In a class of its own

Global Reits are well positioned to outperform other asset classes while infrastructure is a reliable portfolio diversifier

By Matthias Meyer

REAL Estate Investment Trusts (Reits) and infrastructure securities are a unique and growing asset class that continues to garner attention from the investment community for multiple reasons. They are backed by hard assets that offer the potential to provide low correlations to other asset classes, attractive risk-adjusted returns, high and sustainably growing dividend yields, a link to inflation, daily liquidity and immediate access to expert real assets management teams.

While Reits have been an established asset class in Asia for the past 10 years, many may not realise that Reits have actually been in existence far longer, dating back to the 1960s, when the US introduced the Real Estate Investment Trust Act of 1960. By 1994 only four countries had established Reit markets, but during the last 20 years the global Reit opportunity set rapidly evolved, with their presence rising to 33 countries.

By far the largest and most mature Reit market is in the US, which at about US$850 billion, accounts for almost 71 per cent of the global Reit universe (as measured by the FTSE EPRA/NAREIT Developed Reit Index). Continental Europe, the UK, Japan and Australia also have large and mature Reit markets, while the Singapore and Hong Kong Reit markets represent roughly 3 per cent of the global Reit universe.

In addition, gaining access to the global Reit universe has never been easier, with an array of ETFs (exchange-traded funds) and mutual funds on offer, along with an ever expanding universe of Reits for investors to choose from, both locally and offshore.

Compared with real estate, infrastructure is a relatively newer asset class, but it has been identified as a reliable and effective portfolio diversifier as it delivers stable, predictable, inflation-linked, non-business cycle sensitive cash flows from the ownership of physical hard assets – those that are critical building blocks for the modern economy to function and operate. Examples of these essential assets include toll roads, airports, sea ports, utility power grids, mobile phone towers, waste facilities, energy pipelines or water utility systems.

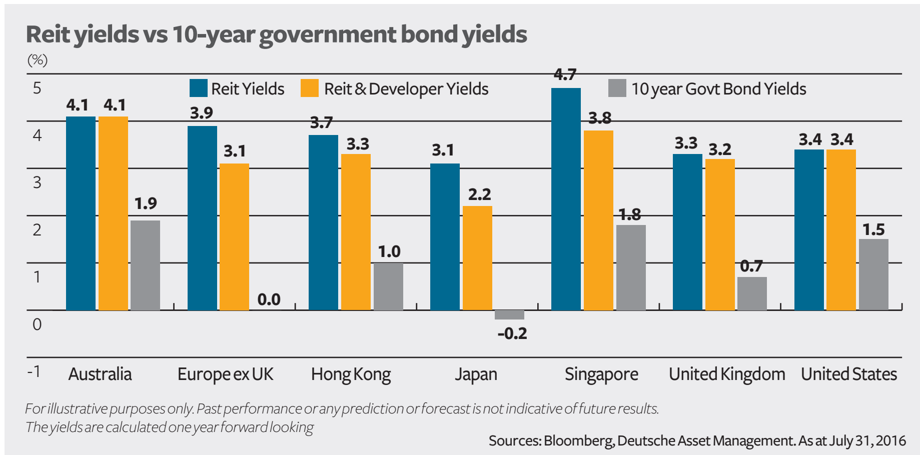
Over the past several decades, access to infrastructure has been generally limited to large institutional investors via the private market. But since the early 2000s we have witnessed a proliferation of listed infrastructure predominately in the US, which are publicly traded equity securities that generate the majority of their cash flows from owning and/or operating physical infrastructure assets.

Apart from the strong yield component and attractive risk-adjusted returns, listed infrastructure also provides investors with the opportunities to access the asset class in a liquid format, and create a globally diversified portfolio that is otherwise difficult in the private market.

The benefits of global Reit investing are apparent, given the broad opportunity set with local property market dynamics that are lowly correlated to Asian property markets. This in turn spreads the risk across a greater number of companies and markets with unique real estate cycles. Global Reits have historically delivered a lower beta relative to broader equity markets such as the MSCI World Index (three-year beta of 0.62).

Furthermore, Reits display relatively lower correlation to other asset classes which may reduce a portfolio's overall risk and may enhance the risk/return profile. Lower correlations to broader equities primarily stem from the stability of commercial real estate and the fact that real estate reacts differently to various market environments when compared to other asset classes.

Additionally, Reit sectors are driven by unique supply/demand cycles. For example, certain sectors, such as hotels, are more cyclical and sensitive to economic conditions, compared to the healthcare sector, which is often considered one of the more stable and defensive Reit sectors, with long-dated (up to 15-year lease term) rental income streams. Reits have also historically provided a suitable hedge against inflation, with real yields outpacing inflation growth. In addition to providing high current yields,



Reit income has historically grown in excess of inflation. Since real estate income comes from property rents, which are included in the reported consumer or producer price inflation indices, there is a natural correlation between the two.

At the heart of Reit investing is the property itself. Over the long term, underlying property performance will drive individual, country and regional Reit performance. Encouragingly, on the property front supply remains subdued in most real estate markets, providing limited downside to rental rates. Transaction volumes also remain robust, yet investors are using less leverage this cycle than in the past and banks are not being overly aggressive in lending – on average, Reit leverage (debt/asset value) is around 30 to 35 per cent).

On the pricing front, increasing appetite from institutional investors in the form of strong flows into real estate from, for example, sovereign wealth funds, pension funds, insurance companies and emerging market high net worth capital, is helping to keep pricing firm. Furthermore, there is a record amount of capital waiting to be invested. Global private equity real estate fund dry powder has increased by 14 per cent in 2016 and is over 43 per cent higher than pre-crisis levels.

Looking forward, in the current low growth, low interest rate environment we believe global Reits are well positioned to outperform other asset classes. Low (or even negative) interest rates are helping to drive demand for high and stable dividend-paying stocks such as Reits, especially with the pool of global negative yielding debt at about US$13 trillion and climbing. Global Reits are well placed to meet this demand for yield, generating quality income backed by hard real estate assets.

Dividend yields are well-covered overall and stand at roughly 3.5 per cent. This is approximately 210 basis points (bps) above the US 10-year Treasury, and well in excess of the historical average spread of 55 bps, suggesting Reits are attractively valued relative to fixed income alternatives. At high absolute levels, we expect dividend growth to remain in the high single digits in 2016 due to strong underlying property cash flow growth and low payouts.

In addition, there are several near-term catalysts that would support Reit prices, compared to traditional equities, meaning Reits would likely offer more downside protection compared to traditional equities. This includes a positive regulatory backdrop, an expanding opportunity set and the solidification of Reits as an asset class through the assignment of their own Global Industry Classification Standard sector. W

Matthias Meyer is Director and Head of Liquid Real Assets for Asia & Europe, Deutsche Asset Management