Capitalising on the Global Growth of Listed Real Estate

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Sophisticated investors have long looked to real estate as a longer-term source of income, capital growth potential and portfolio diversification. The growth of listed property companies such as Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs) has further enhanced real estate investing with the liquidity and transparency of the public marketplace. In recent years, we have witnessed another important stage in the evolution of the market: the expansion of REITs and public real estate as global investments.

For a variety of reasons that we will outline in this article, the maturation of the listed global real estate market offers investors an important new avenue for alpha generation and diversification. Along with outlining the fundamental case for the asset class, we also provide our view on promising sectors of the market.

Growth of Global Public Real Estate

The emergence of listed property companies on a global scale is a very recent phenomenon. Since 2003, the market capitalization of the global universe of listed real estate securities, represented by the FTSE EPRA/NAREIT (European Public Real Estate Assn. / National Assn. of Real Estate Investment Trusts) Global Index, has quadrupled to about $1 trillion. Over the same period, the U.S. share of the FTSE EPRA/NAREIT Global Index has declined to 35% from over 60%. We project that the market will continue its heady expansion and double its size to $2 trillion in seven years, as more companies become publicly traded.

The growth in size and diversification both have been fostered by legislation that has spurred IPO activity in countries such as Hong Kong, Japan, Brazil, Germany and France. All major global regions now offer investors the ability to select from a range of strong and viable property companies. And as the global universe has become less concentrated in the US, it has become a much better source of diversification.

Investors seeking exposure to the asset class can consider portfolios that mirror major benchmarks such as the FTSE EPRA/NAREIT Global Index. A growing number of exchange traded funds and derivatives offer exposure to that Index. Because it is capitalisation-weighted, investors would passively gain a greater exposure to ex-US real estate as that sector grows. As of December 31 2007, the FTSE EPRA/NAREIT Global Index had 38% in North American properties, with 19% in Europe and 43% in Asia.

The Case for Active Management

However, because of the many idiosyncrasies in real estate, the prevalence of local factors in valuation and the numerous inefficiencies, there is a strong case for active management that is supported by expertise and proprietary research. Managers seek to add alpha by overweighting those countries and regions likely to provide the highest risk-adjusted returns. Often, the optimum risk/reward portfolio bears very little resemblance to the index. The market's ability to support such strategies is a very recent development.

Thus the diversification available from public, global real estate is three-fold: First, real estate itself historically has a low correlation with equities and other major asset classes. Second, because real estate is still primarily driven by local economics, regions within the asset class also tend to perform independently. Third, if global real estate is pursued through an actively managed strategy, the weightings and positions selected will typically work to distinguish performance from the "beta" represented by the benchmarks.

Since inception in 2000, the FTSE EPRA/NAREIT Global Index has had a 17.21% compound annualised return, with annualised volatility (standard deviation) of 15.4%. Its Sharpe ratio is 1.12, indicating a favorable risk-adjusted return. Over the same period, the S&P 500's compound annualised return was 0.85%. Its standard deviation was 13.2%, with a Sharpe ratio of 0.06. One should not expect such dramatic disparities between listed real estate and the equities market all the time, but the period underscores the diversification value of global public real estate.

Just as diversification works on several levels for global REITs, their transparency also has different aspects. First, REIT financial reporting conforms to the same requirements as all publicly traded securities of the relevant country and shares are valued through exchange trading. Such distinctions set REITs apart from privately held real estate.

But there is also a more fundamental kind of transparency pertaining to enterprise risk. With real properties as the underlying assets, there is near perfect transparency into a company's strategy and business plan. While real estate certainly requires sophisticated analysis, the "wildcards" that exist in sectors such as technology (e.g., product obsolescence or loss of patent protection) are not factors. There are virtually no derivatives or complex securitised instruments on the balance sheet.

Global REITs also provide the liquidity common to exchange-traded securities, which removes one of the major obstacles many investors have to participating in private real estate strategies. And while total return is still the major objective, global REITs by nature are still one of the higher-yielding equity stocks. As of December 31, 2007, the FTSE EPRA/NAREIT Global Index had an average yield of 3.5%.

For the balance of this review, we offer Urdang's perspective on the global public real estate market. Our strategy is to focus on high growth markets with above-average GDP growth and population trends that favor strong real estate fundamentals. For example, we view Hong Kong/China, Singapore and Western Canada as high growth markets that are likely to provide strong real estate returns for years to come.

Urdang's Outlook for 2008 and Beyond

Looking back at 2007, the top-performing country was Hong Kong, with a return of 53.4%; the fifth-ranked was Belgium, with a return of minus 3.4%. This wide dispersion of returns reminds us that the world is still a very big place and that real estate, like politics, remains a very local business. While the US and UK property markets face stiff headwinds, Asia, South America and western Canada real estate fundamentals continue to improve as a result of broad-based economic expansion.

While globalisation ties financial markets together in real time, property markets are far more dependent on longer-term trends, demographics, economic lifecycles and geography. Regional trends like urbanization in China and India, the aging of populations in Japan and Germany, and Canada's emergence as a competitive producer of oil will dominate the health and structure of their real property fundamentals for years to come.

The year's volatility underscored the need for diversification and served as a reminder to keep the big picture in perspective. As managers of global listed real estate property funds, we take comfort in the following big picture trends affecting public real estate for 2008:

- Global growth remains strong, fueled by trade-based economic expansion in Asia, but tempered by weaker growth in G5 countries.
- Burgeoning middle class populations in the "BRIC" countries – Brazil, Russia, India and China – are creating unprecedented demand for housing and commercial property.
- In developed countries, high land prices and rising commodity prices have pushed up the costs of new construction, thus limiting the risk of an imbalance between supply and demand.
- Widening credit spreads are being met with lower short-term interest rates, which should buoy financial investments into 2008.
- Global legislation trends favor public ownership of real estate as more jurisdictions adopt REIT-like structures.
  - o Italy, Germany and the UK adopted REIT legislation in 2007.
  - o IPO activity in emerging markets should remain robust, as private companies seek to capitalize on significant growth opportunities.
  - o IPO pipelines for property companies in Russia, Philippines, India and Mexico are growing.
- The vast majority of capital flows into listed property funds in 2007 were global mandates.

Potential Issues of Investing In Global REITs

As with any relatively new and growing market sector, investors considering allocations to global listed equities should be aware of potential issues. These include:

- Changes in legislation could make REITs less attractive (e.g. China, Canada).
- Volatility can stem from two sources: the underlying property assets and general equity market sentiment. In certain markets, real estate securities tend to be highly correlated with broader equity markets, where the real estate market cap represents a significant portion of the overall equity market cap (e.g. Hong Kong). In such an environment, REITs tend to become more correlated with the economy.
- Liquidity may be restricted at times, as many property securities are smaller cap stocks.
- There are few truly global managers, and most lack significant track records. Many global REIT funds are fairly young, with limited performance histories.
- Inefficient markets are a double-edged sword: they create opportunities for investors with the expertise and resources to perform the necessary due diligence. On the other hand, real estate markets can present pitfalls even for sophisticated investors, where there is a lack of analyst coverage and limited public information.

Conclusion

Global listed real estate has reached the "sweet spot" for sophisticated investors. It has developed sufficient visibility and liquidity to support robust "betas" represented by a number of indexes, along with active strategies capable of adding alpha. At the same time, the tremendous heterogeneity of regional marketplaces and the lack of efficiency present a number of opportunities. It also offers investors the capability of tapping into some of the world's fastest growing economies. Assuming investors observe the caveats appropriate to any growing sector, global listed real estate deserves careful consideration as a strategic portfolio investment.

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Urdang was founded in 1987 and has achieved an outstanding investment track record of consistently exceeding investor's investment performance objectives. This success is anchored in entrepreneurial culture that enables Urdang to uncover hidden investment opportunities. Presence in both the private real estate and public real estate securities markets has allowed Urdang to expand its investor's investment opportunities with programs tailored to their strategic goals. BNY Mellon Asset Management distributes the capabilities of Urdang Securities Management to global (ex US) clients. For further information please contact the BNY Mellon Asset Management client services team on +44 20 7163 2594.