

Constructing property portfolios using REITs

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Insights

How do real estate investments trusts (REITs) compare? AMP Capital Head of A-REITs Mark Ferguson investigates what global REITs offer versus Australian REITs in portfolio construction.

Real Estate Investment Trusts were first established just over 50 years ago in the US. Since then, 34 countries have established REIT or REIT-like legislation and the size of the global REIT market has grown to more than US\$1 trillion, according to Bloomberg.

Australia was the third country in the world to enact REIT legislation in 1970 and now approximately 23 per cent of Australian property has been securitised onto listed markets with a market capitalisation of AU\$84 billion.

A-REITs provide investors with a variety of benefits including access to the highest quality Australian properties, a diversified and liquid exposure to Australian property with much lower transaction costs compared to direct property and consistently high yields. A large proportion of high quality core real estate is available for investment through REITs. These core assets are typically large, scarce and relatively illiquid, dominated by a small number of landlords with high average prices. Ordinarily, these kinds of characteristics would be prohibitive for an average investor. REITs, however, overcome the barriers to entry for investors through divisibility and mark-to-market liquidity.

A-REITs also typically have long-term leases of five to 15 years with annual rental increases linked to inflation. This gives A-REITs a predictable, stable earnings profile for a relatively long period of time.

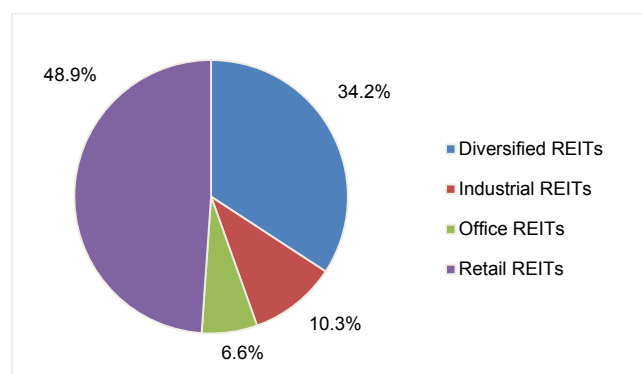
What do global REITs have to offer to an investor? Diversity is one aspect.

Almost half the A-REIT index is composed of Retail REITs. The second largest sector of the index is diversified. Combined, retail and diversified REITs make up 83 per cent of the Australian index. Diversified REITs have exposure to retail, office and industrial as well a limited development exposure to these three sectors and residential.

The global index in contrast comprises a greater variety of sectors, many of which are pure-plays. A pure-play is a company that invests its resources in only one line of business and, as a result, its performance is tightly correlated with the performance of that particular industry. As an investor, this allows for goal-oriented portfolio

construction through target exposures to specific sectors given their return profiles under different market conditions as well as an opportunity to outperform the aggregate market by tilting exposure to different market sectors as conditions change.

AREIT index sector composition



Source: Bloomberg, AMP Capital

This also provides exposure to a number of sectors that are yet to be fully developed in the Australian market place, including health care REITs, self-storage REITs, campus REITs, apartment REITs and even prisons!

What's next for G-REITs?

The global REIT universe is set to continue growing. If global property was securitised to the extent of Australia, from where it is currently at 9.5 per cent, the investment universe would grow by \$4 trillion,

G-REITs have enjoyed the positive tailwind generated by unconventional monetary policy undertaken by the Federal Reserve, the European Central Bank and the Bank of England. The differences in macroeconomic environment have led to the 'bounce' in stock prices we have seen post-GFC in global REIT markets versus those seen in Australia where the Reserve Bank of Australia was not forced into unconventional policy. We expect the difference in performance to continue.

After the fallout from the GFC, Australian banks took a particularly conservative approach to the enforcement of their debt covenants in comparison to global banks. As a result, A-REITs undertook vast equity recapitalisation programs in order to ensure their survival during the cyclical downturn.

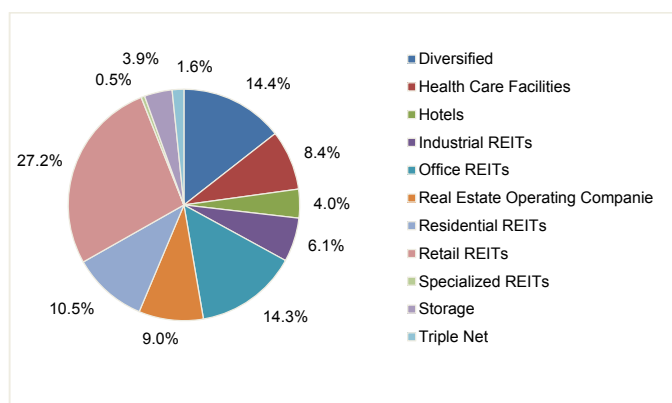
These strategies meant A-REITs diluted their capacity to earn the same return on equity potential through recapitalisations

Recent analysis by the European Public Real Estate Association shows that during a ten-year period, adding 30 per cent exposure to G-REITs in a UK unlisted real estate fund would have improved returns by 30 per cent in absolute terms and 50 per cent in relative terms over the ten-year period between June 2003 and June 2013.

Ultimately, investing in global REITs allows an investor to get exposure to different risk-return profiles. Different countries tend to experience different parts of the economic cycle.

Diversification in the REIT markets can be achieved through the asset allocation across regions, sectors and stock selection to identify the best companies in each segment.

Global rental index sector composition



Source: Bloomberg, AMP Capital as at November 2013.

Even within REITs, investors can obtain diversification across sectors, and construct portfolios designed to provide the optimal risk-return profile under different scenarios.

One of the benefits of having width and/or size from a market can be outweighed by a lack of market liquidity. A way of gauging market liquidity is through the dollar value of transactions conducted on a periodic basis as well as the

absolute size of the market as measured through its market capitalisation.

The absolute size of the global market (US\$1 trillion) and even the Australian market (AU\$84 billion) means that it is easier to move into and out of investment positions as the need arises without moving market prices against the investor's desired position.

Conclusion

Overall, REITs provide a flexible and liquid entry into investing in property.

A-REITs give investors access to a defensive asset class through the structure of their contracted leases, with high quality assets, strong yields and a relatively predictable earnings growth profile that will continue to grow given their links to inflation and annual increases.

G-REITs provide a larger depth of high quality assets with predictable earnings linked to inflation. Like A-REITs, GREITs are also a defensive and growing asset class but with substantially more levers to drive portfolio performance due to the wider composition of sectors and regions available for investment.

A combination of increased securitisation of property, more countries enacting legislation to create REIT structures and a legacy of more supportive debt markets during the GFC have led to a difference in earnings potential between Global and Australian REITs; that continues to play out.

These structural differences mean that G-REITs can add greater diversification benefits and exposure to growth in markets other than Australia, adding positive risk-return dynamics to a balanced, A-REIT or even unlisted property portfolio.

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