Sector independence: listed real estate comes of age

Content table

Contact

Contact EPRA Research Team:

Ali Zaidi
a.zaidi@epra.com

Inna Maslova
i.maslova@epra.com

Disclaimer

Key points

- Listed Real Estate became a separate GICS sector from September 2016.
- This is the first time that a sector has been separated out since the Classification system was introduced in 1999.
- This move, by S&P and MSCI, confirms that listed real estate is both an important equity sector in terms of size, and an important sector amongst all asset classes because of its unique investment characteristics.
- It used to sit as a sub-sector in the Financials grouping, and we believe the separation will create extra visibility and attention on the sector from a new range of generalist fund managers/analysts.
- This comes at the same time as a report by the EDHEC Infrastructure Institute concludes that listed infrastructure is not an asset class or a unique combination of market factors.[1]
- If institutions, who are reported to be currently underweight listed real estate, seek to maintain a market weighting there could be significant extra demand for the listed sector in the short term.
- The key point, however, is the long term, ongoing benefit to the sector, with further stimulus expected if other index providers eventually follow suit and separate it out from being a sub-sector of the Financials Index.

Background

On 1st September 2016 MSCI separated Real Estate as a separate sector in their Global Industry Classification Standard ("GICS")[2], which is used by asset allocators for benchmarking weightings of individual sectors. S&P followed suit on 16 September 2016. There were 10 sectors in the ACWI[3], which we show below, together with their weight in the Index pre and post the change.

	Pre Sep 1	**Post Sep 1**
Consumer Discretionary	12.29%	12.29%
Consumer Staples	10.45%	10.45%
Energy	6.75%	6.75%
Financials	20.25%	16.85%
Health Care	11.87%	11.87%
Industrials	10.49%	10.49%
Information Technology	15.67%	15.67%
Materials	5.11%	5.11%
Real Estate	-	3.40%
Telecommunication Services	3.81%	3.81%
Utilities	3.32%	3.32%
Total	**100.00%**	**100.00%**

As can be seen, Financials are the largest weighting, accounting for a fifth of this global equity index. It should be noted that sector weightings between different equity indices can vary, according to the Index Provider criteria. Prior to the change Real Estate sat within Financials, which was broken down as follows:

[1] *Searching for a Listed Infrastructure Asset Class – EDHEC Infrastructure Institute June 2016*

[2] *GICS was developed by MSCI and Standard & Poor's to offer an efficient investment tool to capture the breadth, depth and evolution of industry sectors.*

[3] *MSCI All Country World Index ("ACWI")*

	Pre Sep 1	Post Sep 1
Banks	9.29%	9.29%
Diversified Financials	3.74%	3.79%
Insurance	3.78%	3.78%
Real Estate	3.44%	-
Total	**20.25%**	**16.85%**

Some explanation is required here regarding the Index Classification hierarchy. Within the Real Estate category there is another division, into REITs and Real Estate Management and development companies.

REITs are then further split into:

Diversified REITs
Health Care REITs
Hotel & Resort REITs
Industrial REITs
Mortgage REITs
Office REITs
Residential REITs
Retail REITs
Specialised REITs

Real Estate Management & Development is split into:

Diversified Real Estate Activities
Real Estate Development
Real Estate Operating Companies
Real Estate Services

Typically, generalist fund managers would allocate an active weighting to the top level (10 now 11) industry codes, relative to their benchmark weighting. The sub-sectors provide generalists with an appreciation of the variety of specialisation, and differentiation within the sector, although weightings can be more subject to asset allocation preferences rather than Index weightings.

As at 1st September Real Estate became the 11th separate sector, and was no longer grouped as a sub-sector in the Financials category. Since the formation of GICS in 1999, this is the first and only sector to be separated out in this manner. Whilst there may have been a short term boost ahead, and immediately after, this event, we believe that the real benefits will continue to flow to the sector over time. In particular:

- The separation clearly provides third party validation for the growth, institutional demand, investment characteristics and “independence” of listed real estate. This ensures that it will receive an increased level of attention from generalists on an ongoing basis.
- The short term boost will come from investors positioning to a more market weight ahead of the new classification.
- Over the coming months and quarters, we expect there could be enhanced levels of activity and liquidity in the sector as asset allocators determine the portfolio attribution impact of the sector weighing.
- Not all Index Providers are making the change. FTSE Russell has not yet decided to change. If and when they and others do we believe this would provide a further longer term stimulus to profile, and, more importantly, funds committed to the sector.

Structure

To coincide with the event, we examine what impact this may have on the European listed real estate sector. We believe that there are three key areas which are particularly relevant, and have divided this report into the following sections to analyse the potential impact.

1. Sector independence: the rationale behind the new classification. We look at this in terms of:

    1.1. The growth of the sector in absolute and relative terms
    1.2. The correlation with the Financials grouping
    1.3. The listed sector providing an alternative way of accessing a third asset class (after equities and bonds).

2. Key potential implications of the new classification. A number of claims have been made and we seek to establish whether there will be:

    2.1. An increase in demand over time from generalist, equity, multi-asset, income and direct property fund managers. This could take the form of passive or active exposure, and internally or externally managed funds.
    2.2. A decline in volatility
    2.3. An increase in recognition and the image of the sector, increasing visibility and exposure, and most likely leading to greater levels of research on the sector.

3. Why listed real estate is being (and may in future be) used in practice by generalist fund managers. Given the new separation, will generalist fund managers choose to utilise a separate listed real estate allocation?

1. Sector independence

It is important to understand the reasons why the sector is being separated out from the Financials grouping. The first factor relates to size. The move marks a major step in recognising that the sector is now sufficiently large to warrant separate allocations and dedicated resources.

The second factor relates to the fact that asset allocators are able to formulate and execute real estate strategies incorporating listed real estate outside of a standard (c.3-4%) equity market allocation. In particular the larger pension funds and Sovereign Wealth Funds have been using a combination of direct real estate, Joint Ventures, Unlisted Funds, and Listed Real Estate to achieve their objectives. Typically, real estate receives an explicit allocation vs. equities and bonds, but listed real estate does not always, and can be used to form part of the real estate allocation. Allocations can vary enormously, from 0-20%, but are more commonly in the 5-10% band. These apply not just to benchmarked funds but also absolute return funds and those using an Opportunity Cost Model. As a result, a number of smaller funds are re-assessing the role that listed real estate can play in their portfolio allocations.

The third factor is the unique structure of REITs, particularly in a market environment of low inflation and bond yields. REITs now account for around 70% of the EPRA Global Developed Index. The structure means they are comparable to underlying real estate in the cash flows they produce and have unique characteristics because of the obligatory (typically 90%) payout ratio. The sector has therefore found increasing favour with asset allocators as they seek to combine income and growth as the market adjusts to expected rate rises and more normalised bond yield levels.

1.1 Growth of the sector

In terms of absolute size, the sector can now be considered significant. At the trough of the latest market cycle (end of February 2009) the free float market capitalisation of the EPRA Global Index was US$297bn and the sector represented just 1.1% of the equity market. Fast forward to December 2015 and through a combination of equity fund raising and strong investment performance the free float market capitalisation of the EPRA Global Developed Market Index wasUS$1,284bn, (a fourfold increase) and, as we have seen earlier, it currently represents c. 3.5% of the global equity market. Therefore, in global terms, it is easy to understand why it has become worthy of a separate classification.

With regard to the specific issue of the size of the listed real estate sector relative to the size of the Financials sector, it is important to understand the regional variations to determine the likely initial impact of the change in classification. In table 1 below we show the breakdown by region of i) the overall equity market weighting, ii) the weighting of financials in the index, the weighting of real estate in the index and as a percentage of Financials as well as a breakdown of the number of companies in the index, broken down by sector.

Table 1 Regional weightings (May 2016)

		Europe	North America	/Pacific Ex Ja	Japan	Africa/Mideas	Latin America
ACWI Weight	Weight in ACWI	22.5	56.7	10.8	7.6	1.1	1.3
Financials	Weight of financials in index	21.29%	18%	35%	18%	34%	30%
Real Estate	Weight of real estate in index	1.51%	3.27%	7.04%	4.99%	8.16%	1.81%
Real Estate %	Real estate % of financials in index	7.1%	18.5%	20.1%	28.2%	24.1%	6.0%
	Number of companies in index	527	714	702	318	93	121
Financials	Number of financials in index	123	143	178	58	45	28
Real Estate	Number of real estate in index	14	43	58	18	14	3

As can be seen North America is by far the largest region of the total equity index and accounts for around 57% of the total weighting, followed by Europe at 22.5%. Within the regions there is a huge variation of the Financials weighting, ranging from 35% in Asia Pac ex Japan to 18% in Japan and the US. Europe is 21%. Next, we need to look at the weighting of Real Estate within Financials and the overall equity market. Japan has the highest weightings for real estate within financials at 28% and Europe the lowest at 7.1%. Finally, in terms of real estate as a total of the whole equity market this is highest in Asia Pac ex Japan at 7.04% and lowest in Europe at 1.5%. What are the implications for the separate classification of the index? Initially, it would appear that the greatest initial impact will be on the biggest overall market (the US) as well as the regions with greatest percentage of real estate in the Financials index (Asia Pacific, and Japan). Thus far, in terms of press coverage and literature, it is the US which has received the most attention regarding the likely impact. By contrast the attention Europe has received is relatively small currently.

In terms of the breakdown within Europe (Table 2), and using the same analysis, we can see that it is the largest markets of the UK, France and Germany that are most likely to be affected.

Table 2 European weightings

	Comment	United Kingdom	France	Germany	Netherlands	Belgium	Sweden
ACWI Weight	Weight in ACWI	6.6	3.3	3.0	1.0	0.5	1.0
Financials	Weight of financials in index	22%	18%	18%	19%	17%	32%
Real Estate	Weight of real estate in index	1.70%	3.94%	2.50%	0.00%	0.00%	0.00%
Real Estate %	Real estate % of financials in index	7.9%	21.8%	14.1%	0.0%	0.0%	0.0%
	Number of companies in index	113	73	54	23	11	30
Financials	Number of financials in index	27	14	8	3	3	7
Real Estate	Number of real estate in index	5	5	2	0	0	0

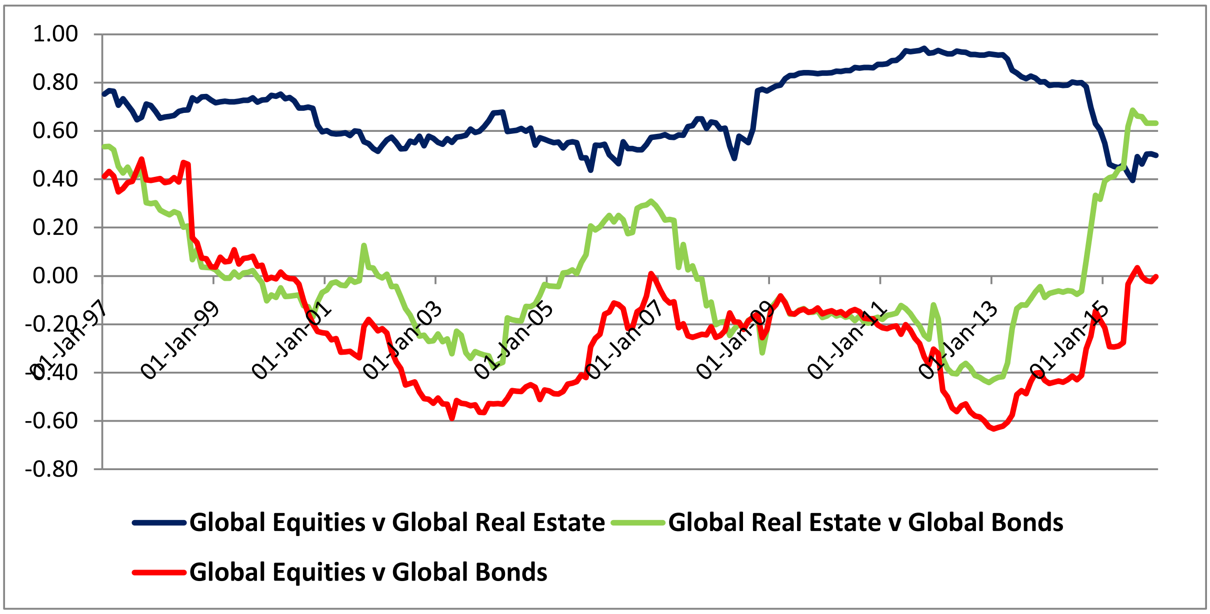
1.2 Lack of correlation with the Financials sector

One of the reasons given for the separation has been that the listed real estate sector does not have a significant correlation with the rest of the financial sector. Obviously, this can vary over time, but Cohen & Steers[4] have estimated that over the period 1990-2015 US REITs had a correlation of 55% with the S&P 500 Index, whereas the US Financials sector had a correlation of 84%, suggesting that there are very different drivers of performance over the longer term. The implication of this being that some of the volatility attributed to real estate stocks by being part of the Financials sector may erode once they are classified as separate sectors.

EPRA monitor the rolling correlation of the global listed real estate sector with the global equity market and the global bond market (Chart 1). What may surprise some generalist investors, who regard listed real estate as “pure” equities, is that over the last two years the sector is more correlated with the bond market than the equity market. This has important, positive diversification implications for the sectors’ role within multi-asset portfolios, particularly as we appear to be in long term “lower for longer” phase globally, where investors have become more income sensitive.

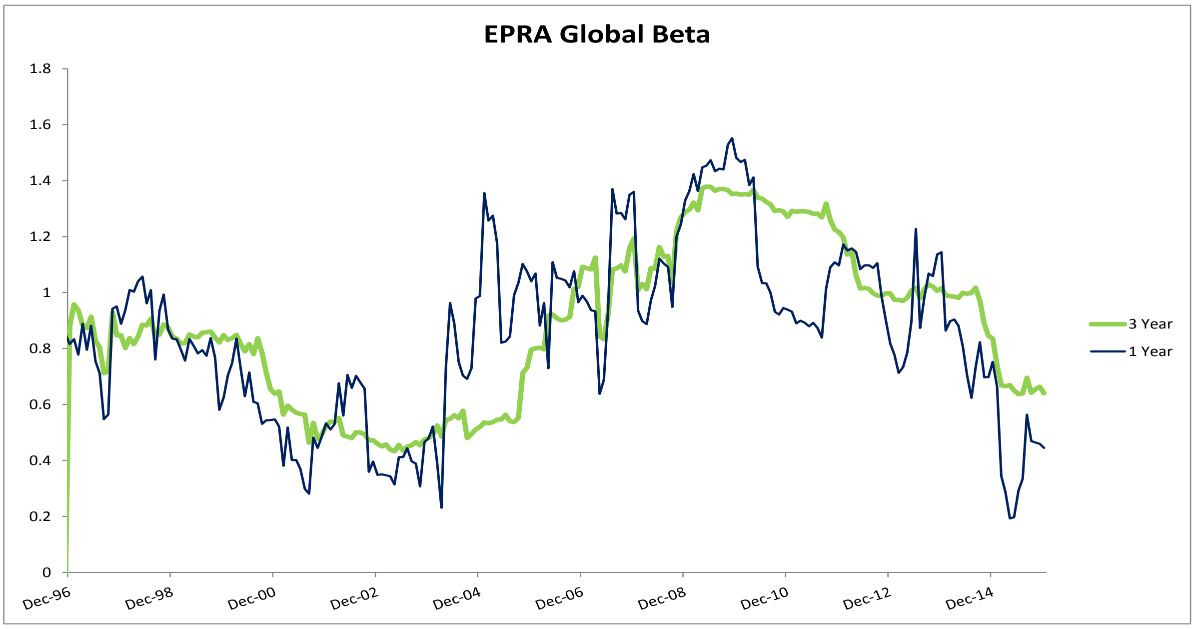
[4] *Cohen & Steers “Real Estate in a Class of its Own” March 2016*

Chart 1 REIT correlations with Equities and Bonds (Source: EPRA Statistical Bulletin)



We can also look at this way, in terms of the sector "beta". As can be seen in chart 2 this has been reducing significantly since the GFC.

Chart 2 Global Listed Real Estate Beta – Rolling 1 and 3 year periods – Source: Consilia Capital

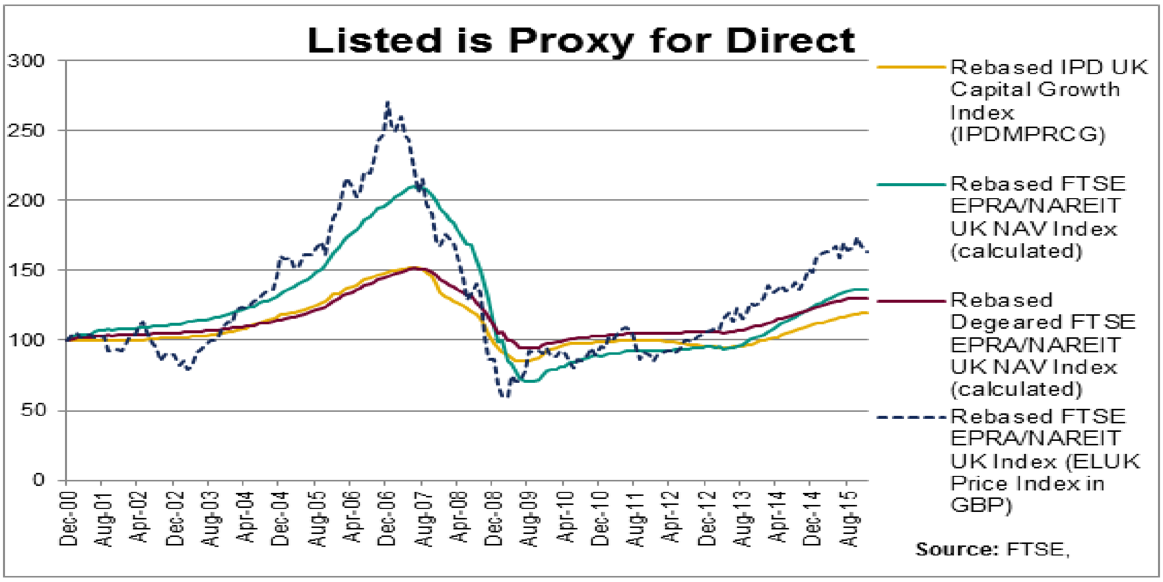


Another popular misconception from some generalist investors is that the listed sector is highly leveraged and dependent upon bank debt. In fact, post GFC the sector has been reducing leverage (despite ever lower costs of debt capital) as well as diversifying away from bank sources to the debt capital markets. For the European sector, EPRA produces a monthly LTV Monitor, which shows the trend in LTVs, broken down by country, as well as all the equity and debt capital issues that have occurred. In particular this document shows the leading European listed real estate companies have been able to transition away from dependence upon debt provided by banks by using the wide range of instruments available in the debt capital markets. This has allowed them to enhance earnings (and therefore dividends) via the lower interest costs available on debt refinancing, diversify risk away from individual lenders, reduce the level of secured debt in their portfolio, extend maturities, and achieve a balanced loan portfolio with a reduced level of risk.

1.3 Alternative way of accessing the asset class

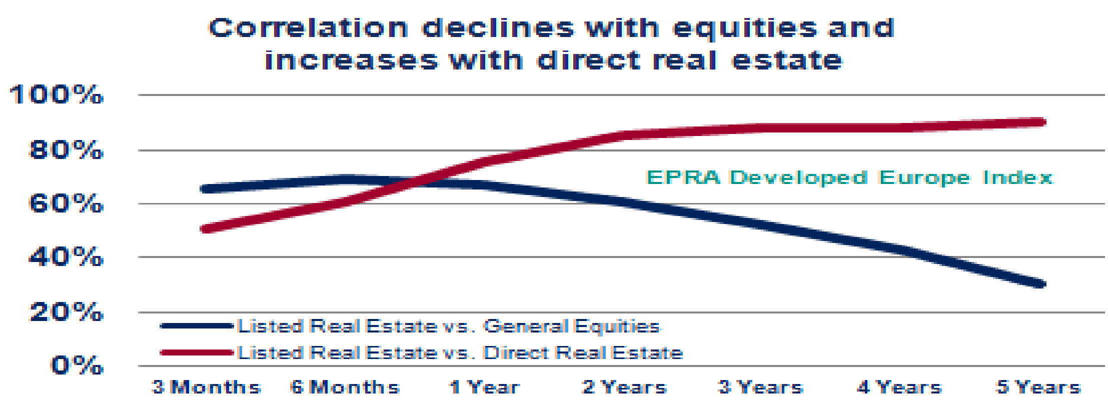
Following on from the declining correlation with the equity market, the question that generalists who will be seeking to take an explicit weighting in the sector for the first time will be asking, is to what extent would an exposure to the listed sector provide effective exposure to the underlying asset class? There are two ways of illustrating this point clearly. Firstly, by comparing the performance of the listed sector to a direct property benchmark, and secondly by determining the time it takes for listed real estate returns to correlate more closely to direct property returns rather than equity market returns. It should be noted that this approach is easiest in Europe in general and the UK in particular, where frequent property valuations are incorporated into the balance sheet of listed companies, and analysts forecast the expected NAVs for the next 2-3 years, which are then assimilated at an aggregated consensus level into share prices. Firstly, Chart 3 shows how we can compare ungeared property returns at an asset and corporate level, then to geared corporate NAV returns, and finally total share price returns. As can be seen from the chart below the UK sector as a whole has outperformed its property benchmark. This outperformance is obviously increased at the listed entity level. It is worth noting that large asset owners who aren't liquidity constrained have invested in listed for a significant period of time, with allocation often via the direct real estate teams. Therefore, listed real estate is not only for investors who lack the funds to diversify sufficiently on a global scale.

Chart 3 Property Returns relative to corporate returns



Secondly we look at the relationship over time of listed real estate returns with direct property returns. As can be seen in chart 4 the correlation with direct real estate overtakes that of the correlation with the equity market after one year and continues to increase thereafter.

Chart 4 Correlation of listed real estate with direct real estate



We can therefore see very clearly that the separation of the sector can be expected to provide generalists with a clear way of gaining exposure to the return characteristics of the underlying assets.

2. Key potential implications of the new classification

We seek to establish whether there will be:

1. An increase in demand over time from "generalist" fund managers who may be underweight the sector;
2. A decline in volatility;
3. Fund managers will have to make an explicit weighting decision on the sector for the first time.

2.1 Demand

There has been a lot of debate over recent months over both the extent to which generalist fund managers may be underweight real estate equities, and the extent to which they may seek to reduce this underweight position. Firstly, why might generalists be underweight? The reason lies in the fact that a fund may have a market-weighting in Financials, but be long Banks and Insurance Companies but underweight Real Estate. In a widely quoted report JP Morgan Research stated that in the US long-only 1940-Act equity funds have an average real estate weight of 2.3%, compared to 4.4% for their benchmark, representing a 2.1% underweight. Translating this to absolute amounts it is estimated that this would require US$100bn of inflows (c. 12% of the value of the US sector) to move to a neutral position. Clearly there is unlikely to be a move of that proportion in the short term, but the analysis does illustrate a potential positive impact of the sector having a separate classification.

2.2 Volatility

With regard to volatility there is an argument that with increased visibility and by implication liquidity, the real estate sector should exhibit lower volatility as it "de-merges" from the historically more volatile Financials sector, and becomes more related to the lower volatility of the underlying real estate. Intuitively this makes sense, and Table 3 illustrates the superior returns and lower risk of real estate vs. Financials.

Table 3 Risk and return: 2000-2015 Source: Investec Asset Management[5]

Asset Class	annualised return	standard deviation
Real Estate Securities	9.70%	18.90%
Bonds	5.00%	5.70%
Equities	3.30%	15.80%
Financials Sector	2.00%	20.80%

Although it is often claimed that direct real estate has a significantly lower level of volatility, it is interesting to note that over a 10-year period to June 2016 the annualised volatility of the IPD total Return All Property Index was 15.0%, not significantly lower, whilst the annualised total returns were 4.3%, i.e. significantly lower than for listed real estate (Source: IPD Monthly Property Index June 2016).

In the Expert Report prepared for the Norwegian Government Pension Fund Global (GPFG) published in December 2015 the authors looked at the long term performance of listed real estate and found that over the period 1999-2015 global core real estate had an average annualised return of 9.8%, and an annualised volatility of 17.6%. It can therefore be seen that listed real estate typically exhibits superior raw returns with only marginally higher levels of volatility, but far greater levels of actual liquidity.

2.3 Explicit weighting

One of the issues surrounding the separation of the sector is clearly that generalists will be required to make an explicit weighting. Whilst this is potentially positive, the interesting question is how that weighting will be determined. Whilst the fundamental outlook for the underlying real estate will obviously be considered it is important to note that there are typically three broad valuation methodologies utilised for listed real estate, namely; earnings (or Adjusted Funds From Operations, "AFFO") based, dividend based, and NAV based metrics. Whilst the first earnings and dividend data can be accessed from the same sources as the other 10 GICS sectors, typically listed real estate specialists focus on AFFO and NAV data which is not commonly available or used for other sectors. This may therefore create greater liquidity in the sector as multiple valuation methods are applied. To help generalists in this area, EPRA publishes two documents for its members which relate to the NAVs of European listed real estate companies: "Monthly Published NAV data "(PDF) and "Discount to NAV "(Excel spreadsheet).

[5] *"Real Estate Securities: Securing its own space" May 2016 Investec Asset Management*

3. Why listed real estate is being (and may in the future be) used in practice by generalist fund managers

Given the new separation, will fund managers choose to utilise a separate listed real estate allocation?

The role that listed real estate can play in portfolio management continues to evolve. In this section we highlight some of the key topics which we believe will be of interest to generalists new to the sector in determining a separate listed real estate allocation, and provide a guide to some of the publications which are available to EPRA members. To ensure up to date and independent data we have provided conclusions from the recent expert report commissioned by the Norwegian Ministry of Finance[6] (the "GPFG Report"). The key questions we are trying to answer are as follows:

1. Does listed real estate provide true real estate exposure?
2. Performance: has listed real estate performance justified a separate allocation?
3. Weighting for real estate – what is an appropriate figure?
4. How beneficial is adding a global listed exposure to a multi-asset portfolio?

3.1 Listed real estate: true real estate exposure?

Academic evidence has established that listed (public) and unlisted (private) real estate markets have the same return characteristics over the long run. The GPFG Report suggests that there is no evidence for superior performance or reduced risk of unlisted, or of diversification benefits of adding unlisted to listed, and they also find that the volatility of unlisted is similar to listed after adjusting for smoothing and extending the time horizon.

3.2 Performance of global listed real estate: sufficient to justify a separate allocation?

Listed real estate has on average outperformed private real estate by 3% pa over the period 1994-2015 (i.e. from the beginning of the Modern REIT era). Over all three periods studied in the GPFG report public real estate outperformed private real estate, which outperformed stocks, which outperformed bonds.

The evidence is clear that listed real estate has generated sufficient levels of return across the short, medium and long term to warrant inclusion of at least market weighting.

3.3 Weighting

The Norges Ministry of Finance recently determined to increase maximum allocation to real estate from 5% to 7%. A weighting range of 3-10% is consistent with broader institutional real estate allocations. The GPFG Report estimates that real estate represents about 6% of the world market portfolio with listed real estate comprising 15% of the real estate universe. REITs make up only a small fraction of (12-13%) of total real estate investment by pension funds.

[6] *"A review of real estate and infrastructure investments by the Norwegian Pension Fund Global (GPFG) "December 2015*

3.4 How beneficial is adding a global listed exposure to a multi-asset portfolio?

A number of academic studies have highlighted the benefits to risk adjusted returns of adding a global listed real estate allocation to a multi-asset portfolio. Alongside studies which focus on a permanent long-only exposure there has been increasing interest in adding automated trading strategies which can increase/decrease allocations to the sector. The most recent study, by the team at Cass Business School investigated the impact of adding Global REITs to a multi-asset portfolio, using momentum and trend following strategies. They found that the main improvements arose when a broad index is replaced with one of the four trend following (TF) strategies. The portfolios deliver similar returns but volatility is reduced by up to a quarter to the 8-9% range, the Sharpe ratios increase by 0.1 to 0.5 with the main benefit being the reduction in the maximum drawdown to under 30% compared to 43% when the broad index was used. They concluded that a combined momentum and trend following Global REIT strategy can be beneficial for both a dedicated REIT portfolio and adding REITs to a multi-asset portfolio.

Conclusions

- A stand-alone real estate sector is a recognition that listed property companies are an important investment sector in their own right, standing shoulder to shoulder with telecommunication services, healthcare and other mainstream industries. It underpins what EPRA research has highlighted for years: the inclusion of real estate stocks in a portfolio means that over the medium term investors can access the returns of the direct property market with the added advantages of much greater liquidity and lower costs.

- The growth in the global listed real estate market is due largely to the expansion of tax-efficient Real Estate Investment Trust (REIT) regimes, which now make up 70% of the Global Developed Market Index. REITs distribute most of their rental income cash flows as dividends, so gaining favour with investors seeking income and capital value growth in the prevailing low interest rate environment.

- One of the reasons for removing real estate from the GICS Financials sector (the largest of the 10 industry sectors with a 20.12% weighting under the former treatment) was the low correlation in the performance of property stocks relative to other equities classified as financials, such as banks. This is supported by the relative volatility of listed real estate and financial stock indices. The 10-year volatility of the FTSE EPRA/NAREIT Developed Europe Index is 19.4%, whereas for MSCI Europe/Financials it is 29.52% for the same period. Changing the listed property sector’s status should therefore reduce volatility to levels that are closer to that of the underlying direct property.

- The volatility of listed securities has been the main reason referred to by European institutional investors for why they do not allocate to listed property. The decoupling from Financials is expected to improve the risk-profile of REITs and start attracting new allocations.

- The potential for these additional investment capital flows is enormous, even though attracting the money would be a gradual process.

- The GICS move may well be replicated by other major equity indices providers, given the momentum of growth in the global listed real estate sector. We are witnessing the increasing maturity of real estate as an asset class with the listed property sector becoming a credible and sizeable complement to fixed income and general equity investments.