Asia-Pacific REITs: why an allocation to the region should not be overlooked

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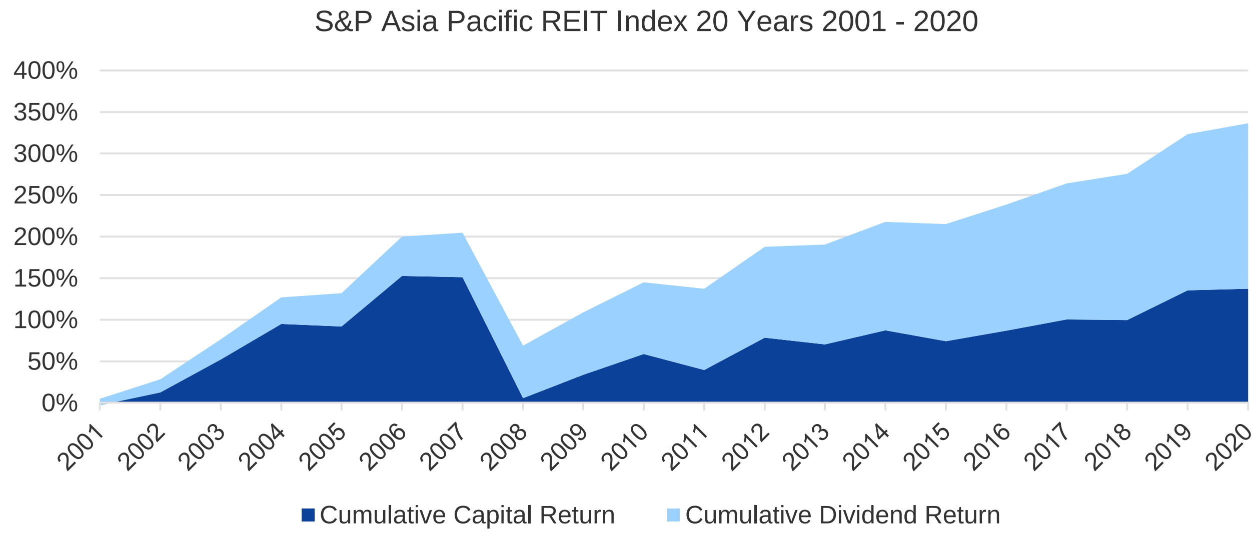
When investors consider REITs they tend to first look at their local market or the US as the longest established market. As a consequence, Asia Pacific can be overlooked. Asia-Pacific REITs comprise around 20% of global market capitalisation with the region's importance continuing to grow. In this paper we revisit why REITs are an important component of diversified portfolios, demonstrate why Asia-Pacific REITS are attractive and make the case for an allocation to the region.

The Case for REITs

Academic studies tell us that in the short term REITs tend to behave more like stocks, however over the long term the return characteristics of REITs and direct property are similar [1]. For all but the very largest investors, REITs provide valuable advantages over direct property, including liquidity, investable size, geographic and sector diversification and transaction costs.

Regulatory requirements oblige REITs to distribute the majority of rental income, making yield a significant proportion of REITs' total return, around two-thirds compared to a third for equity securities [2]. As a consequence investors receive more of the total return in up-front regular cash flows and less in deferred capital gains.



Source: S&P Asia Pacific REIT USD Total Return Index 2001 - 2020

The capital value of bonds suffer in times of inflation and interest rate rises, whereas the returns of REITs are not similarly exposed, as REITs are influenced by other factors such as the underlying drivers of inflation, property value trends and portfolio characteristics such as whether borrowing interest rates are fixed or variable and lease rentals adjust for inflation [3].

REITs within Diversified Portfolios

REITs are one of the highest return contributors within pension fund portfolios, yet are one of the least used asset types [4]. Studies confirm REITs sit between equities and bonds within multi asset portfolios, providing both diversification and return benefits, although their liquidity features gives rise to higher short-term volatility. An allocation to REITs within a multi asset context adds value in two ways: firstly by increasing returns within lower risk bond portfolios and secondly by having the effect of reducing risk within higher risk equity portfolios [5].

Asia Pacific's Fundamentals Favour Property

The region's demography, with 60% of the world's population in only 30% its land mass, is a factor contributing to intensive urbanisation, making it home to seven of the ten largest cities in the world [6]. It is also diverse; cities such as Tokyo and Sydney have well established infrastructure, while Beijing, Shanghai and Delhi continue to experience multiple decades of intensive development.

Developing countries' above average global growth rates are an important contributor to REITs' prospects. The region's economic diversity means each real estate market has its own specific characteristics and sector strengths; Singapore has a strong industrial sector, Japan the largest office sector, retail is important in Australia and through Hong Kong indirect exposure is provided to mainland China.

Development of markets and regulatory systems vary; the first REIT in the region was launched in Australia in 1971, REITs were introduced in Singapore in 1999 and Japan in 2000, while in China and India REITs are at an early stage of development [7]. Although specific regulatory requirements differ, unlike western REITs, listed property vehicles in Asia tend to be separately established from their sponsoring companies providing flexibility for portfolio re-organisations, acquisitions and disposals.

The qualitative characteristics of Asia-Pacific REITs are supported by the quantitative data. Over the last decade Asia Pacific has produced superior returns with more attractive risk attributes than global, US or European indices, providing a higher return for each unit of risk taken.

	Annualised Returns			Risk			Return / Risk		
	3 years	5 years	10 years	3 years	5 years	10 years	3 years	5 years	10 years
Global	2.89%	4.81%	7.29%	19.54%	16.65%	15.46%	0.15	0.29	0.47
Asia Pacific	7.57%	9.39%	8.32%	19.23%	16.68%	15.70%	0.39	0.56	0.53
US	3.45%	4.62%	8.17%	19.79%	17.21%	16.48%	0.17	0.27	0.50
Europe incl UK	-5.31%	-1.45%	3.53%	25.66%	22.71%	20.45%	-0.21	-0.06	0.17

Source: S&P REIT USD Total Return Index – Global, Asia Pacific, US, Europe including UK, 2011 – 2020. Risk is defined as annualised standard deviation calculated based on total returns using monthly values.

High Quality Growth at a Reasonable Yield

The approximately 150 Asia-Pacific REITs, which make up around 20% of the total USD1.5 trillion market capitalisation of global REITs, are far fewer than the region's stocks, however the heterogeneous nature of its countries and property sectors together with its market inefficiencies provide opportunities for skilled managers to add value in excess of index returns by navigating economic cycles, secular themes and identifying well managed businesses [8].

The region's growth characteristics together with the importance of yield as a component of total return leads us to favour an investment approach emphasising growth at a reasonable yield, while at a stock level focusing on high quality businesses. High rates of economic growth allows well managed firms to achieve superior capital appreciation such as by financing acquisitions through new equity issuance creating synergies that increase share prices, as well as effectively managing risks such as tenant defaults and poor corporate governance.

High environmental, social and governance (ESG) standards have long been a critical component of high quality businesses. Properties developed and managed to high ESG standards in normal circumstances command a premium. However COVID-19 has heightened investors' risk aversion further re-enforcing the importance of effective risk management, social responsibility and environmental sustainability.

Living with COVID-19

The impact of COVID-19 has been felt across all sectors; negatively impacting offices, retail, residential and hotels, while boosting beneficiaries of stay at home policies such as e-commerce fulfilment, data centres and properties with high ESG credentials.

Countries in the Asia Pacific have been relatively successful in controlling the spread of the pandemic so have not suffered the economic shock of successive lockdowns to the same extent as Europe and the US. Notably China's economy has continued expanding showing no evidence of economic scarring, while Japan and Singapore were successful in attracting global real estate capital in 2020.

Nevertheless the pandemic is catalysing major changes in working practices; Fujitsu, which employs 80,000 people in Japan, has initiated fundamental changes to staff working practices by committing to increase home working long term [9]. Such changes will bring about major portfolio re-organisations potentially providing acquisitive REITs with attractively valued opportunities.

Long Term Resilience

A combination of demographics and growth in developing countries has contributed to the rise of a sizeable and wealthy middle class growing from 2 billion today to 3.5 billion in 2030 - an expected source of new demand for retail, residential and hotel property [10]. The fortunes of China's economy sets the lead for the rest of the region; it's expected to reach the World Bank's definition of a high income country by 2025 with per capita income of US$14,000 [11], while its leaders aim to double the economy's size over the decade to 2030 [12].

Capital markets in the region's developing economies are relatively immature, representing a small proportion of GDP compared to developed countries. However market infrastructure is developing rapidly in certain countries with foreign capital flows increasing; mature capital markets will enable REITs to finance and manage the wide range of properties these developing societies require.

The heterogeneous nature of the Asia-Pacific region, with a combination of sophisticated developed and rapidly developing economies together with its diverse property sectors provides diversity of opportunity for REITs investors.

In conclusion:

- REITs are a valuable but under used diversifier that can enhance results of both low and high risk multi asset portfolios;
- Investors should not overlook Asia-Pacific REITs which have a track record of benefitting from the region's strong economic growth and whose strong fundamentals make them well placed to do so going forward both in absolute terms and compared to other regions;
- Qualitative analysis is supported by quantitative data illustrating the attractive characteristics of Asia-Pacific REITs.

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†Source: SMDAM, 31 December 2020

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