Why Invest in Real Estate Investment Trusts (REITs)?

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This article discusses the benefits of investing in Real Estate Investment Trusts (REITs). In particular, it discusses the issue of diversification. Although it draws upon the experience of the relatively new REITs market in Singapore, it also discusses econometric evidence provided by the well established Australian Listed Property Trust (LPT) sector.

What are REITs?

REITs usually use the pooled capital of many investors to purchase and manage income-generating property assets – examples include industrial parks, warehouses, shopping centres and apartments. In Singapore, REITs may invest in listed or unlisted debt securities, listed equity or cash and cash equivalents, but the majority of their assets must comprise real estate or real estate-related assets. They must also distribute at least 90 percent of their taxable annual income to shareholders.

The REIT market became active in Singapore in July 2002, when the first REIT, CapitaMall Trust, was listed. However, since then, two other REITs have been listed – Ascendas Real Estate Investment Trust was listed in November 2002, and Fortune Real Estate Investment Trust was listed in August 2003. In contrast, the first LPT was listed in the Australian market in 1971 and the sector reached a critical mass in the early 1990s. The Australian LPT sector is now considered one of the foremost REIT markets in the world. It is one of the biggest sectors on the Australian market, and accounts for about eight percent of the world's listed property assets. There are currently 46 LPTs in Australia.

The Benefits of Investing in REITs

In addition to providing opportunities to diversify risk, as discussed in detail later, investing in REITs provides a number of other benefits, which are discussed below.

Liquidity

REITs enable investors to gain access to the property sector, without being as constrained by the lack of liquidity that is usually associated with the sector. In general, property assets tend to be large, difficult to value accurately, and difficult to divest quickly. As a result, investors are less able to manage and match their asset allocation strategies on a timely basis. However, since REITs are listed on the Singapore Exchange, this provides an easy mechanism for entering and exiting the sector in small tranches. In addition, since they are traded on the exchange, REITs are continuously being valued at prices that are determined by market demand and supply.

Increased Transparency

Corporate governance can be a major concern with respect to Asian companies, many of which are state-controlled or may be family businesses. In contrast, REITs offer investors greater transparency, since REIT managers need to comply with stringent disclosure and reporting requirements. In Singapore, REITs are required to disclose all the details of their real estate assets, including where they are located, how much they were purchased for, occupancy rates, rental income, the term on remaining leases, and the latest valuations. According to Moody's Investor Services[1], REITs in Singapore exhibit better disclosure standards than many other corporate sectors.

Access to Higher Quality Assets and Property Management

Since REIT investors are investing as part of a pool of investors, they have access to higher quality assets than they may be able to access on their own. In addition, due to the stringent reporting and performance standards imposed on them, REITs tend to use experienced property managers, and strive to maintain their asset quality.

Stable Yield

Since their major income generating assets are real estate investments that have already been developed, the operating income of most REITs tends to be derived from stable and recurring fixed rents, with low property development risk. Thus, REITs tend to exhibit strong cash flows. In addition, they tend to have low leverage levels and good debt service coverage.

Diversification

As mentioned previously, one of the major advantages of investing in REITs is that they provide investors with the opportunity to diversify their risk. Unlike most listed stocks, REITs do not tend to move with the Straits Times Index (STI). This implies that there should be good opportunities for equity investors to diversify their risk by including REITs in their portfolio. This is apparent from the following charts, which compare the movements and weekly performance of

CapitaMall Trust (CMT), Ascendas Real Estate Investment Trust (A-REIT) and Fortune Real Estate Investment Trust (Fortune REIT) with the index.

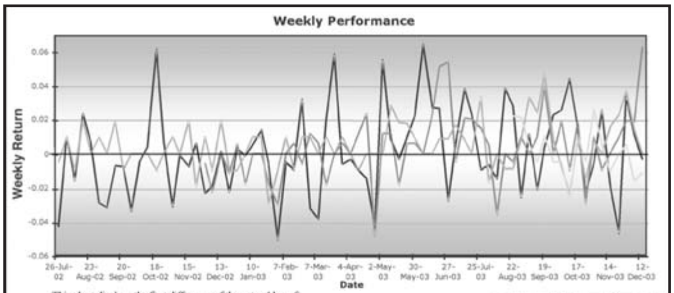
As Chart 1 shows, none of the weekly price series for the REITs appear to have moved with the STI since listing. However, the prices of the A-REIT and CMT seem to have moved in the same direction, particularly since mid-2003. This implies that the sector may face different conditions from the listed equity market in general.

As can be seen from Chart 2, there does not seem to be any discernible relationship between the weekly performance of the STI and the three REITs. Chart 2 also shows that, in general, the troughs and peaks of the STI weekly performance series tend to be greater than those of the REITs weekly performance series. This implies that the volatility of REIT performance may be lower than that of equities, further strengthening the argument for including REITs in investment portfolios.

Chart 1: Weekly Prices (since listing)

This chart displays the natural log of weekly price data.

Chart 2: Weekly Performance (since listing)



This chart displays the first difference of the natural log of weekly price data.

Although there is insufficient data on REIT prices to conduct a detailed econometric analysis of their relationship with listed equities (due to their relatively recent listing), preliminary correlation results (shown in Table 1) indicate that there is no significant correlation between any of the REITs and the STI[2].

The correlation results in Table 1 also indicate that there are no strong relationships between the returns produced by any of the REITs.

Table 1: Correlation Results - using weekly performance data

Data from July 2002 to December 2003

	STI	CMT
STI	1	
CMT	-0.01	1

Data from November 2002 to December 2003

	STI	CMT	A-REIT
STI	1		
CMT	-0.014	1	
A-REIT	0.190	0.327	1

Data from August 2003 to December 2003

	STI	CMT	A-REIT	Fortune REIT
STI	1			
CMT	-0.238	1		
A-REIT	-0.043	0.406	1	
Fortune REIT	-0.133	0.261	0.023	1

This table uses the first difference of the natural log of share prices to measure weekly performance.

Evidence from the Australian LPT sector

As mentioned previously, the Australian LPT sector has a greater depth of data, which can be used to understand the relationship between listed equities and REITs.

A recent report produced by FitzBiz Investment Analysis & Strategy (FitzBiz) examined the relationship between the performance of LPTs, listed equity and direct property[3]. FitzBiz conducted this extensive econometric analysis using data collected over 18 years[4],

With Error Correction Modelling, FitzBiz found that there was a weak short term relationship between LPTs and equity (a 1% increase in the one period return of the equity market resulted in a 0.53% increase in the one period return of the LPT sector), a strong long term relationship between the two, and a weak long term relationship between LPTs and direct property. However, despite the strong long term relationship between LPTs and equity, the LPT sector took about two to two and a half years to react to changes in the equity market. LPTs also took about two and a half to three years to react to changes in the direct property market. This shows that even in the more established Australian market, investors have the ability to take advantage of short term diversification benefits by including LPTs in their portfolios.

Obviously, the Australian LPT sector is not identical to the Singaporean REITs sector. However, it is sensible to conclude that the relationship between the Singaporean equity market and REITs sector could be similar to that between the Australian equity market and the Australian LPT sector. Thus evidence from the Australian market can be used to support the assertion that investing in REITs may provide Singaporean investors with diversification benefits.

1 MOODY'S INVESTOR SERVICES (July 2003): "Asia's Road to Establishing Real Estate Investment Trusts – Singapore: Strengths and Constraints for a High Credit Rating – Special Comment.

2 Due to the lack of data, weekly performance data was used to construct correlation matrices. However, where possible, it would be better to use less frequently measured data, to remove the influence of any serial correlation that may be present.

3 The report, entitled "The Impact of the Direct Property Sector and Listed Equity Market on Listed Property Trusts in Australia" can be purchased from FitzBiz Investment Analysis & Strategy.

4 The performance of LPTs was measured using the ASX/LPT 300 Index, that of listed equities was measured using the Australian All Ordinaries Index, and the performance of direct property was measured using the Property Council of Australia Australian Composite Index.

Conclusion

In summary, there are a number of positive reasons to invest in REITs. These include benefits derived from diversification of risk, increased liquidity, improved transparency, high asset quality and stable yields.

REIT investors should, however, be aware of high concentration risk associated with this asset class in Singapore, due to two factors. Firstly, there are currently only three REITs listed in Singapore and secondly their underlying assets are located in the same region.

One way to mitigate this may be to diversify across other REIT markets (for example those in Australia and other parts of Asia). However, since all these property markets vary in character, investors need to study the underlying fundamentals of specific REITs, before designing their optimal portfolio mix.

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