

REITs as a proxy for direct real estate investing

Actively managed portfolios of global REITs can deliver the key benefits of direct real estate investing

An allocation to real estate offers a host of benefits for investors of all types: a stable income stream and strong returns, inflation protection, capital preservation and diversification through non-correlation to the broader markets.

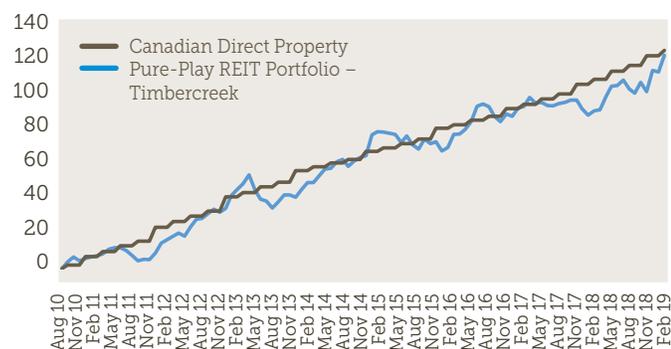
But retail clients may not have the financial capacity to invest in commercial real estate directly. For these investors, real estate investment trusts (REITs) are an effective alternative – with some added advantages. Unlike direct investing, which has high barriers to entry, REITs are easily accessible by investors of all types. REITs also have a highly liquid and transparent structure. Plus, they offer a diversification advantage by providing access to a wider range of real estate exposures than direct investing.

Active management is the solution

Through careful screening and selection, active management is able to create a portfolio of pure-play REITs that retain all the advantages of listed vehicles while at the same time capturing the benefits of direct real estate investments. Figure 1 below compares the performance of Canadian direct real estate and Timbercreek's actively managed portfolio of publicly listed real estate.

Returns for the actively managed, pure-play portfolio of publicly listed real estate is on par with direct real estate

Figure 1: Direct and Listed Property



Canadian Direct Property: Canada REALpac/IPD Total Return All Property Index

Pure-Play REIT Portfolio - Timbercreek: Consists of the Timbercreek Global Real Estate Fund (TGREF) Class B from inception date of Sep. 2010 to Dec. 2017 and the Timbercreek Global Real Estate Income Fund (TGREIF) Class F from Jan. 2018 to Mar. 31, 2019. The two funds followed the same strategy with small differences due to regulatory restrictions. The returns are net of all management fees, trading costs, operating expenses, applicable foreign dividend Withholding Tax (WHT) expenses. TGREF was merged into TGREIF in Jan. 2018. The 1, 3, and since inception annualized returns as of 3/31/2019 for TGREIF is 16.6%, 6.8%, and 5.9%. The 1, 3, 5 year and since inception annualized returns as of 12/31/2017 (before it was merged into TGREIF) for TGREF is 4.2%, 6.0%, 7.8%, 9.5%. As a result of the merger Class B holders received Class F. Returns represent what a holder of Class B of TGREF at inception and consequently Class F in TGREIF subsequent to the merger would have received as of March 31, 2019.

investment. Volatility for direct real estate will always be lower than publicly listed investments.

The power of process

A strong process is the key to achieving the advantages of active management described above. It should include two key phases:

1. Filtering out companies that undercut the benefits of real estate investing
2. Comprehensive company and market analysis of remaining candidates to identify stocks for inclusion in the portfolio

FILTERING OUT DETRACTORS

Out of the approximately 500 companies that make up the universe of listed global real estate securities, about one-third tend to detract meaningfully from performance and should be screened out. Think of this initial screening step as a removal of impurities.

Common detractors include:

- real estate developers;

- brokers;
- construction companies;
- poorly located assets;
- highly levered assets; and
- emerging markets-based names, particularly developers and home builders.

Developers typically don't pay dividends. They usually redirect capital gains into the next project. Builders and brokers often pay very low dividends. Emerging markets names also pay weak dividends and tend to have unstable businesses. By stripping those away you see your income rise tremendously. Poor-quality real estate, financially engineered cash-flow streams and highly levered assets are other hallmarks of the group of names that a strong active manager screens out immediately. Those are the things that tend to give you more volatility and diminish the positives of exposure to real estate. Removing them can help you get closer to the experience of direct real estate investing, but through a liquid vehicle.

ACTIVE SELECTION

At this point in the process, it's all about the underlying assets. A wide range of variables are parsed and analysed, and while quantitative tools help crunch the numbers, final calls on which names make it into the fund should be shaped by the portfolio manager's real estate experience and expertise.

One group of variables measures internal growth prospects. They include occupancy rates, lease rollover relative to comparable local-market units, operating margins, and contractual rent increases. The goal of the analysis is to develop forecasts for a number of key metrics, including net operating income, cash flows and dividend sustainability, as we would with direct real estate investments.

It's also critical to examine companies' track records and prospects for external growth. This involves assessing acquisition and sale activity. Is management making smart choices when they buy and sell properties? Have they shown good judgement in the way they've financed acquisitions? Another important variable is capital improvements. Things like renovating an apartment building's lobby or adding high-end amenities can generate higher rents over the long term.

Strong, sustainable income is the goal, but only at an acceptable level of risk. An elaborate risk management regime will examine a host of variables, including:

- **Real estate risk** – Considers asset quality and location (in part through property tours), as well as lease structure
- **Corporate risk** – Assesses management quality (partly through in-person meetings) and company business model
- **Balance sheet risk** – Examines key metrics such as leverage, interest rate sensitivity and fixed charge ratio
- **Stock price risk** – Analyzes liquidity (30-day average volume) and volatility (one-year standard deviation)

The result: A high-active-share portfolio of quality global names that offers a liquid proxy for direct real estate investing. Such a portfolio will have exceptional prospects for income generation and growth because its constituents are purchased at a discount to intrinsic value.

A real alternative

With the right process and management expertise, an actively managed global REIT portfolio can deliver the key benefits of direct real estate investing. Even though they're liquid portfolios of stocks, they behave much more like a bricks-and-mortar real estate portfolio.

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