

Investing in real-estate securities: the benefits of active management

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Interest rates are continuing to cause uncertainty. A strategic allocation to real estate securities plays an important role in a diversified investment portfolio. This asset class provides opportunities for potentially superior risk-adjusted returns while maintaining investor liquidity. Furthermore, real estate securities have proven to be inefficiently priced at times, providing active managers an opportunity to generate additional returns on behalf of investors.

Nevertheless, the proliferation of exchange-traded products and index mutual funds has prompted many investors to revisit the “active vs. passive management” debate, asking whether active real estate managers will eventually face the same performance hurdles as managers in larger and more efficiently valued sectors of the equity market.

The analysis is not to take a position in the broader active versus passive management debate, but to explore why active management is well suited for less efficiently valued asset classes — in particular, publicly traded real estate securities.

ACTIVE MANAGEMENT IN REITS HAS PROVEN SUPERIOR TO ACTIVE MANAGEMENT IN LARGE-CAP CORE EQUITIES

It is important to distinguish between asset classes when evaluating the merits of active management relative to passive management. Many market participants naturally think of the challenges of active management in the U.S. large-cap core space. However, history has shown that over both the short and long term, active management in REITs can add value relative to a passive index. Despite the difficulty in recent years, on a five-year basis, 83 percent of REIT managers outperformed their benchmarks by an average of 135 basis points; over a 10-year period, the percentage of managers that outperformed moves higher for both asset classes, with REIT managers outperforming an impressive 97 percent of the time by an average of 160 basis points.

Figure 1: Three-year rolling returns for active US REIT manager (6/30/93-6/30/14)

Average rolling 3-year outperformance	209 bps
% of time underperformed	0.0%
% of time outperformed by 50 – 100 bps	10.2%
% of time outperformed by 100 – 200 bps	45.1%
% of time outperformed by > 200 bps	39.5%

Source: eVestment Alliance as of 6/30/14. Performance is historical and is no guarantee of future results. Active US REIT managers are represented by the eVestment Alliance US REIT Universe. This chart is for illustrative purposes and does not represent any Deutsche Asset & Wealth Management product. Category returns include reinvestment of all distributions and do not reflect fees or expenses. Results would have been lower if fees had been deducted. It is not possible to invest directly in a category.

Having shown the outperformance of active REIT managers relative to their benchmarks, the question arises as to whether this was accomplished by taking on more risk relative to the benchmark. As Figure 2 illus-

trates, the average active REIT manager has consistently delivered better returns on a risk-adjusted basis than the Wilshire U.S. REIT Index, managing portfolios that have lower standard deviation, higher Sharpe ratios, and positive information ratios. This ability to produce positive risk-adjusted returns is an important aspect of active management. It stems from the fact that active managers are able to increase and decrease portfolio risk at different points in the economic cycle. That is in contrast to passive investments, which, due to structural constraints, remain indifferent to risk throughout the cycle.

Figure 2: Active REIT managers have delivered better returns on a risk-adjusted basis

	Active U.S. REIT managers	Wilshire U.S. REIT Index
10-yr. return	11.1%	9.5%
10-yr. standard deviation	24.9%	26.2%
10-yr. Sharpe ratio	0.45	0.36
10-yr. tracking error	2.80%	—
10-yr. information ratio	0.57	—
20-yr. return	13.1%	11.0%
20-yr. standard deviation	20.0%	20.9%
20-yr. Sharpe ratio	0.66	0.53
20-yr. tracking error	2.39%	—
20-yr. information ratio	0.89	—

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AN INEFFICIENT MARKET: INVESTING IN REITS IS DIFFERENT

One of the key determinants of an inefficient market is the ability to aggregate, understand and invest using information that is better than that of the market as a whole. We believe one gauge of market efficiency, and the access to information for the incremental investor, is the magnitude of coverage by sell-side firms on individual securities. A larger degree of sell-side coverage of a security or benchmark typically results in a greater amount of information being disseminated to the market, and thus less opportunity to capitalize on information inefficiencies in the market and on mispriced securities. For example, if you used data from Factset and Bloomberg, the average number of analysts covering a S&P 500 Index stock is double the number following a MSCI US REIT Index name (June 30, 2014).

SECURITY SELECTION: A SOURCE OF VALUE CREATION FOR ACTIVE MANAGERS

From a security-selection standpoint, the ability to generate excess returns lies with the manager’s ability to find

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and exploit opportunities that the market has not fully reflected in the price of a security. Part of this ability depends on securities diverging in price and exhibiting lower correlations, both to the sector and to the broader equity market. Dispersion refers to the range of values for particular variables — for example, the difference between the highest and lowest returns in a given universe of securities. The greater the difference in returns between the best- and worst-performing securities within a given investment universe, the higher the potential for active managers to find superior risk-return opportunities among them. Other sources of value creation for active managers include:

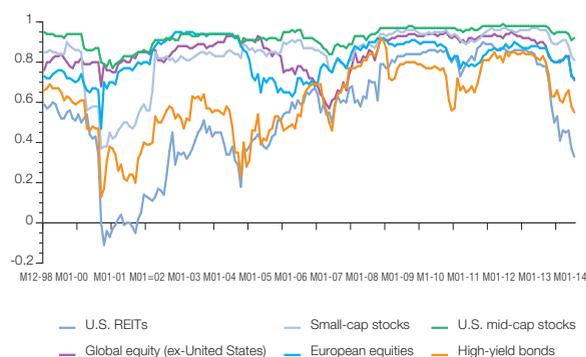
- **Property-sector rotation:** Active managers can focus their portfolio on sectors or macro themes. Similar to security selection, sector rotation requires a dispersion of returns to be worthwhile on a risk-adjusted basis
- **Style and quality:** The inefficiency of the REIT market can be exploited by alpha drivers beyond bottom-up stock selection and top-down sector rotation. Several quality or style factors, around which passive investment options do not position, have been shown to be additional sources of value-add for active managers.
- **IPOs and follow-on offerings:** New offerings include IPOs, follow-on equity offerings and at-the-market transactions. Active managers are better able than passive managers to take advantage of such offerings. Active managers are able to determine whether they will participate in these offerings, and may receive a discount to market pricing as well as liquidity, both of which can create potential short-term alpha opportunities. The secondary-issue market represents another source of potential value creation for active managers. As a means of funding external growth, many companies have historically pursued follow-on equity deals. In recent years, we have seen some of the highest levels of new equity issuance for U.S. REITs, with more than \$20 billion of issuance in both 2012 and 2013.

WHY HAS RECENT PERFORMANCE DIVERGED FROM HISTORICAL TRENDS, AND WHY WILL IT CHANGE?

The foundation of this view lies within a broader global asset theme that policy decisions, both fiscal and monetary, over the past several years have driven correlations to all-time highs, rendering fundamental analysis a less effective tool for stock selection. As the cycle progresses, dispersions and correlations will likely revert closer to long-term averages as dictated by the underlying fundamentals of the respective businesses, resulting in active-manager performance reverting back to its strong historical trend.

Correlations have begun to trend downward since 2013, reflecting more divergent policies taking place globally. In the first half of 2013, active-manager performance was weak, characterized by correlations ramping up and drastic reductions in the cost of capital, which benefitted lower-quality companies; the market remained indifferent to their underlying fundamentals. One area that has not seen a drop off in correlation for REITs, however, is the correlation to direct real estate. Based on rolling three-year returns of the respective benchmarks since the beginning of 1993, the correlation between listed and non-listed real estate is 0.77, suggesting that real-estate equity returns are highly correlated to the underlying business drivers of direct real estate.

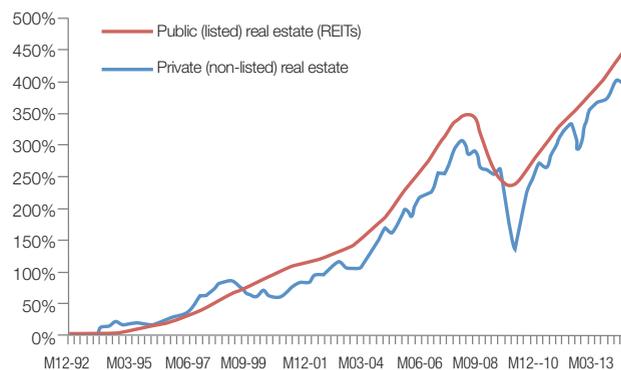
Figure 3: Rolling two-year asset-class correlations to the S&P 500 Index (12/31/98–6/30/14)



Source: Bloomberg as of 6/30/14. Asset-class representation is as follows: REITs, MSCI US REIT Index; global equity (ex-United States), MSCI World ex-USA Index; US small-cap stocks, Russell 2000 Index; European securities, MSCI Europe Index; US mid-cap stocks, Russell Mid-Cap Index; high-yield bonds, Barclays US Corporate High Yield Index. This chart is for illustrative purposes and does not represent any Deutsche Asset & Wealth Management product. Index returns include reinvestment of all distributions and do not reflect fees or expenses. Results would have been lower if fees had been deducted. It is not possible to invest directly in an index.

As is the case with any security, its price is meant to reflect the underlying business characteristics, regardless of whether it is a technology stock or a REIT. Unless investors believe that all sectors are impacted by the same fundamentals and macro drivers, correlations and a more rational pricing of risk should revert to historical norms. We expect this historical relationship to remain going forward, and believe that active REIT managers who have a competitive advantage in understanding direct real estate values will continue to outperform passive alternatives.

Figure 4: Cumulative returns for public and private real estate



Source: Bloomberg, GreenStreet as of 6/30/14. Performance is historical and is no guarantee of future results. Asset-class representation is as follows: private (non-listed) real estate, the NCREIF Property Index; public (listed) real estate, the FTSE NAREIT All Equity REITs Index, adjusted for leverage and lagged by 12 months. This chart is for illustrative purposes and does not represent any Deutsche Asset & Wealth Management product. Index returns include reinvestment of all distributions and do not reflect fees or expenses. Results would have been lower if fees had been deducted. It is not possible to invest directly in an index.

CONCLUSION

In summary, the best way for an investor to gain exposure to REITs is through an allocation with an active manager. REIT active managers have historically delivered strong risk-adjusted returns to investors over all time periods. While the recent market environment has made outperforming an index more challenging, active managers have still outperformed. Importantly, we believe there is clear evidence the investing landscape has already shifted and is turning into a very favorable environment for active managers.