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The case for listed real estate and its place in a diversified portfolio

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At the very bottom of Maslow's Hierarchy of needs, next to breathing, food and water, lies *shelter.* Since the beginning of human existence, shelter has been pivotal to a surviving human race. With such great demand, it is no surprise that a significant amount of money has been made over the years in real estate development, sales and operations. The importance of real estate as an investable asset class has never been more relevant than it is today.

If you were to ask the average person what comes to mind when one says, "real estate investing", chances are high that they will mention buying their first apartment or house. Alternatively, you might hear someone mentioning an office or hotel developer if they were familiar with the early 2000s show, "The Apprentice," featuring Donald Trump.

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Listed Real Estate vs Direct Real Estate:

In 1961, the first REIT, American Realty Trust, was founded under a new bylaw passed in 1960 which allowed investors the opportunity to invest in large-scale, diversified portfolios of income-producing real estate in the same way they typically invest in other asset classes – through the purchase and sale of liquid securities. Every one of the 39 nations that currently possess a portion of the roughly $1.7 trillion market capitalization of REITs, which constitutes about 490 stocks, has its own distinct set of regulations concerning the eligibility criteria for a REIT. However, at the core of what distinguishes a REIT is the mandatory distribution of the majority of their earnings available for distribution, in the form of dividends.

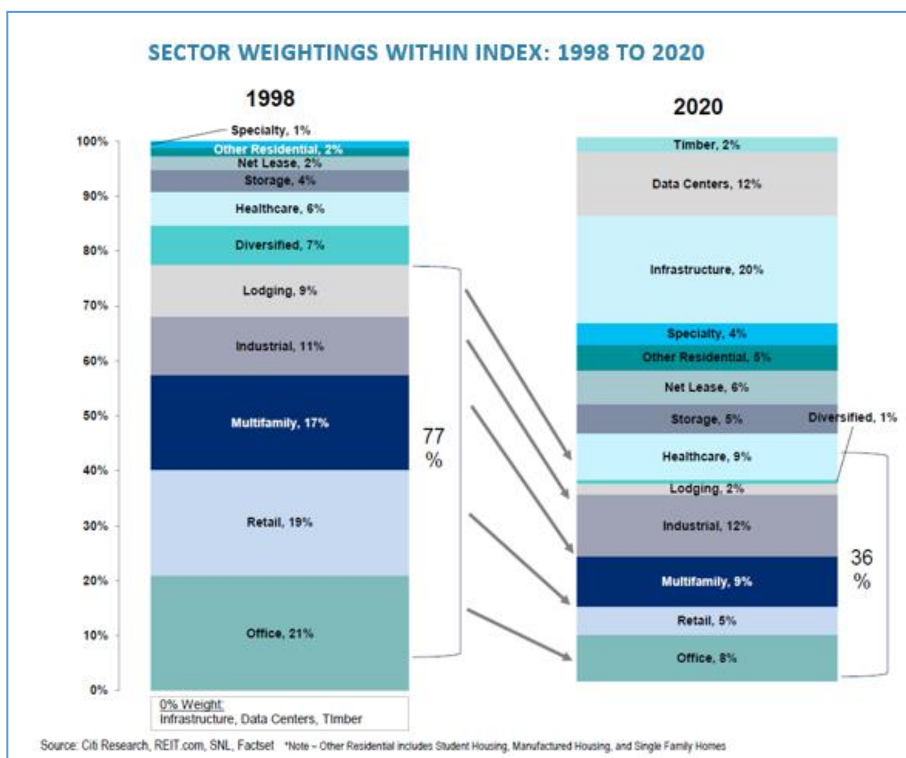
There are numerous benefits to investing in listed real estate as opposed to direct real estate:

- Liquidity: Listed real estate gives investors the ability to enter and exit their investments in a much shorter time frame and with less effort than direct real estate.
- Cost: The frictional costs of entering and exiting a listed investment are far cheaper than all the costs associated with entering and exiting a direct real estate transaction.
- Diversification: Usually, investing in direct real estate requires a large cheque to purchase one building. In listed markets, that same cheque can buy a portfolio of shares in multiple sub sectors of real estate in multiple geographic regions reducing asset, company, country and currency risk.
- Lack of Property management requirements: By buying a stock as opposed to an actual asset, there is no requirement to manage tenants, spend capital and incur other administrative costs. The costs get dealt with in the company and the stock is priced accordingly.
- Platform and Economies of scale: A listed REIT can have a market capitalization in the tens of billions of USD and can be a well-known entity with a strong platform. As a result, efficiencies of scale and management expertise can enhance shareholder returns versus spending that same money on an individual direct asset.
- Transparency and Corporate Governance: Being listed, management teams have a requirement to adhere to the highest standards of corporate governance to ensure that the shareholders are protected against potentially controversial business practices.
- Taxation benefits: Generally, as long as a REIT pays out the majority of its earnings as a dividend, it is granted a tax benefit within the corporate structure. The dividend paid to the investor will be subject to dividends tax, which is generally at a lower rate than the income tax rate to which income from a direct property would be subject to.

Listed real estate in a diversified portfolio

Traditionally, listed real estate bridged the gap between bonds and equities. The compulsory dividend and predictable cash flow, underpinned through long-term leases, provided a stable income stream for investors. The ability for the experienced management teams to extract value through decreasing building vacancy, maximizing income from tenants, accretive spending of capital, and raising equity opportunistically would allow an element of growth in the underlying earnings and thus, hopefully, the share price. These characteristics are more equity-like.

Globally, the listed real estate universe has changed significantly since its inception. In the early years, Retail, Offices, Industrial and Apartments dominated the market cap of listed REITs. However, in the last few decades, a number of new and economically relevant sub-sectors have started to gain institutional recognition. These sub-sectors are often extremely fast growing due to having tailwinds from current trends in global economies, for example, increased data usage or work-from-home trends. This allows for an outsized portion of the investor's total investment return to come from growth, rather than the dividend income. A few examples of these sub-sectors are:



- Single Family Housing: Individual family homes are purchased and rented out to individuals. This market is a highly fragmented market in the US and benefits from tailwinds of a large cohort of the US population being in their 30s and moving out of apartments and into houses. The increased penetration of remote work has fueled demand for more space. Additionally, the higher interest rate environment also creates a bigger pool of renters versus buyers.

- Data Centres: These, specialized buildings house critical internal infrastructure such as servers and fiber connections. With robust and reliable electricity supply and cooling systems, they enable large corporations to centralize their supercomputers. In the information age, the evolution of the quantum and speed of computing power is exponential. Data Center landlords have an exceptional tailwind of demand that continues to grow.

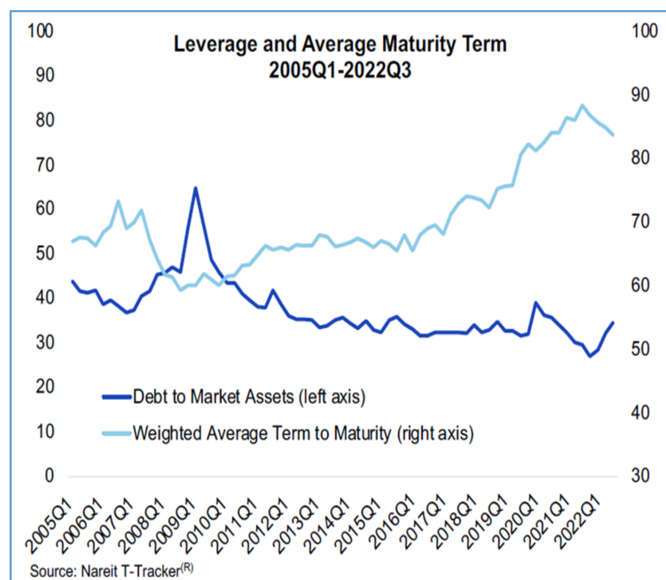
- Self Storage: This sub-sector, offers various sizes of individual storage units that are available for rent to individuals or businesses. Generally, self-storage is seen as fairly recession resistant because it has certain tailwinds in every part of the cycle. For instance, during challenging financial periods, families might downsize and use self storage to store excess furniture and belongings.

Listed Real Estate in the current macro environment

The case for listed real estate, on a fundamental basis, makes sense when one considers the favourable risk and return characteristics. However, it is important to also incorporate the macro environment when one considers this asset class.

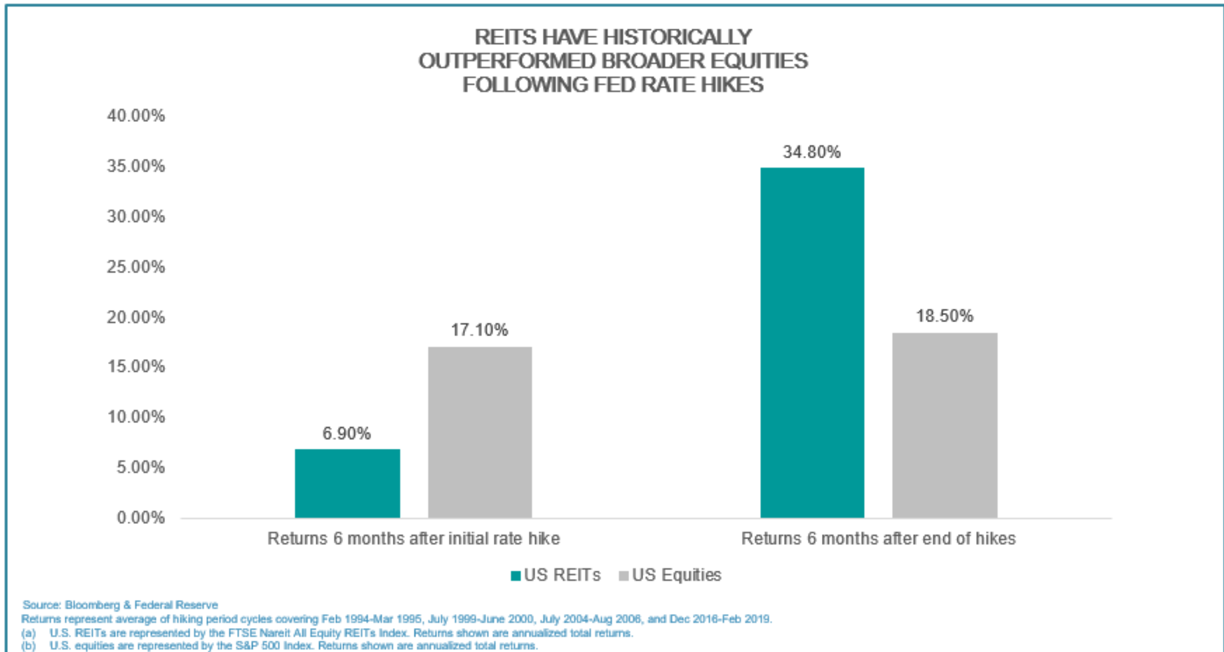
In a higher inflation environment, listed real estate can benefit due to the often inflation linked lease escalation terms. In many cases, a higher inflation environment can also have correlation to higher nominal market rental growth, which will allow for positive rental reversions when leases expire. If companies can keep their operating costs under control, the positive operating leverage effect can be significant.

REITs generally use leverage to maximize return on equity when acquiring, developing and managing their portfolios. In a high interest rate environment, debt becomes expensive causing expansion opportunities to become less accretive, and servicing the existing debt can eat into distributable earnings. The silver lining is that REITs utilise approximately half the leverage of private market real estate companies. Even so, REITs have leverage ratios that are lower than those before the Great Financial crisis. Additionally, companies have been highly disciplined in their hedging strategies, with only a small relative portion unhedged or expiring in the short term. This allows companies optionality when determining how to navigate the current environment.



Source: Nareit T-Tracker(R)

The upside to the current interest rate cycle is evident. Although global listed real estate has underperformed general equities over the past 18 months through the monetary tightening cycle, history has shown us that listed real estate tends to outperform when the hiking cycle ends and policy loosening commences.



Conclusion

In an analysis done from 1976 to 2022 by Firer and McLeod, it was determined that to maximize the risk adjusted return or Sharpe ratio of an unconstrained portfolio, local property should compromise 11.7% of a property portfolio. This despite the average SA multi manager holding less than 5% of SA Property in their portfolio.

Similarly, in global asset allocation, a target allocation of approximately 9-12% to real estate (across direct real estate and REITs) is appropriate per a survey done by Oxford Economics, Cornell University and Hodes Weill.

Listed real estate, both locally and globally, has long proven itself as an effective diversifier within a portfolio. It's low correlation to other asset classes, income + growth total return profile and accurate forecast ability of underlying earnings are all unique characteristics. In addition, being able to get access to the fundamental attributes of physical real estate through the liquid market has cemented its place as an important asset class that should be at the forefront of multi asset investors' minds.

Glacier Research would like to thank Marcus Erlank for his contribution to this week's *Funds on Friday*

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Marcus Erlank joined Catalyst Fund Managers in 2017 as an Investment Analyst. In March 2022 he was promoted to Portfolio Manager on the Alternative Investments team. He manages a long short equity fund with a mandate to invest in local and global listed real estate. Marcus is a qualified Chartered Accountant, CA (SA) and CFA Charter holder. He has spent time in the US working for Ernst & Young LLP as well as working in London for a year on a long term secondment to gain conviction on global real estate markets.

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