■Passport to Profits

From France to Japan, REITS are growing all over the world.

7/1/2006
By Bruce W. Fraser

Real estate, they say, is location, location, location. And increasingly that location doesn't have a USA zip code. These days, as American real estate gets pricier and becomes less attractive for investment purposes, astute wealth managers are beginning to allocate more of their clients' portfolio assets to real estate overseas. They could be on to something.

After six straight years of stratospheric gains, valuations of U.S.-listed real estate holdings have begun to wobble with rising interest rates—casting an especially enticing spotlight on foreign real estate investment trusts. So if you're looking for a good alternative for some of your clients' money, you might consider investing in foreign-listed real estate securities or a global REIT mutual fund. In search of higher yields, some advisors are putting clients into these vehicles, with exposures ranging from 2 percent to upwards of 10 percent of total assets…or at least are moving in this direction.

There is a growing appetite for listed real estate assets worldwide to make up for a lack of domestic real estate investment opportunities. More mutual fund companies, in addition to other investment companies and institutions, are rapidly crossing borders in Europe and Asia. Several factors are fueling REITs' rising popularity abroad: More foreign regulators have given them the green light; more foreign owners want to sell real estate to generate cash or improve returns on equity; and more investors are looking for relatively low-risk, liquid proxies in this property market.

"Investors have come a long way in terms of including real estate in their portfolios," says Christina Chiu, a research analyst with Morgan Stanley Investment Management's Global Real Estate team. "We've already seen an increased willingness by institutional investors to make a strategic allocation to global real estate securities within a multi-asset class portfolio, and we expect this to continue as a global real estate market evolves and gains acceptance as a distinct asset class."

The barriers to entry abroad are crumbling. Traditionally, illiquidity has been the biggest impediment for U.S. investors in the international real estate market. The development of REIT markets in Europe and Asia solves that problem. According to the National Association of Real Estate Investment Trusts (NAREIT), more than 20 countries have created REIT-like structures, and more are seriously considering doing the same.

Within the past five years, France, Hong Kong, South Korea, Taiwan, Singapore and Japan have established regulatory frameworks for REITs. Other countries that already offer REIT-like structures include Canada (since 1993), Australia (since 1971), the Netherlands (since 1969) and Belgium (since 1995). At press time, legislators in the UK had passed legislation legalizing

REITs there, effective Jan. 1, 2007. Germany is moving in this direction as well. (The table on page 61 provides a summary of the global listed property markets, including the size of the various listed property markets, as well as which countries have enacted REIT legislation.)

About a dozen U.S.-based REIT companies have expanded their businesses to include international exposure. The largest worldwide player is ProLogis, with properties in North America, Europe and Asia. Others include AMB Property Corporation, Mills Corporation, Simon Property Group, Kimco Realty Corporation and Shurgard Storage. Among pension funds, the California Public Employees' Retirement System, or CalPERS, with $206 billion under management, recently announced plans to increase the international real estate allocation in its real estate portfolio to no more than 50 percent over the next 10 years. "It's not that we're bailing out of domestic (real estate); we're still making deals here, but we see plenty of opportunities in China, India and Japan," a CalPERS spokesman told Wealth Manager.

In the U.S., after nearly six years of outperformance, most observers don't expect the party to last in a time of rising interest rates. To be sure, over the past five years, as the U.S. stock market has mostly languished, the one bright spot has been real estate. And REITs have more than done their part, delivering average total annual returns of nearly 13 percent over that time frame. In fact, figures supplied by NAREIT show that U.S. REITs have handily beaten all major benchmarks for each of the past three-, five-, 10-, and 15-year periods. But cold air is setting in. Current yields of domestic REITs are hovering around 4.5 percent—down from recent highs of 7 percent to 8 percent. So it's little wonder the hot money in this sector is moving in the direction of foreign real estate investments.

"We expect the same kind of situation that prevailed in U.S. REITs will occur in foreign countries," says wealth manager Louis Stanasolovich, CFP, president and CEO of Legend Financial Advisors Inc. in Pittsburgh, Pa. "We've been big fans of REITs for a long time. The recent move going into foreign REITs is relatively new. At this point, it's effectively been a trickle, but it could be the start of something big."

Sensing lurking treasure, some mutual fund companies have begun to offer this foreign asset class. Big names like Morgan Stanley, Fidelity Investments and AIM Investments are leading the way. "Most of these firms had domestic REIT funds for years," notes James Reilly, CFP, a wealth manager at RegentAtlantic Capital LLC in Chatham, N.J.—a firm with $1. billion AUM. "Now they're adding international REIT funds."

Altogether there are more than 65 global real estate funds, of which nine or 10 originate in the U.S. The Morgan Stanley International Real Estate Fund was launched in 1997. More recently, the firm broadened the investment strategy and investable universe of this former European-only institutional product to include an allocation to Asian-listed real estate securities.

Most of the growth has been more recent. Fidelity launched a foreign REIT fund in 2004; AIM in April of last year. There's also the ING Clarion Global Real Estate Income Fund introduced in February 2004 and ING Global Real Estate Fund, incepted in 2001. Other investment firms are involved as well. Cohen & Steers, a money management firm specializing in REITs, is managing the Cohen & Steers Worldwide Realty Income Fund and the Cohen & Steers International Realty

Fund, both launched in March 2005. The first such fund, the Alpine International Real Estate Fund, was introduced in 1989.

Today, more forward-thinking advisors are recommending that international REIT funds be part of their clients' portfolios. Part of the allure is diversification on two counts: First, within clients' mixed-asset portfolios and, second, geographically. Advisors and their clients have the opportunity to broaden their portfolio exposure in REITs in other countries and on their exchanges as well. There is also a low correlation of returns—which range from 33 to 100 basis points—between real estate securities listed in North America and those in Europe and Asia, according to Morgan Stanley figures.

"This provides exposure to varying economic cycles, varying rates of return and higher yields," says wealth manager David M. Taube, founder and president of Kalorama Wealth Strategies in Washington, D.C. "Companies and investors are seeking acquisition opportunities outside the U.S. because the U.S. property market is very competitive. There has been significant property return compression over the past decade (that is, return from owning property, versus yield from owning the stock). Also, REITs used to pay out more of a richer dividend, but as prices have gone up, yields have come down."

Another reason the fire is burning is performance. Over the past 20 years, according to LaSalle Investment Management Securities, real estate securities, of which REITs are part, have outperformed other equities and government bonds around the globe, providing double-digit returns over five-, 10- and 20-year time horizons. Foreign commercial real estate is also currently selling at more attractive valuations than U.S. commercial real estate. "Foreign REITs are a bit cheaper than U.S. REITs," says Stanasolovich. "Though U.S. real estate may be expensive now, that's not to say it's expensive in other countries."

Don Cassidy, senior research analyst at fund tracker Lipper Inc., says, " This movement reflects two predictable trends: Product differentiation and the chasing of performance by investing internationally. It makes sense to have some international property exposure, but it is interesting to note that the interest is coming now, after a huge run, rather than earlier when prices were lower."

As the movement has gathered momentum, a variety of global real estate benchmarks have developed, providing transparency and more credibility to the sector. Among the most widely used is the FTSE EPRA/NAREIT Global Real Estate Index, which tracks the performance of listed real estate companies and REITs worldwide. At the end of March 2006, it was up 12.5 percent. The index could conceivably be the base for a global exchange traded fund (ETF) index. None currently exists. Amy Schioldager, a managing director at Barclays Global Investors—whose main ETF product is iShares—says, "We recognize the interest in an iShares global REIT exchange traded fund, and it's something we are looking into."

Advisors are taking note. Stanasolovich is looking to put most of his firm's 185 clients into international REIT funds shortly, "with a minimum of 5 percent allocation, assuming our due diligence is completed favorably," he says. About half are currently in U.S. REITs. All 650 clients of Reilly's firm currently have a 4 percent allocation to real estate, half of which is foreign real estate. Despite the high minimums ($500,000 for Class A shares and $100,000 for B shares), Reilly has been placing clients in Morgan Stanley's global REIT fund since early 2005. His firm's investment minimum is $1 million. Since inception, the fund has had an average annual return of 15.95 percent. Its YTD return as of Feb. 28, 2006, was 11.38 percent.

Reilly says the advantage of working with big houses like Morgan Stanley and Fidelity is that they have analysts on the scene in Europe and Asia studying the market. "Morgan Stanley has a premier global real estate team on the ground," he says. "We are impressed by their in-depth knowledge. The fund only exists at the institutional share class level so we are investing alongside other large parties like ourselves."

Advisors with clients who want exposure with much lower cost of entry might consider the Alpine International Real Estate Equity Fund, which has a $1,000 minimum. "They have a consistent track record, have the same lead manager since 1989, and have beaten the benchmark Lipper Real Estate Funds average for the last one-, three-, and five-year periods," notes senior wealth manager Robert B. Greene of Tow Financial Advisors in Sherman Oaks, Calif. Greene has been placing clients in the Alpine fund with varying asset allocations ranging from 5 percent to 7 percent.

The fund invests in homebuilders, development companies, hotels and resorts and has investments in many countries around the world. "In 2005, they participated in approximately eight IPOs, and they see merger activity increasing," says Greene. "While the fund doesn't currently have a large REIT holding, the domestic REIT model is germinating overseas, which will lead to more opportunities for investors and companies forming them."

Some advisors cite the Cohen & Steers International Realty Fund as a good model. "We began putting clients in this fund last June," says Jon P. Yankee, CFP, of Fox, Joss & Yankee LLC in McLean, Va., a business with $150 million in AUM. The firm allocates approximately one-third of the client's real estate allocation to the international asset class. "We've owned Cohen & Steers' REITs since the late 1980s. They have a long track record of beating their benchmark and doing what they do best." From inception through Dec. 31, 2005, the fund was up 16.8 percent. YTD through Feb. 28, 2006, it was up 9.41 percent.

In late 2004, Cohen & Steers purchased a 51 percent interest in Houlihan Rovers, a Belgium investment company that invests in international real estate securities. "You put the companies together—one with strong expertise in the U.S. and the other in Europe and Asia—and you have a fund that can deliver returns in the international REIT asset class, plus alpha," says Yankee. Likewise, both Stanasolovich and Mike Palmer, CFP, a principal of the Trust Company of the South ($600 million AUM), are considering the Cohen & Steers International Realty Fund for their clients. "We find the fund attractive and may pull the trigger soon," says Palmer.

Other advisors, however, are moving more cautiously or taking a wait-and-see attitude. Some cite the limited track record of these funds, and the fact that some economies, particularly in Asia, are more volatile. Indeed, the risks of investing in foreign REITs are similar to the risks of investing in international stock markets: Limited public information, less liquid trading markets, political risk, different tax regimens, and less developed economic and political environments.

There is also the added cost of investing in foreign markets. International REIT funds tend to have higher expense ratios than their U.S. counterparts.

Other operational challenges include logistics, language barriers, different reporting standards, currency risk, and the need for management capability and controls. Says Taube: “Real estate is still a local business. You need to have local market knowledge and know the customers.”

So far, Taube has held off from purchasing an international REIT fund. “They are too few in number and have a limited track record,” he says. Currently, he provides international exposure to real estate for his clients through domestic REITs with international holdings or international mutual funds with real estate investments. He says he has reduced clients’ exposure to “a neutral weighting of 5 percent of an equity portfolio.”

Adds Chiu: “While global real estate investing has been relatively easy to overlook in the recent past given several consecutive years of outsized domestic returns, the higher level of volatility associated with foreign investing—particularly in Asia—and the relatively few available global real estate investment vehicles for achieving core-type returns, growth in the sector’s overall market capitalization and increased demand from a broader base of global institutional investors have resulted in an improved investment universe in terms of both liquidity and transparency.”

Bruce W. Fraser (frasernyc@aol.com) is an independent financial writer in New York.

SUMMARY OF GLOBAL LISTED PROPERTY MARKETS

	FTSE EPRA/NAREIT Index		REIT Legislation		
Country	**Mkt cap (U.S. $, bn)***	**No. of securities**	**Status**	**Structure**	**No. of and market cap of REITS****
North America					
United States	298.7	126	Enacted 1960	REIT	152 REITS (excluding mortgage REITs) (U.S. $300.6 bn)
Canada	20.8	18	Enacted 1993	REIT	25 REITS (U.S. $17.2 bn)
Europe					
Netherlands	16.5	8	Enacted 1969	Dutch BI (Fiscal Investment Institution)	152 REITS (excluding mortgage REITs)
Belgium	2.9	5	Enacted 1995	SICFI (Societe d’Investissement a Capital Fixe)	10 SICAFIs (U.S. $4.8 bn)
France	12.2	6	Enacted 2003	SIIC (Societe d’Investissement Immobiliers Cotees)	10 SIICs (U.S. $17.1 bn)
United Kingdom	53.9	37	Pending	—	—
Germany	3.6	3	Pending	—	—
Finland	1.2	3	Pending	—	—
Sweden	5.7	6	—	—	—
Spain	8.2	2	—	—	—
Italy	2.7	4	—	—	—
Switzerland	3.7	4	—	—	—
Austria	5.9	4	—	—	—
Asia-Pacific					
Australia	66.7	24	Enacted 1971	LPT (Listed Property Trust)	24 LPTs (U.S. $66.1 bn)
Japan	53.6	20	Enacted 2001	J-REIT	23 REITs (U.S. $22.9 bn)
Singapore	8.7	9	Enacted 2002	S-REIT	7 REITs (U.S. $6.5 bn)
Hong Kong	42.6	12	Enacted 2003	H-REIT	—

*Based on FTSE EPRA/NAREIT Global Real Estate Index
**Represents total market capitalization and total number of REITs in the country; not all REITs included in the FTSE EPRA/NAREIT Global Real Estate Index
SOURCE: Morgan Stanley Investment Management