International Journal of Economics, Commerce and Management
United Kingdom Vol. II, Issue 7, 2014
http://ijecm.co.uk/ ISSN 2348 0386

A QUALITATIVE EXAMINATION OF GLOBAL REAL ESTATE INVESTMENT TRUSTS (REITs)

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Abstract

Global Real Estate Investment Trusts are a relatively new investment vehicle which are now widely available to U.S.-based investors. Although there are several potential benefits, such as greater diversification and a hedge against the dollar, there are potential pitfalls as well. This paper is a qualitative, preliminary study into the nature of Global REITs, their characteristics, and how U.S. investors may be able incorporate this "alternative" asset class into their respective portfolios. It was found that the current Global REIT funds in existence may not be as well-diversified as is portrayed. These funds all appear to be heavily concentrated in a small group of developed countries and have a significant percentage of their assets in a relatively small number of very similar holdings.

Keywords: Investment, Real estate, Asia, Latin America, Europe, REIT

INTRODUCTION

Experienced U.S.-based investors have always been keenly interested in the diversification of their investment portfolios. Modern Portfolio Theory (MPT) states that a broad array of asset classes should be utilized in order to minimize volatility (risk) while maximizing returns (i.e. maximizing the "efficiency frontier"). As such, international diversification is key to the reduction of risk via lower correlation with U.S.-based markets. This paper will be a qualitative study into the nature of international real estate investing through a relatively new vehicle called Global Real Estate Investment Trusts (Global REITs).

Real Estate Investment Trusts invest in assets such as office buildings, apartment complexes, storage facilities and shopping malls. They have become extremely popular over the last 10 to 15 years with the average U.S.-based investor. It is considered an "alternative" asset class, distinct from equity or fixed-income type investments. Generally speaking, many financial professionals recommend for the average investor to have between 10% and 15% of his or her investable assets in these "alternative" types of investment vehicles. In addition, it is also an easy way for the average investor to gain broad exposure to the real estate market without having to own the physical property outright. Lastly, the dividend yield on REITs is relatively high compared to traditional equity investments, making them attractive to yield-hungry investors.

This topic is important for several reasons. REITs have become an important tool in the average investor's "toolbox" to diversify away from equity-based investments. In addition, the global (excluding the U.S.) real estate market comprises the bulk of real estate value in the world and again, assists in portfolio diversification. Although REITs have been available to investors since the 1990s, Global REITs have only been available to investors for a few short years. Lastly, the proliferation and success of index (i.e. "passively-managed") funds has caused millions of investors to question the value of an investment management team. An actively managed fund is generally much more expensive in terms of annual fees, and most studies show that actively-managed funds do not consistently exceed the performance of a broad-market index. As will be shown later in this paper, most of the Global REIT funds available now are passively-managed funds.

The general research question is the following: "Is there a benefit to including a Global REIT fund in the average U.S. investor's portfolio?" There have been a number of studies published regarding REIT funds in general, but most (if not almost all) of these examined traditional U.S.-based REIT funds. There have been very few that have examined the nature of Global REITs currently in existence to try to determine whether or not this would be something of benefit to a U.S. investor. This would therefore fill a gap in the literature.

HISTORY OF REITs

Real Estate Investment Trusts date back to the 1960s in the U.S., when investors were able to avoid double-taxation on real estate by using trusts, which were considered to be "pass-through entities". In 1993 any remaining barriers preventing pension funds from investing in REITs were removed. Essentially, a REIT is a property management company whose primary activities include managing, leasing, and selling real estate, investing in other real estate companies, and financing real estate. They are far more liquid than other alternative investment vehicles (Suarez and Vassallo, 2005). REITs are designed very similarly to a mutual fund—they provide a vehicle for individual investors to acquire a portfolio of real estate (Ponda et al, 2013). Investors own shares in a REIT fund, much like they would with any other stock (i.e. mutual) fund. They are generally able to open an account with a few thousand dollars and are subsequently able to buy and sell at their own discretion.

Since their inception, REITs have gone through many changes and have transitioned from passive real estate portfolios to actively-managed corporations with increased access to investor capital. Thus, the period from the 1990s to the present is known as the modern REIT era and has witnessed the entrance of a large number of newly formed REIT entities (Feng et al, 2011). This trend has also been present on the international level. In 1995, REITs were only present in six countries, but by 2007 over 30 countries had introduced REIT regimes and several others were considering such legislation. This demonstrates the demand by individual investors for securitized real estate as an alternative asset class (Serrano and Hoesli, 2010).

ACTIVELY-MANAGED vs. PASSIVELY-MANAGED REITs

In general terms, there are two major types of mutual funds (including REITs)—actively-managed and passively-managed. In an actively-managed fund, there is a fund manager (or team of managers) that buys and sells stock holdings within a fund in an attempt to maximize returns. In a passively-managed fund, there is no fund manager, and the fund simply "tracks" a particular index (such as the S&P 500, Wilshire 5000, etc.). Kallburg et al. (2000) find that positive alphas (return above-and-beyond the expected return) are much more likely to occur when the real asset market is performing poorly, suggesting that fund managers add more value in down- markets that in up-markets. However, when examining the Brazilian fixed-income mutual fund market, evidence was found against active management in all circumstances (Eld and Rochman, 2009).

Briddell (2010) makes a case for active management with regard to investing in international real estate markets, stating that while the real estate markets of the U.S. and U.K. are some of the most transparent in the world, corporate governance and reporting standards vary considerably around the globe. He also goes on to cite some of the most important benefits of real estate investing—portfolio diversification (through low correlation to other asset classes), solid cash flows, and significant inflationary protection through rising rents.

In a more general sense, Bird et al. (2013) question why investors tend to place such a large proportion of their investments in mutual funds with active managers, given managers' suboptimal performance over time and general inability to add net value. They go on to say, "the industry is captive to a pervasive prior towards active management. The prior is reinforced by a competitive environment and supported by a complex mix of behavioral, agency, organizational, and cultural factors."

In a similar vein, Jones and Wermers (2011) conclude that "the average active manager does not outperform but that a significant minority do add value… [and] investors may be able to identify superior managers in advance by using public information." French (2008) sums it up nicely with a very important question, "Why do active investors continue to play a negative sum game?"

BENEFITS AND RISKS OF INTERNATIONAL REAL ESTATE INVESTING

In general, REITs are considered to be an important component of a well-diversified portfolio by many U.S.-based investors for several reasons, such as alternative economic exposure and a hedge against a weak dollar. However, one of the most noteworthy reasons is that they pass approximately 90% of taxable income to shareholders in the form of dividends. Although traditionally only U.S. REITs have had this special privilege, many other countries now allow this structure to exist (Myrmo, 2013). Since REITs distribute the vast majority of their income, they generally owe no income tax—taxes are paid by shareholders on the dividends received (Ponda et al., 2013). The ownership of large real estate assets has historically been inaccessible to the "small" (i.e. individual) investor. This process of real estate securitization represents a dramatic change in the ownership structure of this massive store of wealth (Feng et al, 2011).

Investing in international real estate further enhances the degree of diversification. Suarez and Vassallo (2005) examine the relatively new European REIT market and its impact on the real estate industry. Serrano and Hoesli (2010) examine whether the predictability of securitized real estate returns differs from that of stock returns. Their results, based on an 18-year period, show that securitized real estate returns are generally more predictable than stock returns in countries with well-established REIT markets (e.g., the U.S., the Netherlands, Australia, etc.). Steinert and Crowe (2001) predict that global real estate investment will become an increasingly important aspect of an individual investor's portfolio allocation. According to their estimates, the average global real estate allocation will rise over time to approximately 10% of the average investor's portfolio, and perhaps most noteworthy, offer the same rate of return as equities with only half the risk.

However, global securitized real estate is not without risk. One of the major risks is a lack of transparency in many markets. Although many international markets are transparent, such as the U.S., the U.K. or Australia, there are many important emerging markets that are still opaque, such as China and Brazil. Corporate governance and reporting standards also vary greatly across the globe. Other considerations for the real estate investor looking to invest overseas are inflation and interest rate risk, currency risk, and identifying appropriate performance benchmarks. Lastly, liquidity (being able to sell the investment in a fair and timely manner) is a major factor, especially in developing markets (Briddell, 2010). Perhaps as a partial response to these questions, along with the issue of volatility, Australia has created REIT futures which began trading on the Australian Stock Exchange in 2002. These have served as a risk management strategy for institutional investors for hedging their REIT exposure during times of increased volatility, such as the most recent global financial crisis (Newell, 2010).

CURRENTLY AVAILABLE GLOBAL REIT FUNDS

This preliminary study focuses on the small but growing category of Global Real Estate Investment Trust funds. Currently there are only a handful of these funds; however, given the fact that investors continually scour the horizon for new investment opportunities, coupled with the ever-growing familiarity the average investor has with international funds, this category will no doubt continue to grow.

The following table lists the Global REIT funds currently traded. As the reader may notice, the majority are passively-traded funds—in other words, there is no fund manager actively buying and selling stocks held within the respective fund in an attempt to "beat the market". Instead, most are funds that look to track a certain index.

Table 1—Global REIT Funds and Management Style

Fund Name	**Ticker Symbol**	**Management Style**
Cohen & Steers Global Realty Majors	GRI	Passive
First Trust FTSE EPRA/NAREIT Developed Markets Real Estate	FFR	Passive
iShares FTSE EPRA/NAREIT Developed Real Estate ex-U.S.	IFGL	Passive
iShares FTSE EPRA/NAREIT North America	IFNA	Passive
iShares S&P Developed Ex-U.S. Property	WPS	Passive
SPDR Dow Jones Global Real Estate	RWO	Passive
SPDR Dow Jones International Real Estate	RWX	Passive
Vanguard Global ex-U.S. Real Estate	VNQI	Passive
Wisdom Tree Global Ex-U.S. Real Estate	DRW	Passive
iShares Europe Developed Real Estate	IFEU	Passive
iShares Asia Developed Real Estate	IFAS	Passive
ING Clarion Global Real Estate Income Fund	IGR	Active
Alpine Global Premier Properties Fund	AWP	Active

Source: Fund Annual Reports, 2013

One of the primary benefits of passively-managed (i.e. "index") funds is that their expense ratios are much lower than those of actively-managed funds. This difference can range from 1.0 to 1.5% of assets per year. In fact, many passively-managed funds from the larger investment houses (such as Vanguard) boast expense ratios in the range of .10% per year (miniscule when compared to some actively-managed funds).

As can be seen from Table 1, most of the Global REIT funds fall into one of several major categories—ex-U.S. (to potentially include all countries except the U.S.), Developed Country, International (to include all countries of the world, including the U.S.) and Asia.

Although developing markets (i.e. Brazil, Mexico, Indonesia, etc.) can potentially be included in International or Asia Funds, generally they seem to comprise a small percentage of holdings—no more than roughly 10% of total assets held (Annual Reports, 2013).

As examination progressed on this subject, it became apparent to this researcher that there was a good bit of overlap or similarity in the Global REIT funds currently available. Let us examine the following tables to develop an idea of the degree of the redundancy. In Table 2, we see the "Percentage of Assets in the Ten Largest Holdings" of each fund. This percentage ranges from 24.39 to 49.79%, with the average being 33.85%.

Thus, there is a relatively large concentration of assets in just a few stock holdings among all of these funds. This could lead to more risk than the average investor would like to assume, and potentially be more volatile than is realized when the average investor places money into one of these funds.

Table 2- Global REIT Funds and Top Holdings

Fund	**% of Assets- Ten Largest Holdings**
GRI	33.70
FFR	24.39
IFGL	32.95
IFNA	36.04
WPS	29.06
RWO	27.97
RWX	38.23
VNQI	26.00
DRW	24.56
IFEU	49.79
IFAS	47.56
IGR	41.40
AWP	28.40

Source: Fund Annual Reports, 2013

Besides being very concentrated into a limited number of holdings, the "Predominant Country of Origin" is very similar across the Global REITs currently in existence. In Table 3, it may be observed that most funds invest primarily in the U.S. or Japan. Thus, investors may actually have a much more limited array of choices than these thirteen funds would indicate at first glance.

Table 3- Global REIT Funds and Predominant Country of Origin

Fund	Predominant Country	% of Overall Portfolio
GRI	U.S.	47.42
FFR	U.S.	46.00
IFGL	Japan	26.98
IFNA	U.S.	90.07
WPS	Japan	29.91
RWO	U.S.	54.88
RWX	Japan	21.36
VNQI	Japan	25.00
DRW	Hong Kong	24.55
IFEU	U.K.	35.60
IFAS	Japan	40.08
IGR	U.S.	41.00
AWP	U.S.	34.00

Source: Fund Annual Reports, 2013

As can be seen in the above table, eleven out of the thirteen funds invest in one of two countries, with an average of 41.51% in the predominant country. It would behoove investors to realize this when seeking diversification. In the case of the average U.S.-based investor, there is already a strong “home bias” toward investing the vast majority of assets in U.S. companies. In cases such as these, it would be wise to examine the prospectus or annual report of a Global REIT fund to ascertain the percentage of assets invested in U.S. real estate holdings. Along the same lines, for those investors looking for exposure to Asian real estate—the vast majority of ex-U.S. or Asia REIT funds are geared primarily toward Japan.

In a similar sense, Table 4 illustrates the Top Holding of each fund and the percentage of the overall portfolio that it comprises. Again, it is quickly apparent that a select number of property firms hold the top ranking in this regard for the majority of the funds in question—Simon Property Group, Inc. (U.S.), Mitsubishi Estate Co., Ltd. (Japan) and Unibail-Rodamco SE (France). Again, this seems to indicate that investors may not have as much choice as would appear on the surface. However, two of the three exceptions to this are the actively-managed funds of IGR and AWP (with top holdings of Liberty Property Trust and ARA Asset Management, respectively). The average Global REIT fund holds more than 100 stocks within its portfolio, so a 4.00% or more weighting of one particular stock is significant. In our current sample, this percentage ranged from 4.00 to 17.14%, with the average being 6.74%.

Table 4- Global REIT Funds and Top Holding

Fund	Top Holding	% of Overall Portfolio
GRI	Simon Property Group, Inc.	4.00
FFR	Simon Property Group, Inc.	4.26
IFGL	Mitsubishi Estate Co., Ltd.	6.78
IFNA	Simon Property Group, Inc.	8.83
WPS	Mitsubishi Estate Co., Ltd.	6.05
RWO	Simon Property Group, Inc.	5.88
RWX	Mitsui Fudosan Co., Ltd.	6.75
VNQI	Mitsubishi Estate Co., Ltd.	4.80
DRW	Unibail-Rodamco SE	3.87
IFEU	Unibail-Rodamco SE	17.14
IFAS	Mitsubishi Estate Co., Ltd.	10.03
IGR	Liberty Property Trust	5.20
AWP	ARA Asset Management	4.00

Source: Fund Annual Reports, 2013

CONCLUSION

With investors becoming ever more sophisticated in their approach to investing, as well as having more tools and options at their disposal, Global REITs have begun to have a presence in the average U.S. investor's toolbox as not only an additional layer of diversification, but also as a hedge against a weakening dollar and a way to gain exposure to faster-growing regions of the world. Over the last several decades, as investors have become more aware of REITs and the benefits they offer, Global REITs are now seen as one of the potential next steps in profit-seeking. Although most of the funds currently on the market are passively-managed, there are several that take the active-manager approach. It is unclear as of yet if the active-approach will provide any excess return, or "alpha", but it is possible that an outstanding fund manager, one that is highly-knowledgeable of local markets, perhaps speaks the local language, and is familiar with the political and legal structure of the country from which the respective fund originates, would be able to provide a return superior to that of a simple index (i.e. passively-managed fund) which simply "tracks the market". However, it is also clear that investors may not have as much choice regarding funds as may appear at first glance, given the apparent compositional redundancy and asset concentration of the currently available funds.

FUTURE RESEARCH

A possible next step in this line of research could be to attempt to ascertain whether or not an actively-managed Global REIT offers any degree of "Alpha", or return above-and-beyond the expected return. In other words, is there value in having a fund manager that frequently buys and sells fund holdings in an effort to “beat” a particular benchmark index? This would especially be the case given the above evidence that most Global REIT funds have very similar compositions (i.e. stock holdings, country concentrations, etc.). There has already been much debate regarding actively vs. passively-managed mutual funds, and the general consensus is that fund managers are unable to beat a passively-managed index fund on a consistent basis. However, would this same conclusion apply to something as nuanced and complex as a Global Real Estate Investment Trust?

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