Access the opportunities.

The proper(ty) allocation

Research Paper
September 2021

Introduction

Most Australian portfolios do not have exposure to international property securities. While most Australian investors have exposure to local property securities for their regular income and potential capital growth, it's unlikely they've considered property beyond our shores.

The rationale for an allocation to international property for investors is compelling.

As interest rates globally hover at historic low levels, investors are being starved of income from traditional sources such as bonds or savings accounts. Investors are having to take on more risk and are moving to Real Estate Investment Trusts (REITs) because they provide a reliable income stream. Savvy investors are also looking beyond Australian shores and starting to include international REITs as a way to diversify.

A key benefit of including international REITs in a diversified portfolio, as this paper will show, is that while additional risk is incurred, the historical risk adjusted returns over the past five years have been higher. A portfolio of international REITs also provides investors with important benefits.

International REITs offer opportunities not available on Australian shores.

Benefits of international REITs

The global economy, in the aftermath of the GFC (global financial crisis), has been characterised by periods of low economic growth and low interest rates. Since the onset of COVID, 10-year government bond yields around the world had fallen to historical low levels. In Australia these fell below 0.6% for the first time. In other developed nations they went to zero. Real returns on cash investments were barely sitting above 0%. This raised significant challenges for investors seeking to generate income from their portfolios while also preserving capital value.

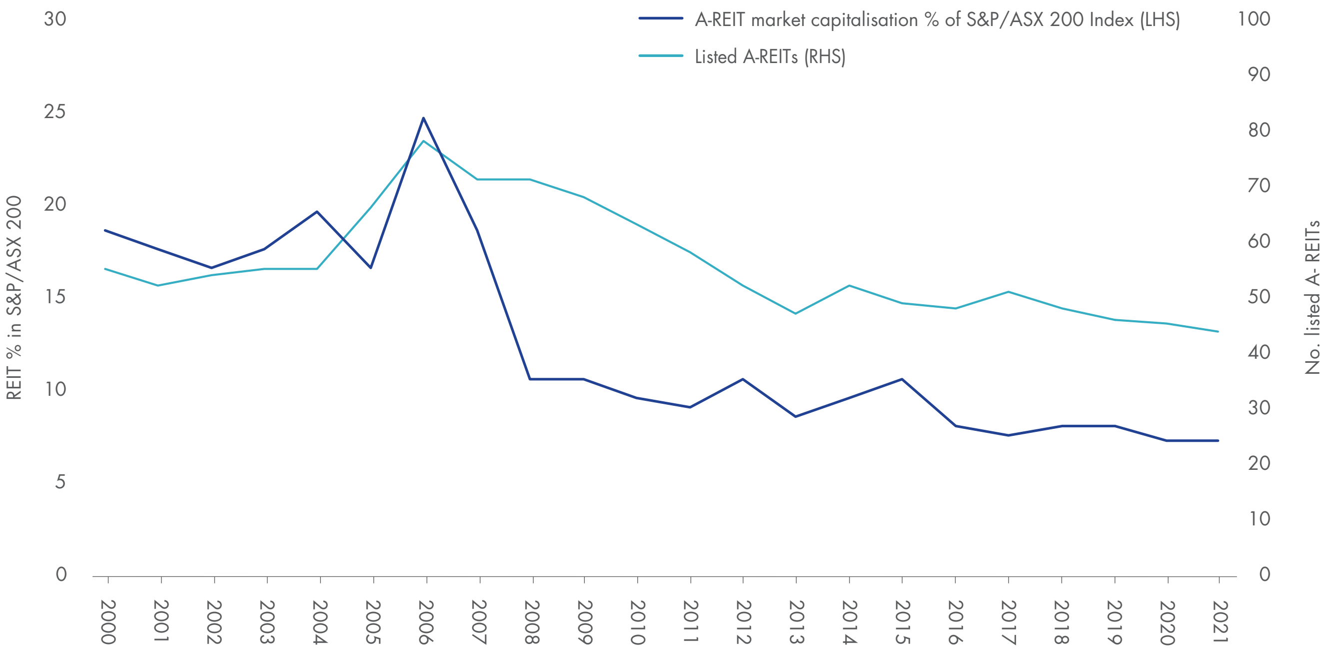
As interest rates globally hover at historic low levels, investors are seeking income by taking extra risk. REITs have been a beneficiary. A key benefit of REITs is the defensive income streams they can provide. Property assets typically earn reliable income from rent, which provides a regular income stream to investors, even during an economic downturn. Additionally, rents can be linked to inflation, which is important because it means income increases with the costs of living.

Diversification – sectors and exposures beyond Australia

Australia was one of the pioneers of listed real estate investing. General Property Trust was the first Australian Listed Property Trust (LPT) in 1971. LPT's were subsequently renamed REITs in line with international practice.

Since the beginning of the century, the proportion of the S&P/ASX 200 represented by REITs has fallen to below 7%, down from a peak of 25% in 2006 as illustrated in Chart 1. One of the major reasons for the decline of the sector hasn't been poor returns, but rather a number of corporate actions, mergers and acquisitions. In 2006 there were a record 71 listed A-REITs, today there are 45. A number of A-REITs have been sold to offshore investors, a number have merged while others have been restructured. For example, Westfield and its various entities have experienced several corporate actions consolidating, spinning off and finally being taken over by Unibail Rodamco for $32 billion (the Australian shopping centres branded as Westfield and held by Scentre were not acquired by Unibail). Investa was bought by funds managed by JP Morgan for $6.6 billion and Multiplex became part of Brookfield, a US Listed company for $7.3 billion. You can see the impact of these changes to the Australian REIT market in Chart 1. With local opportunities shrinking, it's time for Australian investors to consider diversifying offshore.

Chart 1: A-REIT's diminishing importance on ASX



Source: Factset, ASX, VanEck, 2000 to 2021.

Today, Australia accounts for just 3% of the world's REIT opportunity by market capitalisation. While the US remains the largest listed real estate market, the opportunity is increasingly becoming global. Today, nearly 40 countries offer REITs, according to Nareit, the worldwide group representing REITs and publicly traded real estate companies.[1]

For those investors holding A-REITs, the Australian market is dominated by a few big trusts, where the top 10 A-REITs accounted for over 90% of the S&P/ASX 200 A-REIT Index as at June 2021. That contrasts with listed property assets offshore. The benchmark for the international listed property market for Australian investors, the FTSE EPRA Nareit Developed ex Australia Rental Index (International REIT Index), is well diversified, with the top 10 stocks accounting for just 23% of the index. Th International REIT Index has a 21% exposure to retail REITs, a 9% exposure to healthcare property trusts, 4% to hotel and resorts, 9% to specialised REITs such as data centres and 14% in residential property trusts[2]. Some of these sectors are not readily available in Australia. Therefore, investing offshore can broaden investors' property opportunities and increase their diversification.

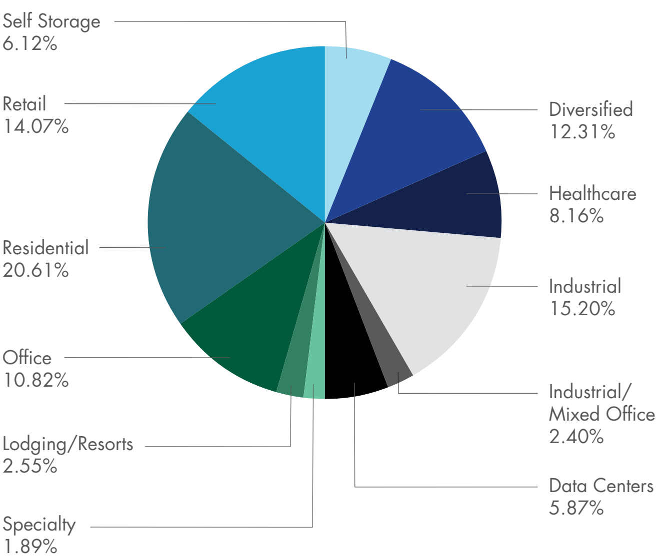
Table 1: Breakdown of Australian REITs compared to international REITs

	S&P/ASX 200 A-REIT Index	FTSE EPRA Nareit Developed ex Australia Rental Index AUD Hedged
Number of securities	21	3.15
Weight of largest constituent	28%	5.73%
Weight of top 10	85.5%	25.60%
Countries	2*	20

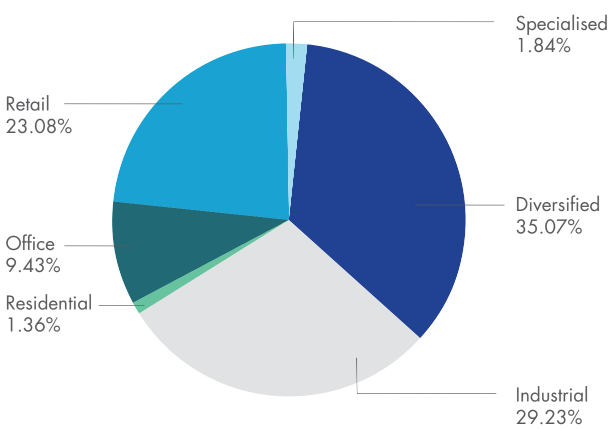
Source: FTSE, S&P, Bloomberg. As at 31 August 2021. *Australia and France due to Unibail Rodamco cross-list.

Chart 2: Sector comparisons of Australian REITs compared to international REITs

FTSE EPRA Nareit Developed ex Australia Rental Index



S&P/ASX 200 A-REIT Index (%)



Source: FactSet, FTSE, 31 August 2019.

1. Investing in REITS: Global Real Estate Investment, Nareit.
2. FTSE, Bloomberg, as at 31 August 2019.

Diversification – low correlation with other asset classes

REITs have been used by investors for their defensive qualities as they achieve a high proportion of their returns from income rather than capital. In addition, listed property has a low correlation of returns with those of other equities and fixed income investments.

Table 2: Correlation between asset classes

Asset Class	Australian Equities	International Equities	Australian Property	Australian Bonds	Global Bonds (Hedged)	International Property (Hedged)
Australian Equities	1.00					
International Equities	0.54	1.00				
Australian Property	0.78	0.45	1.00			
Australian Bonds	-0.02	0.07	0.26	1.00		
Global Bonds (Hedged)	0.18	-0.05	0.43	0.69	1.00	
International Property (Hedged)	0.72	0.38	0.75	0.09	0.42	1.00

Source: Morningstar Direct, all returns in Australian dollars. Correlation: 1 September 2011 to 31 August 2021. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance.

Indices used: Cash – RBA target cash rate, Global Bonds – Barclays Global Aggregate Bond Index A$ Hedged; Australian Bonds – Bloomberg AusBond Composite 0+ years; Australian Property – S&P/ASX 200 A-REIT, International Equities – MSCI World ex Australia Index; Australian Equities – S&P/ASX 200; International Property – FTSE EPRA Nareit Developed ex Australia Rental Index AUD Hedged.

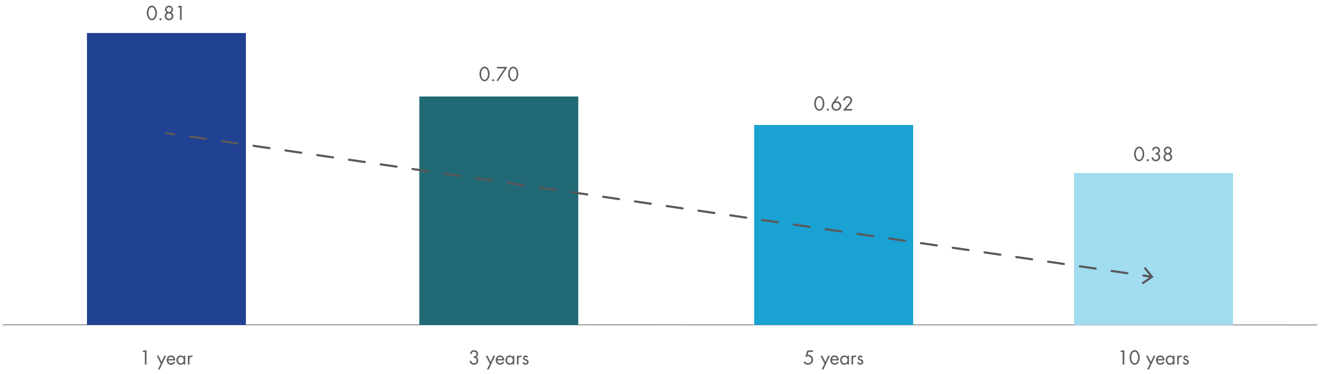
Brad Case, Director of Economics, Fannie Mae and Senior Vice President, Research and Industry Information for Nareit, has researched residential and commercial real estate markets for more than 25 years. In a recent research paper Case illustrated the correlation of returns of US REITs with the US equities Russell 3000 Index. Case showed that, unlike other sectors, the correlation fell over increasing investment horizons[3]. REIT returns, Case says, respond to the long real estate market cycle, whereas the broad stock market responds to the much shorter business cycle.

VanEck research shows that the findings of Case's study are also applicable to Australians investing in international property. To illustrate how international property is correlated to the international equities in most Australians' portfolios, which are unhedged, in Chart 3 we compare the two standard market benchmarks for each asset class. For international equities, the MSCI World ex Australia Index is used. For international property, as most investors seek a hedged exposure to the asset class to limit the impact of currency movements on income, the International REIT Index is used.

Mirroring Case's analysis, international REITs show a downward-sloping term structure of correlations with the broad international equities market.

As their underlying return drivers are fundamentally different, REITs have a powerful diversification role in investment portfolios.

Chart 3: Correlations between International REIT Index and MSCI World ex Australia Index



Source: Morningstar Direct, VanEck to 31 August 2021. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Indices used International Equities – MSCI World ex Australia Index; International REITs – FTSE EPRA Nareit Developed ex Australia Rental Index AUD Hedged.

3. Equity Investing in Real Estate Through Public and Private Markets (January 2018).

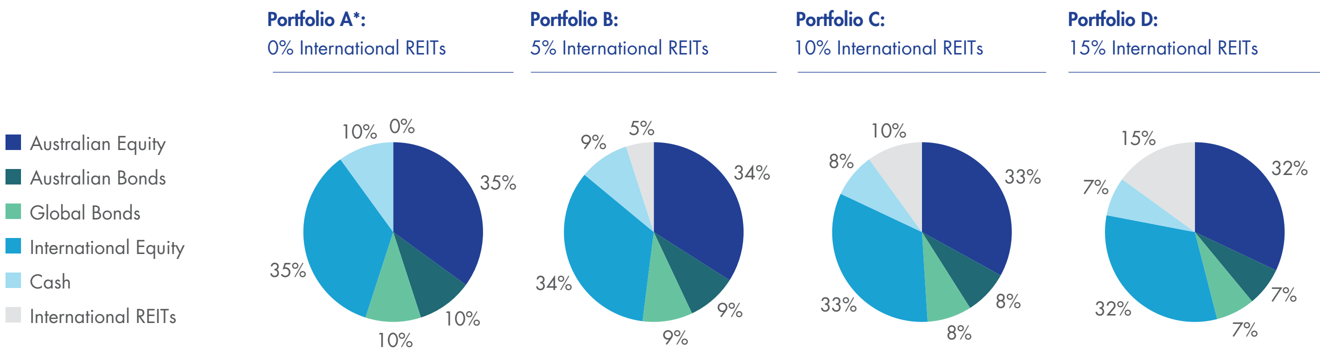
Increased risk-adjusted returns

Case's paper highlighted another very important point, the potential for REITs to provide higher risk-adjusted returns compared to other asset classes. Over the 1998 to 2015 time period which Case analysed, he was able to illustrate that US REITs had higher Sharpe ratios than all other equity asset categories.

The potential application of this research and our correlated findings is that an allocation to international listed real estate assets within a diversified portfolio should help improve its risk adjusted returns. To test this, we have constructed a balanced fund with and without an allocation to international listed REITs. This is based on ASIC's MoneySmart balanced investment option which "invests around 70% in shares or property and the rest in fixed interest and cash". The results can be seen in Chart 4 below.

Our analysis reveals that a portfolio including international REITs historically produced a higher annualised portfolio return than a portfolio without international REITs, without incurring significant additional risk as measured by standard deviation.

Chart 4: Including international REITs in a balanced portfolio over 10 years increased returns for moderate risk



	Portfolio A*	Portfolio B	Portfolio C	Portfolio D
Return (% p.a)	9.69	9.88	10.07	10.26
Risk (Std Dev % p.a)	8.59	8.91	9.25	9.62
Sharpe Ratio	0.91	0.90	0.89	0.87

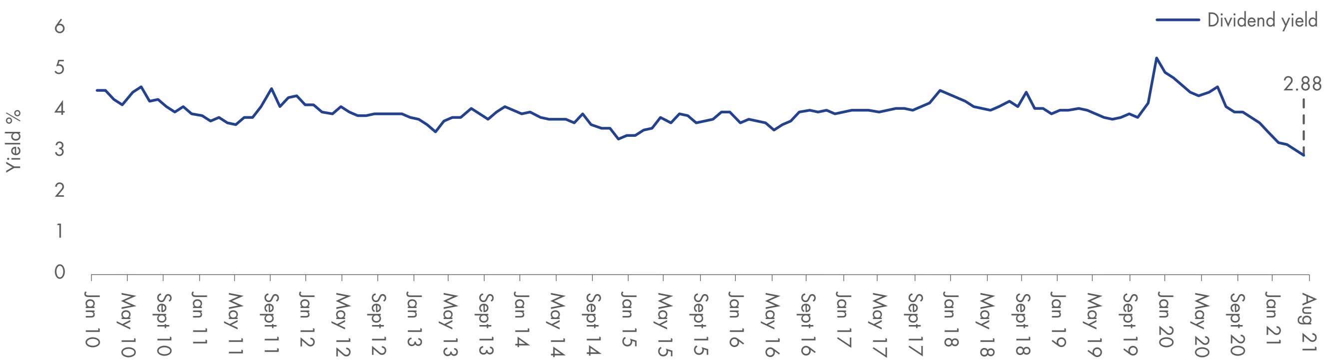
*Portfolio A based on MoneySmart balanced portfolio.

Source: Morningstar Direct, five year performance 1 September 2011 – 31 August 2021. Results are calculated monthly and assume immediate reinvestment of all dividends. The hypothetical performance does not include management costs and expenses and excludes brokerage and bid/offer spreads incurred when investors buy/sell. You cannot invest in an index. Past performance is not a reliable indicator of future performance.

Indices used to approximate investments: Cash – RBA target cash rate; International Bonds – Barclays Global Aggregate Bond Index A$ Hedged; Australian Bonds – Bloomberg AusBond Composite 0+ years; International Equities – MSCI World ex Australia Index; Australian Equities – S&P/ASX 200; International Property – FTSE EPRA Nareit Developed ex Australia Rental Index AUD Hedged.

Dividend yield

Chart 5: 12-month trailing dividend yield of REIT Index



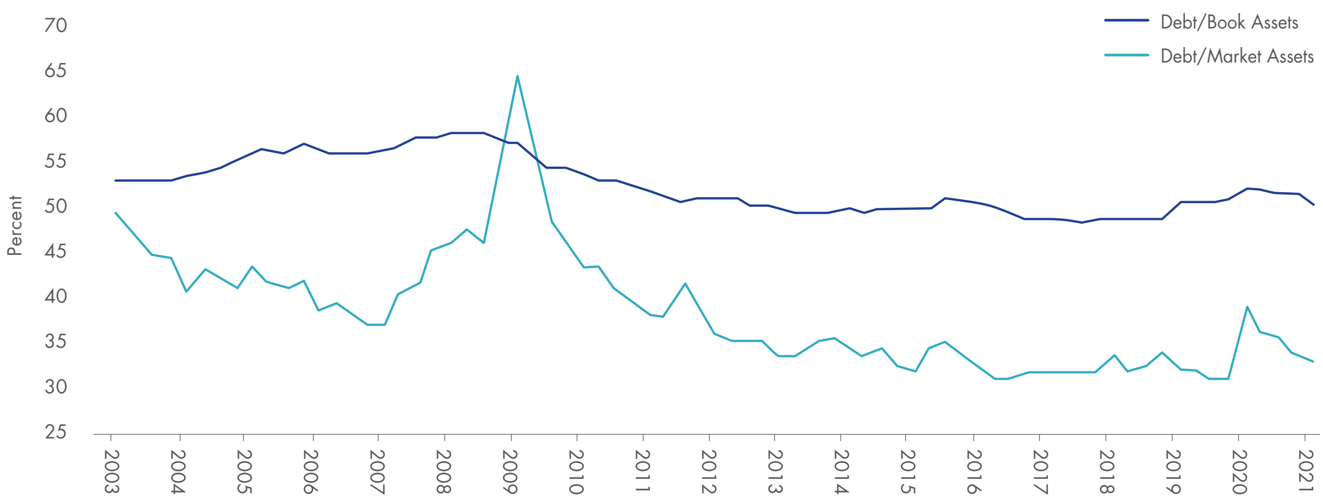
Source: FTSE to 31 August 2021. REIT index is - FTSE EPRA Nareit Developed ex Australia Rental Index AUD Hedged. Results are calculated monthly and assume immediate reinvestment of all dividends and exclude costs of investing in REIT. You cannot invest in an index. Past performance of the REIT Index is not a reliable indicator of future performance of the ETF.

Stronger balance sheets than in the past

The long-term fundamentals for selecting real estate investments are robust. Restricted funding in the current environment has limited supply and with improving demand, strong rental growth has emerged in the start of 2021. We expect this trend to continue in many markets and sectors around the world, particularly in developed markets.

Once a concern for investors, REIT balance sheets have been de-risked over the last 10 years and are in stronger shape. Since the GFC, the REIT industry has reduced leverage and extended maturities of debt instruments to lock-in low interest rates for many years ahead. As the chart below shows, REITs have collectively reduced their overall leverage ratios to the lowest in at least two decades.

Chart 6: Debt to total assets



Source: S&P Global Market Intelligence, Nareit T-Tracker®

Access the proper(ty) allocation

Traditionally the domain of large institutions, investors of all sizes can now access international REITs via managed funds or ASX-listed exchange traded funds (ETFs).

VanEck FTSE International Property (Hedged) ETF (ASX: REIT) is listed on ASX. REIT aims to track the FTSE EPRA Nareit Developed ex Australia Rental Index AUD Hedged Index by fully replicating it. In a single trade REIT gives investors a portfolio of international REITs providing international diversification and defence. To add appeal to investors, recent changes to Australian tax laws and VanEck's tax expertise allow REIT to pay a smoother flow of dividends each quarter than would have been possible in the past.

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