Real Estate Equities

The case for a long/short investment strategy

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A significant asset class with attractive characteristics and performance

Real estate has an important role to play in any diversified portfolio. Global real estate has performed well historically, returning 7.5% p.a. over the 15 years to the end of 2015. It has typically provided a high income return component (over 80% of total return from income and 6.1% p.a. income return over the same period) and can provide inflation protection, making it a desirable asset class for investors and a core, though often overlooked, part of a mixed asset portfolio (see Fig.1). Critically, investable income producing real estate is estimated to have a gross asset value of around $34 trillion[2] and represents some 18% of the total global real estate market of $191 trillion.

Accessing real estate efficiently can prove difficult for many investors, as building a diversified real estate portfolio directly through private ownership can be very challenging. In particular, this is because real estate assets are large and require specialised management and local expertise, making it difficult for investors without large pools of capital to invest at the required scale for both diversification and cost efficiency. An alternative way of gaining exposure is through the public market.

Listed real estate equities, like Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs), can provide access to the attractive returns of global real estate over the medium term. They can do that with greater liquidity, increased efficiency and lower cost. For instance, listed real estate equities have historically provided attractive total returns of circa 8.2% p.a.[3] over the last 20 years, outperforming both global general equities and bonds which returned 5.9% p.a.[4] and 5.6% p.a[5]. respectively, more recently with lower volatility too (see Fig.2). In addition, listed real estate has exhibited relatively low correlation with global general equities (0.29) and bonds (0.58) over the same 20 year period, providing diversification benefits to traditional asset class portfolios that essentially comprise equities and bonds.

Fig.1 Global real estate returns and contributing components[1] *Source: MSCI; data as of 31st December 2015*

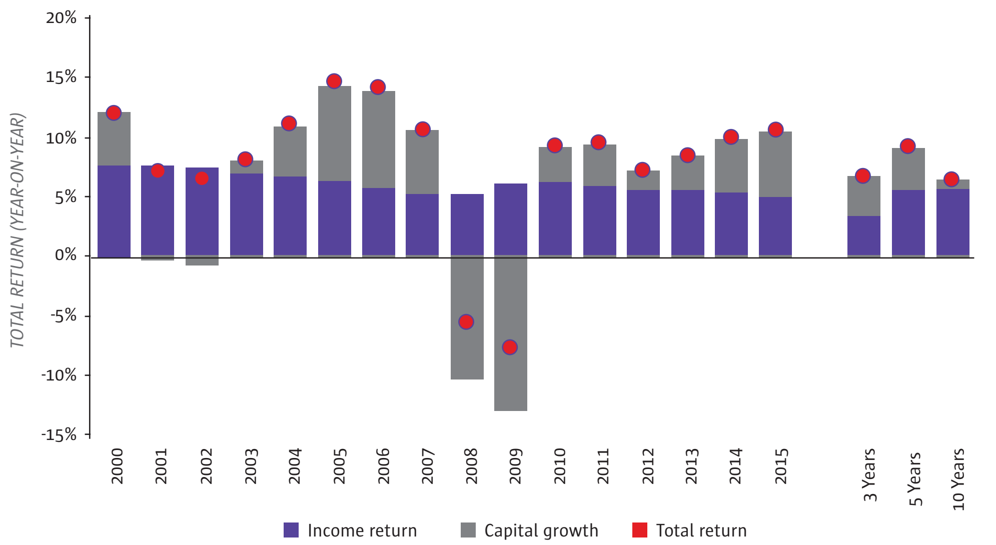
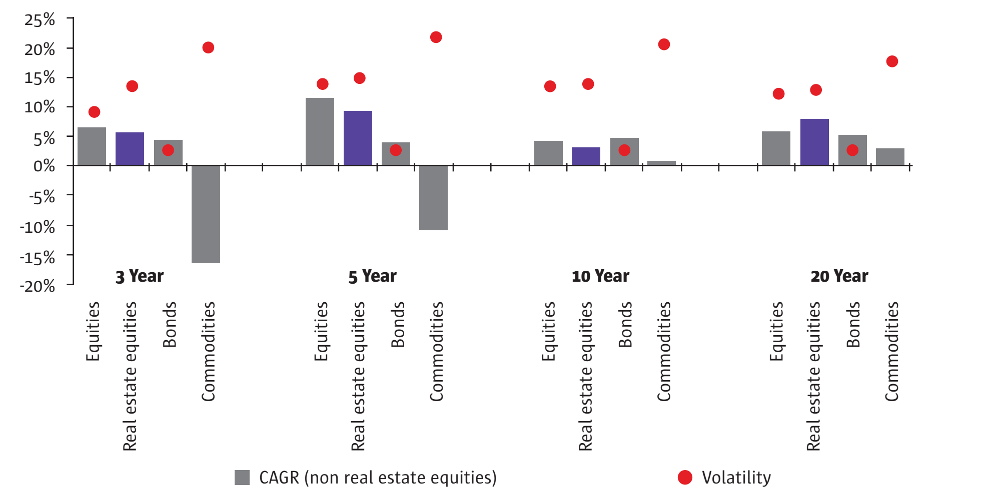


Fig.2 Risk and return profile of major asset classes

Source: Bloomberg; Grosvenor Group; data as of 30th September, 2016



Note: Equities: MSCI World Index, Gross Total Return in local currency; Real Estate Equities: FTSE EPRA/NAREIT Developed Total Return Index in US dollars; Bonds: Barclays Capital Aggregate Bond Index; Commodities S&P Goldman Sachs Commodity Index.

The listed real estate universe is geographically well diversified, providing access to the underlying real estate markets in all continents through more than 500 liquid and tradable companies with a combined market capitalisation of over $2.5 trillion[6]. Sector diversification is also possible in most markets, especially in the US, where sector specialist REITs represent the traditional sectors like office, retail, residential and industrial but also represent alternative niche sectors like healthcare, student housing and self-storage. Listed players hold a valuable (circa 14%) proportion of prime real estate assets and manage them professionally.

On September 1st, 2016, real estate equities were elevated to a class of their own and have become the eleventh sector under the global industry classification standards (GICS) for equities, the first new sector since their introduction in 1999. The elevation reflects an appreciation of the sector's special attributes by index providers and its recognition as a distinct asset class with an increasing role in global equity markets and portfolio diversification. In the past, real estate was historically classified as a sub-group of financials, along with banks, insurance companies, and asset managers, despite its unique operating characteristics and performance drivers. As a standalone sector, real estate represents some $3.3 trillion, or around 5% of the global equities universe, similar in size to telecommunication services and utilities.

The reclassification follows a tripling in real estate's share of the global equities market since the trough of the market cycle in 2009. A combination of equity fund raising, strong investment performance and the expansion of the tax-efficient REIT regime, has facilitated significant growth in the free float market capitalisation of the FTSE EPRA/

Fig.3 Premium/discount to NAV

Source: Bloomberg, UBS Equity Research; data as at 30th September 2016

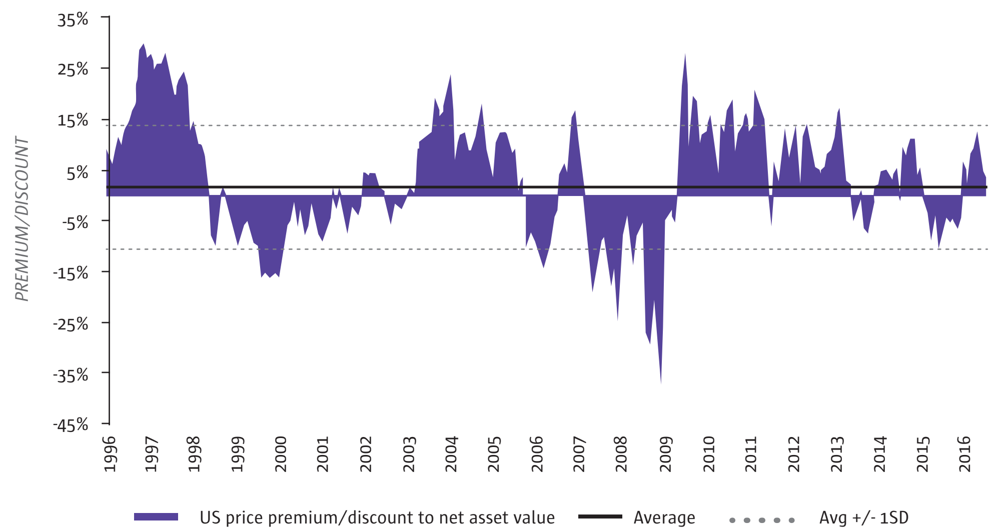
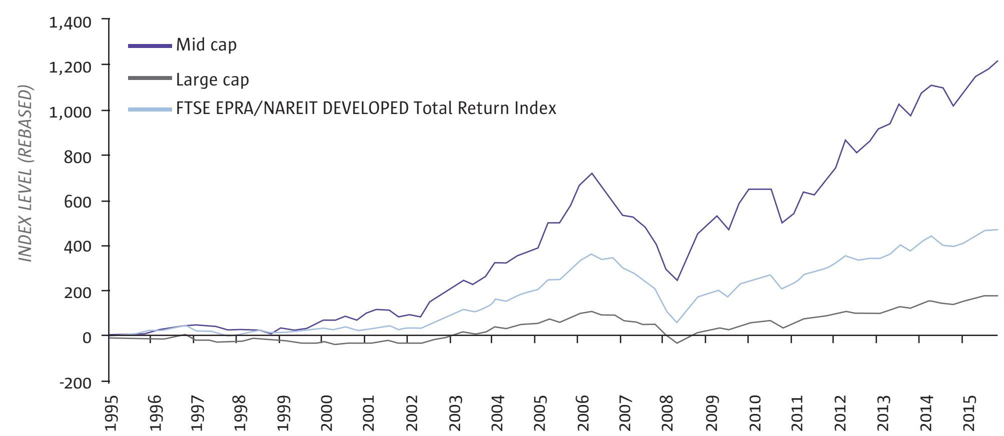


Fig.4 Mid cap real estate equities out-performance

Source: Bloomberg, Grosvenor Group; data as of 30th September, 2016



NAREIT Global Developed Index (the main index for global listed real estate in developed markets) to $1.5 trillion from $508 billion during the same period.[7] The growth is expected to continue as the penetration of listed real estate companies in developed markets increases and more countries in emerging markets introduce REIT regimes.

Accessing listed real estate and generating alpha

As the value of the underlying real estate assets of listed property companies move over the medium term in line with direct real estate values, listed real estate prices tend to fluctuate around the fair value of net asset value. Such mean reversion is a significant difference versus mainstream equities and a potential source of alpha.

Given the cyclicality of the economy and the correlation of real estate to it, a long/short strategy that can target stocks and sectors across the different regional cycles and which are under or overvalued, dampen market volatility and limits potential drawdowns, may be the most effective way for investors to access the listed real estate sector. This approach should constitute a flexible strategy allowing fund managers with a highly developed understanding of the underlying real estate markets (both at the global and local level) to identify value in the listed markets and trade their views profitably through the cycle. Specialist and local knowledge is also crucial in identifying stock opportunities in a sector that is often under-represented in terms of research coverage and where historically mid-cap stocks outperformed both the index and large-cap stocks (Fig 4)[8].

> "The diverse and growing nature of the listed real estate markets by country and sector provides value generating opportunities for investors."

Gaining real estate exposure through listed real estate equities has many positives but in order to access the underlying property performance investors need to manage the short-term market volatility, and the periodically significant discounts to NAV which can materialise during cyclical downturns. Over the medium term, listed real estate prices follow a stable relationship with the value of the underlying assets, but due to stock market fluctuations usually unconnected to real estate, can deviate from it in the short term. This short-term mis-pricing can provide long and short investment opportunities for specialist managers who have a deep understanding of what fair value should be in each market and how equity prices tend to overshoot owing to factors unrelated to real estate fundamentals, such as QE.

The diverse and growing nature of the listed real estate markets by country and sector provides value generating opportunities for investors. Performance amongst regions and countries varies greatly as real estate is fundamentally a local business. This regional dispersion provides numerous opportunities for alpha generation through country selection and the corresponding gross and net exposure management inherent in a long/short strategy.

In addition the significant diversity in performance at the sector and individual stock level provides managers with specialised knowledge of real estate (and local presence), further potential to generate alpha. As well as taking long positions in favoured sectors and stocks, the depth of the listed real estate universe allows one to take advantage of single stock short positions on overvalued and vulnerable stocks and relative value pairs both across and within real estate sub-sectors. The existence of top down and bottom up divergence means that managers can generate alpha by actively managing listed real estate portfolios to exploit these inefficiencies.

The universe of global real estate absolute return funds is small. Equity long/short managers offering sector specific funds tend to concentrate on the larger sectors like financials or technology. Whereas real estate managers tend to offer either regional, as opposed to global products, or long-only, as opposed to long/short funds. For several real estate managers the regional or country focus of their equity offering mimics the exposure of their direct real estate exposure. For those real estate managers with a global footprint there is a tendency to offer simpler long-only funds. However, there are some European and US based managers who possess both a global network of property experts combined with the necessary skills to manage an absolute return fund. These global real estate absolute return funds may offer an attractive alternative way of accessing real estate in a liquid form with lower volatility than a traditional long-only investment.

In sum, given the long run strong absolute return, generated by global listed real estate shares, and relinking poor price discovery in the space, we believe it is a niche but deepening more visible sector which investors should take a closer look at. Over the medium term, the best long/short managers can deliver attractive absolute and risk adjusted returns that in our opinion can add property diversification to institutional portfolios. **THFJ**

FOOTNOTES

1. MSCI Global All Property Annual Index in local currency (total return Index of global commercial real estate in developed markets only); index launched in 2000, data as of December 2015
2. ‘Investable, Income Producing Real Estate’ refers to institutional grade, income producing real estate; Source: Savills; values are estimates as at 31/12/2015
3. FTSE EPRA/NAREIT Developed Total Return; data as of September 30, 2016
4. MSCI World Index, gross total return in local currency; Data as of September 30, 2016
5. Barclays Capital Aggregate Bond Index; data as of September 30, 2016
6. Aggregate market capitalisation of real estate equities with more than $500 million market capitalisation.
7. Source: EPRA
8. Mid-cap’ stocks defined as bottom decile (in terms of market capitalisation) of ‘Developed Market’ ‘REITs, REOCs and homebuilders, excluding mortgage REITs’ with a market capitalisation of at least US$1 billion. ‘Large-cap’ stocks defined as top decile (in terms of market capitalisation) of ‘Developed Market REITs, REOCs and homebuilders, excluding mortgage REITs’ with a market capitalisation of at least US$1 billion.