIT market, should continue to fall over the next 10 years as new global markets open to REIT structures.

The natural growth trend of the global REIT market means that managers of global listed property securities will have an ever-widening universe of securities over which they can exercise their skills (see Figure 2), creating new active investment opportunities on the back of inefficiencies of information and pricing. The Australian REIT market, on the other hand, is still contracting in terms of numbers of securities. This will mean that investment managers will find it increasingly difficult to generate alpha in AREITs for a given level of risk.

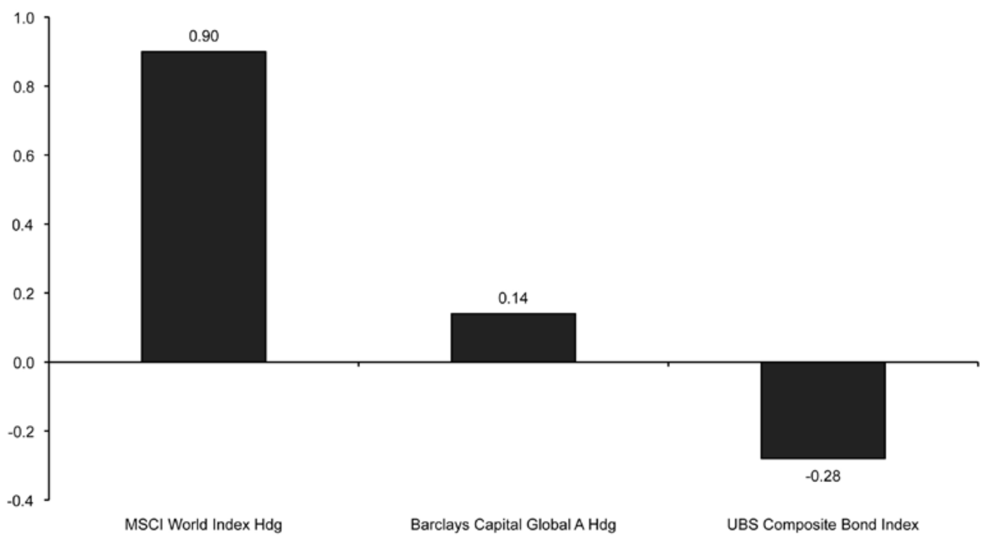
3. DIVERSIFICATION BENEFITS OF GLOBAL REITs

Investing in global REITs offers many opportunities for portfolio diversification: by asset class, by country/region, by sector, and by stock. We discuss each below.

Diversification by asset class

Global REITs offer new and considerable diversification opportunities within a balanced portfolio. Figure 3 below shows the correlations of global REITs with other major asset classes over a five year period to 30 June 2010, with data sourced from Mercer. The chart shows that the correlation of global REITs to global equities is quite high at present, at 0.90. However, this

Figure 3. **Correlation of hedged global REITs with other key asset classes (five years to 30/6/10)**



Source: Mercer

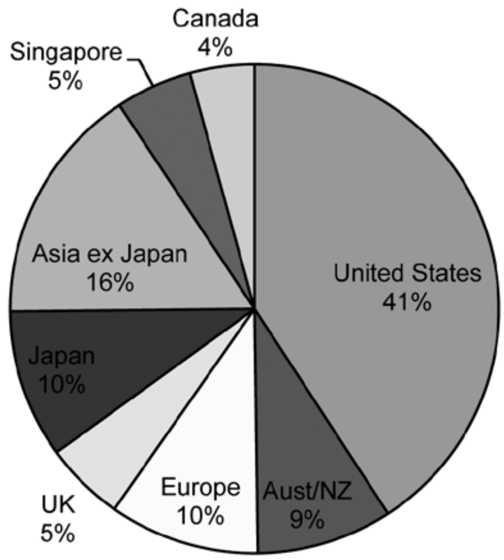
period includes the GFC of 2008–09, during which time equity and property markets slumped simultaneously), thereby increasing the correlation numbers. Over the longer term (i.e. ten years) the global equity/global REITs correlation is much lower at 0.66 (using unhedged data). Over the five year period to 30 June 2010, hedged global REITs had low and negative correlations with hedged global bonds (0.14) and domestic bonds (-0.28). This suggests that the addition of global REITs can provide diversification for a balanced portfolio of assets over the long term.

Investors will achieve lesser portfolio diversification benefits by investing in Australian REITs (AREITs). The S&P/ASX 300 LPT Index has a consistently high correlation of 0.75 with the S&P/ASX 300 Index over three years and a correlation of 0.74 over five years to 30 June 2010. (source: Bloomberg, calculated daily).

Diversification by stock, sector and region/country

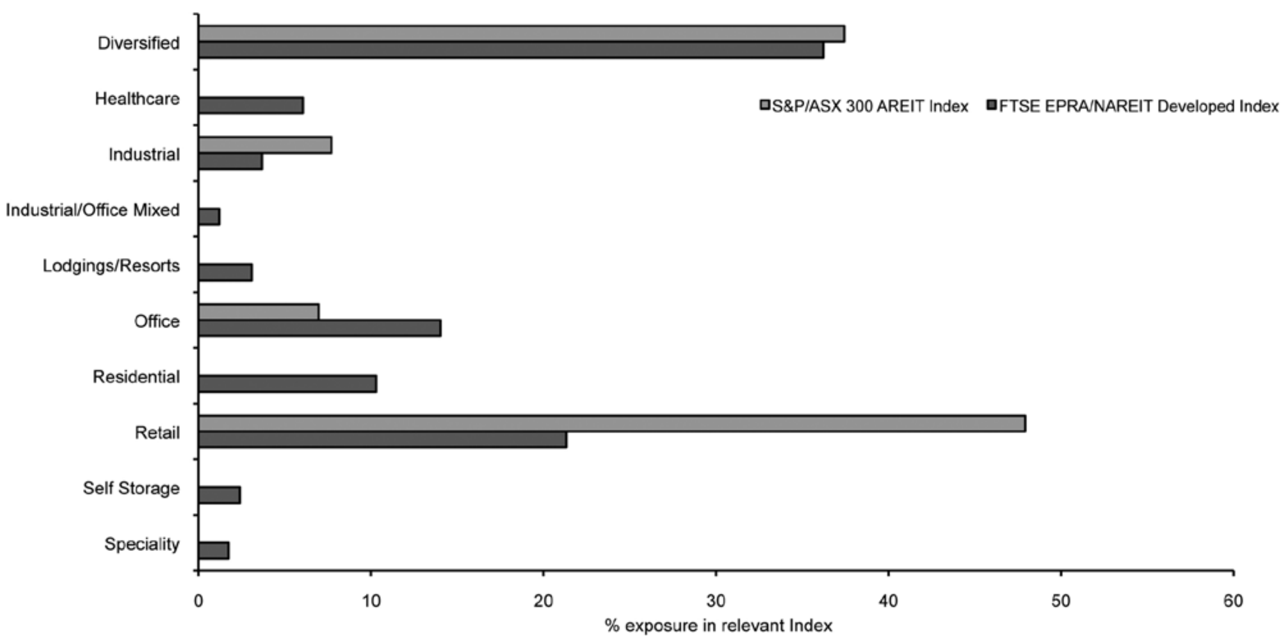
Aside from diversification opportunities at the asset class level, global REITs offer additional layers of diversification compared to Australian REITs at the country, sector and stock level. To better show diversification by country, in Figure 4 we highlight the relatively wide dispersion of country/regional exposures

Figure 4. Key country exposures in the FTSE EPRA/NAREIT Developed REITs Index



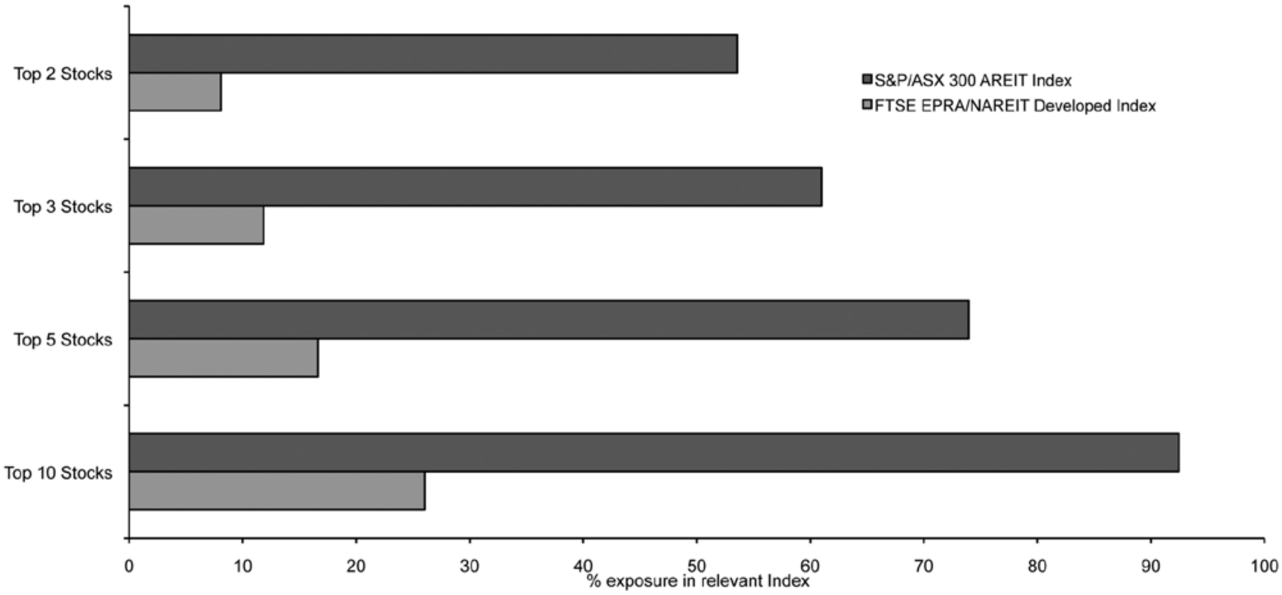
Source: Invesco

Figure 5. Sector exposures: FTSE EPRA/NAREIT Developed REIT Index vs. S&P/ASX A-REIT Index



Source: Invesco; Bloomberg

Figure 6. **Percentage of market cap in top stocks: GREITs vs. A-REITs**



Source: EPRA and Invesco, as at 30 June 2010

within the FTSE EPRA NAREIT Developed REITs Index at 30 June 2010.

In Figure 5 we directly compare the sector diversification of the FTSE EPRA NAREIT Developed REITs Index against that of the S&P/ASX 300 A-REIT Index at 30 June 2010. The chart clearly shows that global REITs also provide exposure to a broader range of sectors (e.g. Residential, Self-Storage, Lodging/ Resorts) compared to A-REITs, which is much more concentrated on sectors such as Retail (i.e. of which Westfield is a dominant part), Industrial and Diversified.

Figure 6 bears out the fact that stocks are also much more concentrated in the largest companies in the Australian REIT sector compared to the global REIT sector. For example, in the S&P/ASX 300 A-REIT Index the top 10 stocks constituted 92 per cent of that Index, while the top 10 stocks of the EPRA/ NAREIT Developed REIT Index constituted a much smaller portion of around 26 per cent (see figure 6) at 30 June 2010.

We can also look at diversification within the global REIT sector itself. Table 1 shows that diversification within the global REIT market is also apparent at the stock level, with a wide dispersion of stocks from a range of countries and sectors in the top 10 stocks of the EPRA/NAREIT Developed REIT Index. Westfield's exposure to the global REIT index is only about 4 per cent compared to its dominant share (approximately 40 per cent) of the A-REIT Index.

Listed real estate as an asset class is usually subject to local factors such as economic conditions, supply/demand dynamics, and tax treatments. It is therefore not surprising that geographical

Table 1. **Top 10 real estate stocks in the FTSE EPRA/NAREIT Developed REIT Index**

Rank	Stock constituent	Country	Sector	Net mkt cap (A$ bn)	Index weight %
1	Sun Hung Kai Properties	HK	Diversified	31.40	4.27
2	Westfield Group	Australia	Retail	28.11	3.82
3	Simon Property Group	US	Retail	27.72	3.77
4	Unibail-Rodamco	France	Office	17.84	2.42
5	Mitsubishi Estate Co	Japan	Diversified	17.40	2.36
6	Vornado Realty Trust	US	Diversified	15.71	2.13
7	Mitsui Fudosan Co	Japan	Diversified	14.75	2.00
8	Equity Residential	US	Residential	13.90	1.89
9	Public Storage	US	Storage	13.28	1.80
10	Boston Properties	US	Offie	11.70	1.59

Source: FTSE statistics, as at 30 June 2010 exposure creates additional diversification benefits. In Table 2 we show that correlations across regional property indices are typically low, creating additional diversification opportunities.

Some AREITs have material exposure to the UK and European property markets, and more recently have started to diversify into Japanese property. Investors can access offshore property exposure through these assets, but typically the exposure is not well diversified and does not represent a close proxy to the total global market. It remains to be seen whether AREIT managers have the necessary skill to invest in unfamiliar foreign REIT markets.

4. OTHER BENEFITS OF GLOBAL REITs

Return and volatility issues

There is typically a wide dispersion of returns across REIT markets in individual countries. This wide dispersion helps provide additional diversification of returns for global REIT investors and greater diversification than investing in AREITs alone. For example, in 2009 Hong Kong returned a slightly positive 0.2 per cent compared to the US which returned – 31.7 per cent . Whereas in 2001 the US returned 15.2 per cent, Hong Kong returned – 13.8 per cent while Japan's REIT market returned – 23.5 per cent . By contrast, an investment in the AREIT sector will not provide the same range of returns diversification. Investors in the global REIT sector, however, can gain exposure to a large number of markets providing varying levels and types of returns. This includes exposure to fast-growing Asian REIT markets to provide additional return opportunities in place of lagging returns from developed REIT markets.

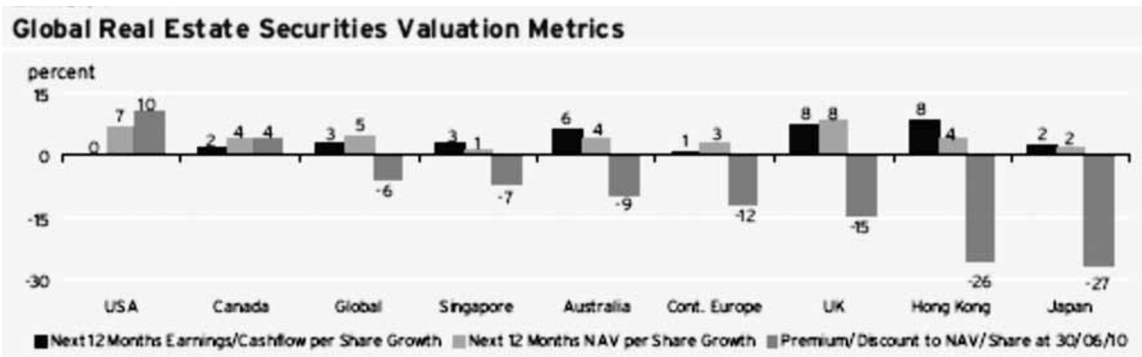
A significant feature of the AREIT sector is the prevalence of stapled securities. By combining a unit trust and a company structure, 'stapled' AREITs link passive rental income with a more active (non-rental) income stream. Despite good performance in the past, investors are increasingly questioning the role of property within a diversified portfolio, and are in many cases determining that a stable income stream is an important part of the diversification benefit of property. We believe this trend will continue and many investors may increasingly favour portfolios with stable income and will grow increasingly averse to the volatility associated with the corporate portion of a stapled structure where business contribution to profit can be highly variable. In this scenario global REITs are likely to provide a smoother return profile than AREITS.

Table 2. Correlation across property regions over the past 10 years

	US	France	UK	Netherlands		Australia	Hong KongJapan
US	1.00						
France	0.60	1.00					
UK	0.63	0.66	1.00				
Netherlands		0.57	0.76	0.68	1.00		
Australia	0.54	0.53	0.49	0.50	1.00		
Hong Kong	0.37	0.36	0.33	0.38	0.30	1.00	
Japan	0.43	0.40	0.40	0.34	0.39	0.20	1.00

Source: S&P Developed Property Index, as of 31 March 2009. The above chart illustrates the correlation between two countries. 1.00 is perfect correlation.
Past performance does not guarantee future performance.

Figure 7. Net asset value (premium/discount) of Global Real Estate Securities by regions



Source: Invesco Real Estate estimated based on consensus data as of 30 June 2010.

Figure 8. **Global REIT annual returns over time (income and price – FTSE EPRA/NAREIT Index)**

Past performance is on guarantee of future results.
Source: National Association of Real Estate Investment Trusts (NAREIT)
REITs' total return is made up of dividend income and capital appreciation / loss from a change in share price.

Valuation considerations

The recovery in markets has seen the global REITs sector move from trading at healthy discounts to Net Asset Value (NAV) to being fairly valued. However, global REITs are still trading at reasonable discounts to NAV in many Asian countries, including Hong Kong and Japan which trade at large discounts to NAV. Figure 7 also shows the much more positive prospects for growth in global REIT cash flows and earnings, as well as NAV per share growth.

Institutional and retail investor interest in real estate has grown in recent months as real estate capital values have fallen in recent quarters. Such interest will continue to be heavily influenced by the availability of capital, the need for income, and the extent of inflation. While further re-appraisals of the risk and return requirements for all investment classes are likely, global REIT valuations should remain fairly priced and will continue to offer investors long-term return and diversification benefits.

Income and growth components

As mentioned earlier, investors are increasingly questioning the role that property plays in portfolio diversification. Investing in real estate securities has historically been a good way to capture both a capital return as well as a significant income portion, via a dividend yield. Indeed, as part of a well-diversified portfolio, REITs have provided a regular income stream that can help investors better match their assets and liabilities.

Figure 8 shows the consistency of (positive) income from global REITs over time despite periods of down markets. It is this feature of REITs and direct property – i.e. high, stable income – that many investors see as the key benefit of the asset class.

Tax considerations for GREITs

Tax and gearing are key advantages of investing in a REIT structure. Most REITs are structured so that otherwise taxable income earned from say rental yields is typically 'passed through' the structure, to be distributed to investors as dividends. Another advantage of REITs compared to other investments is that the unitholder does not pay tax on the deferred income portion until their investment in the trust is sold. The result is a higher after-tax return.

While the US and Australia remain the largest listed property markets with tax-transparent commercial property vehicles, a growing list of countries are rapidly adopting, or are considering, a similar structure. This is making for a 'clearer' global market and is effectively neutralising what is one of the few remaining natural advantages of Australian REITs. Indeed, in certain countries (e.g. Belgium, US, Netherlands and Germany), there is the added flexibility of allowing the reinvestment of pre-tax capital gains.

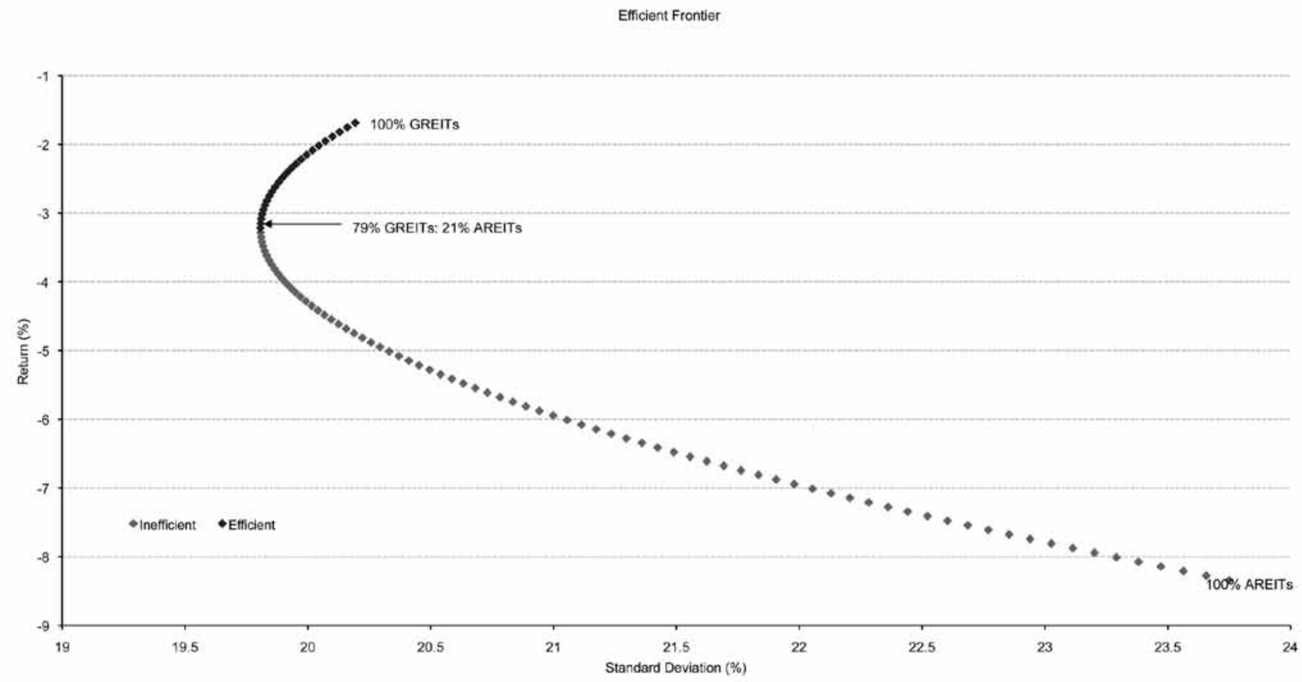
Some REITs impose a self-limitation on leverage to ensure that the REIT is managed conservatively and meets distribution requirements consistently. REITs that are treated in a tax-transparent manner, and that typically pay strong dividend yields, tend to trade higher and more in line with their net asset value than REITs trading in countries without these tax-efficient structures.

Asset allocation implications of REITs

Australian REITs in some quarters have been seen as a defensive, stable and income-producing asset class. However, exposure to AREITs alone will limit an investor's opportunity set. Investors could instead achieve a more optimal risk-return outcome by structuring their global and domestic REIT exposure to allocate a component of their listed property exposure to global REITs.

Applying efficient frontier analysis to determine the possible combinations of global REITs and AREITs in a portfolio; Figure 9 shows all possible combinations of global REITs and Australian REITs for the period of five years to 30 June 2010. The red dotted line represents inefficient portfolios, where in parts of this section another portfolio could be used to achieve a higher return for the same level of risk. The blue dotted line depicts the efficient frontier along which investors can achieve an optimal return-for-risk outcome.

Figure 9. Efficient frontier of global/domestic REIT exposures



Source: Mercer five year data to 30 June 2010. Global REITs are represented by the FTSE EPRA/NAREIT Index; Australian REITs are represented by the ASX 300 AREIT Index.

Figure 9 shows that by combining global REITs and Australian REITs in a property portfolio, or having a 100 per cent allocation to global REITs, it is possible to achieve a better risk and return profile than by investing solely in AREITs.

CONCLUSION

The above analysis demonstrates the many and varied benefits of 'going global' in listed property:

- increased diversification opportunities on a number of fronts, including a low correlation with other key asset classes
- a good balance of income and capital growth
- the opportunity to invest in a fast-growing and liquid global market for REIT structures
- an attractive long term risk-return outcome versus AREITs

Now is a good time for investors to take a broader view and consider global REITs, as part of their portfolio allocation to property. ●

Journal of Investment Strategy

Published by

Financial Standard

a Rainmaker Information company

Level 2, 151 Clarence Street, Sydney NSW 2000 Australia
Telephone (02) 8234 7500 Facsimile (02) 8234 7599
www.financialstandard.com.au
www.jois.net.au

Disclaimer