Global Real Estate Securities: Drivers of Opportunity

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Global real estate securities delivered strong absolute returns in 2014 and outperformed the broader global stock market. The outperformance occurred against a backdrop of improving U.S. economic growth, continued global growth and a decline in sovereign bond yields around the world.

Those factors allowed for generally healthy real estate fundamentals and access to capital at attractive terms, while the low-interest-rate environment drew investors to the above-average yields offered by real estate securities. We continue to see attractive potential for listed real estate across the global landscape, given stable-to-improving demand stemming from job growth in many markets. This update highlights what we think will be drivers of opportunity in 2015 and gives our views from a regional perspective.

Economic Growth and Employment

The strong recent performance for real estate securities partly reflected expectations that fundamentals will continue to benefit from positive economic growth and associated employment creation. In the U.S., where these trends have been more pronounced, the economy has been adding between 100,000 and 300,000 jobs per month, and has now gained back all of the jobs lost amid the financial crisis, as shown in Exhibit 1.

Exhibit 1: Total Employment in the United States

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Complete job recovery


The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend might begin.

(a) Non-farm payrolls, seasonally adjusted represent the total number of U.S. employees on the payroll of businesses. Farm employees, self-employed individuals, employees on strike, and employees on leave or laid off are not included.

The exhibit on the following page provides a sample of how other major economies are faring with employment creation in the wake of the financial crisis. The U.K. and Hong Kong have more than recovered lost jobs. In countries where job growth has lagged, such as Japan, we expect to see an improvement in their economic prospects going forward.
The Implications of Lower Oil Prices

The dramatic decline in oil prices over the past few months presents both opportunities and risks with regard to commercial real estate, but should be a net positive in our view, especially for investors able to identify clear beneficiaries. Starting with a country view, the biggest net importers of oil would seem to be high on that list. As a major oil importer relative to the size of its GDP, Japan, for one, stands to see an economic boost, as does much of Europe, as indicated in Exhibit 3 on the following page.

The U.S., which is a large producer as well as importer of oil, should be a net beneficiary, in our view. Thanks to lower gasoline prices, U.S. consumers have a greater ability to pay apartment rents, for example, and shop more at local malls. When they consume more goods, demand for warehouse storage and activity improves. Real estate stands to benefit from a number of such multipliers, with those nickels and dimes potentially accruing to meaningful levels. To the extent it helps lift GDP, a stronger U.S. economy is also a driver of better overall office and hotel demand. Of course, as active managers, we are cognizant of the risks associated with oil-sensitive markets, such as Texas apartments and offices.
Our Regional Perspective

A favorable combination of economic growth and lower energy costs, along with the appeal of above-average income in a low-interest-rate world, stands to support real estate securities globally. Here are our views on the major regions in which we invest.

Exhibit 3: Oil Importers Stand to Benefit the Most From Low Oil Prices

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<th>Country</th>
<th>Net Oil Imports as a Percentage of GDP in 2012(a)</th>
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<tr>
<td>Hong Kong SAR</td>
<td>Low Oil Winners</td>
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<td>India</td>
<td>Low Oil Losers</td>
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<td>Spain</td>
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Source: International Monetary Fund (IMF), Evercore ISI and Cohen & Steers.

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(a) 2012 was used because it is the most recent year in which this type of data is considered to be final. Calendar years after 2012 contain a degree of forward numbers and projections. Gross domestic product (GDP) is one of the primary indicators used to gauge the health of a country’s economy. It represents the total dollar value of all goods and services produced over a specific time period.

North America. We expect the U.S. economy to continue to improve, assisted by lower oil prices. A positive economic tailwind should drive further increases in demand for all types of properties, and we believe the supply picture will remain favorable as well. While supply has been slowly creeping up, we see little grounds for concern at present. In this environment, we believe U.S. REITs can generate earnings growth of high-single digits to low-double digits, depending upon the property type, supporting more dividend growth. Increasingly, we see listed real estate companies in the U.S. tilting from acquisitions in favor of development as a source of growth.

Europe. We believe the U.K. continues to offer attractive value, as the current expansion cycle has room to continue, in our view. London has seen very strong residential prices, which may have started to correct at the highest end. However, our focus is on the commercial market, where rising cash flows have helped drive net asset values higher. We expect London office supply to modestly increase in 2016–17.

On the continent, we believe real estate fundamentals have bottomed. We see rental growth ranging from flat in weaker markets to the 2.5% area in stronger markets, which, combined with savings from refinancings, is generating earnings growth as high as 6%. That may seem mild compared with growth rates in the U.S., although to us it means that values are very discounted. Investors are overlooking durable business models that pay attractive income streams, especially relative to local bond yields, within companies with good growth potential.

Asia Pacific. We are finding value within certain markets and specific stocks. For example, within Hong Kong, stocks are trading at steep discounts to net asset values; in Japan, property developers also trade at sizable discounts, while J-REITs are at premiums. Given Australia’s lackluster economic growth lately, our focus is on companies with meaningful offshore assets in markets with more compelling fundamentals.
Real Estate Dividends Are Well Above Sovereign Yields

Exhibit 4 below shows how real estate dividend yields compare with sovereign bond yields across major markets. As 2015 began, the average yield on U.S. REITs was 140 basis points above the 10-year Treasury yield, which is even wider than REITs’ historical average. More dramatic differentials are visible in countries such as the Netherlands and France, markets where investor pessimism has led to yield spreads greater than 400 basis points.

Diversification with Potential for Reduced Risk

Today, correlations for both the U.S. and global real estate securities markets have settled back to levels more typical of their historical behavior, as shown in Exhibit 5. REITs have historically been excellent diversifiers, providing returns that are not correlated with stocks or bonds. However, during the global recession and credit crisis, return patterns for REITs and other stocks converged, as the strains affecting financial markets affected many industries and asset classes in similar ways. REITs continued to trade closely with the stock market until 2012, when correlations across a wide range of sectors and asset classes began to trend lower.

Going forward, a structural factor may help keep correlations near their historical averages or even bring them lower. At the end of 2014, Standard & Poor’s and MSCI announced that they will define REITs as a new, distinct industry in their Global Industry Classification Standard (GICS) methodology of stock index construction. Currently REITs are embedded in the financial sector, along with banks and insurance companies, which have very different business models and drivers of performance. With the change...
likely to occur in 2016, REITs’ visibility should be enhanced and investors will be better positioned to judge real estate landlords and developers on their own merits. This has favorable implications for correlations. For instance, if sentiment toward traditional financial companies turns negative and investors start shorting the sector, REITs may be spared if property fundamentals are healthy.

Exhibit 5a: Correlation—Global Real Estate Securities vs. Global Stocks
Rolling Three-Month Periods, 2002–2015

Global real estate securities correlation to global stocks is below pre-crisis levels

Crisis
2008–2009 = 0.86

Pre-Crisis
2002–2007 = 0.64

Exhibit 5b: Volatility—Global Real Estate Securities
Rolling Three-Month Periods, 2002–2015

Global real estate securities volatility is below that of stocks

Crisis
2008–2009 = 33.0

Pre-Crisis
2002–2007 = 10.8


Global real estate securities represented by the FTSE EPRA/NAREIT Developed Real Estate Index; global stocks represented by the MSCI World Index. See below for additional disclosures.


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Index Definitions
Investors cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes.

The FTSE EPRA/NAREIT Developed Real Estate Index is an unmanaged market-weighted total return index that consists of many companies from developed markets and derives more than half of their revenue from property-related activities. The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Investing With Cohen & Steers. The trends discussed above paint a picture of what we believe will be a favorable operating environment for U.S. REITs over the near term. In addition, we continue to find compelling values in Asia Pacific, Europe and the emerging markets. However, the key to making profits in real estate is, as always, allocating capital to the right markets and property sectors. At Cohen & Steers, we’ve been providing solutions for investors seeking to access opportunities in this unique asset class since our founding in 1986. For more information on our global and regional real estate securities strategies, please visit our website at cohenandsteers.com/real estate or contact our institutional marketing and client service team at 212 822 1620.

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