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The benefits of global REITs as a portfolio diversifier

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Notwithstanding their consistently strong performance over long periods, global listed property stocks have generally been one of the more neglected investment sectors by South African investors. This is despite global listed property being one of the best return-enhancing portfolio diversifiers over the last ten years (323.8%)[1], especially when compared to the disappointing results of South African listed property (64.1%)[2] over the same time period.

Global listed real estate has steadily been improving its accessibility as an asset class, primarily through the proliferation and success of listed property investment vehicles, such as REITs. Globally the REIT structure, and similar investment products, have offered a broad range of investors access to the same cash flow characteristics that previously were available only to direct commercial real estate investors. Presently 40 countries have REIT-type structures, and non-REIT structured listed real estate companies operate in almost every global market. The latest market to adopt a REIT structure was Sri Lanka in September 2020, with South Africa adopting its REIT structure in 2013[3].

Analysis of global listed real estate in portfolios

During 2006, the National Association of Real Estate Investment Trusts (Nareit) commissioned Ibbotson Associates to conduct an analysis of global commercial real estate from an investment perspective. The study was conducted to focus on combining modern financial theory and real-world investment practice.

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The research used global listed real estate indices to proxy the international commercial real estate asset class. The advantages of REITs and listed real estate stocks over direct physical property investments include liquidity, corporate transparency, enhanced governance, real-time pricing and lower transaction costs. Several research studies have shown that returns from REITs are a close proxy for direct property investment[4].

During the study, various portfolios were constructed with and without REIT allocations. Whenever allocations to REITs were available, the asset allocation model chose the maximum allowable allocation to REITs. The study stated that the optimal allocation to real estate is 15% to 25%. Various other studies on optimal allocation levels found that while estimates of optimal allocations to real estate vary strongly, the median of the proposed allocation in these studies was 15%, with a median range of 6%-21%[5].

Several studies have built on Ibbotson's findings and the vast majority have supported the study's findings that REITs either increase the returns of the portfolio at the same risk level or reduce the risk while offering the same return. Through the years, the role of REITs in a mixed asset portfolio has been examined extensively across several countries, including the USA, United Kingdom, Canada, Australia and Malaysia.

In 2016, a study by Buller, Wald, and Rubin from Fidelity Investments, looked at a 20-year period (December 1995 to December 2015), again clearly demonstrating that an allocation to REIT stocks would have boosted the risk-adjusted returns of a portfolio including US stocks and investment-grade bonds.

Risk/Return Spectrum of Hypothetical Portfolios with REIT Exposure

Allocation	Average Annual Return	Sharpe Ratio	Standard Deviation
REITs 33.3% / Equity 33.3% / Bonds 33.3%	8.70%	0.61	10.90%
REITs 20% / Equity 40% / Bonds 40%	8.10%	0.68	9.20%
REITs 10% / Equity 55% / Bonds 35%	7.90%	0.58	9.90%
Equity 80% / Bonds 20%	7.80%	0.48	12.20%
Equity 60% / Bonds 40%	7.30%	0.55	9.20%

Source: Buller, S., Wald, S. and Rubin, A. "REIT Stocks: An Underutilized Portfolio Diversifier." Fidelity Leadership Series. April 2016.

The benefits of adding global REITs to South African portfolios

With several studies consistently demonstrating the value of adding global REITs to a portfolio, Reitway Global researched the benefits of adding Global Property (represented by the GPR 250 REIT Total Return Global Index) to various portfolios consisting of diversified South African equities (the All-Share Index - ALSI); bonds (the All-Bond Index - ALBI); money market (Short Term Fixed Interest Index - STeFI); and South African listed property (SA Listed Property Index - SAPY). The time period reviewed was a ten-year period from June 2011 to June 2021.

Risk/Return Spectrum of Hypothetical South African Portfolios with Global REIT Exposure

Allocation	Annualised Return	Sharpe Ratio	Standard Deviation
Global REITs 33.3% / RSA Equity 33.3% / RSA Bonds 33.3%	12.01%	0.29	10.61%
Global REITs 25% / RSA Equity 55% / RSA Bonds 20%	11.85%	0.25	11.62%
Global REITs 15% / RSA Equity 60% / RSA Bonds 25%	11.21%	0.20	11.47%
RSA Equity 60% / RSA Bonds 20% / RSA Cash 20%	9.65%	0.07	11.11%
SA Property 15% / RSA Equity 60% / RSA Bonds 25%	9.62%	0.05	12.76%
SA Property 33.3% / RSA Equity 33.3% / RSA Cash 33.3%	8.41%	-0.04	18.28%

Source: Bloomberg, Reitway Global Analysis

Various model portfolios were constructed to compare the performance of a portfolio mix of the available options of Global REITs, ALSI, ALBI, STeFI and SAPY. The portfolio objective was to maximise risk-adjusted returns and utilised the standard Sharpe ratio to provide the measurement of risk-adjusted performance.

The results demonstrated the positive contribution of Global REITs to portfolios, improving annualised performance and Sharpe ratios, and lowering standard deviations. Mirroring international findings for Global Property allocations of 15% to 25%, the best risk adjusted returns were obtained with an allocation between 15% to 33%.

The drivers of these results are the primary benefits that listed property offers namely:

- **An asset class that offers low correlations**. Compared to South African asset classes, global REITs has demonstrated low correlations, and is negatively correlated with SA fixed income, money market and property.
- **An asset class that offers good inflation protection.** Landlords generally link rental escalations to inflation and rental rates tend to rise during periods of increasing inflation, generally protecting listed property from the detrimental effect of inflation.
- **An asset class that offers solidly growing distributions.** Due to the income distribution requirement, REITs generally have higher dividend yields compared to general equities and bonds.

Conclusion

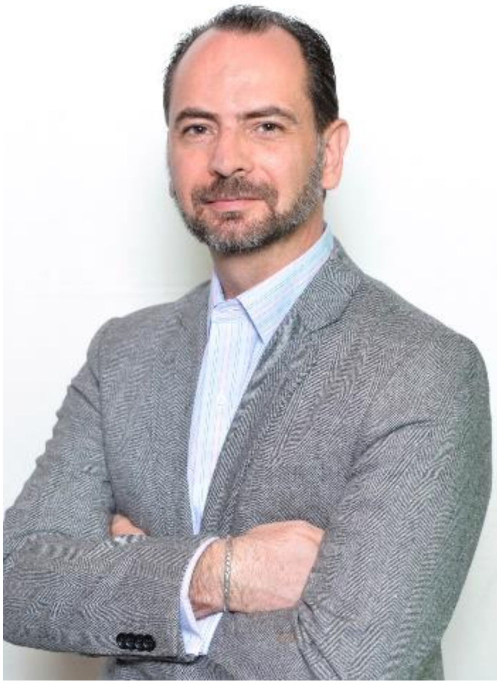
Global REITs is an asset class that has proven itself over the long-term, and it has shown why it should be included in all South African investors' portfolios. Global REITs offer South African investors a diversified, uncorrelated, income-producing asset class that delivers hard currency returns.

Most academic and practitioner studies conclude that adding global REITs improves the risk-return profile of a mixed-asset portfolio, and that achieving the optimal inter-asset allocation of investors' capital is of primary importance due to the critical impact it has on portfolio performance.

The international property universe offers investors over 1,000 investible global companies, 25 diversified sectors and sub-sectors, over 40 countries, and a range of international currencies. All of this combines to offer investors superior long-term diversification, inflation protection and income-generation through varied economic cycles.

SA-focused research bolsters the view that from a diversification standpoint global REITs may boost returns and/or reduce risk when added to a diversified portfolio of South African equities and fixed income.

Glacier Research would like to thank Garreth Elston for his contribution to this week's Funds on Friday.



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Garreth Elston is the Chief Investment Officer of Reitway Global's suite of global listed property funds. He is an investment management professional with over 20 years of international capital markets' experience in South Africa, North America, the United Kingdom and Europe. Garreth has a deep passion for real estate and has significant experience in listed and unlisted real estate investments, property development and real estate private equity. Garreth holds an MBA from the Rotman School of Management at the University of Toronto, an MA in International Relations, and a BCom in Banking Management. He is a Certified Associate of the Institute of Bankers in South Africa (CAIB) SA, and a Fellow of the Institute of Financial Markets (FIFM).

[1] Bloomberg, Cumulative GPR250R Index Total Return in ZAR, 2011-06-30 to 2021-06-30.

[2] Bloomberg, Cumulative J253 Index Total Return in ZAR. 2011-06-30 to 2021-06-30.

[3] In the USA to qualify as a REIT: the company must operate in the real estate business, investing at least 75% of its total assets in qualifying assets; derive at least 75% of its gross income from rentals or interest on mortgages; it must distribute at least 90% of its taxable income

[4] Beath, A. D. and Flynn, C. "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States, 1998 -2018." CEM Benchmarking, October, 2020.

[5] The Diversification Potential of Real estate. Norges Bank Investment Management, 2015.