

# Revisiting the Case for Global Real Estate Securities

## Examining the Long-term Evidence

### Introduction

Much has changed in the global economy since our original white paper in 2005, and subsequent paper entitled “Global Real Estate Securities: The Continued Benefits to a Mixed-Asset Portfolio” published in 2007. The world economy is in the early stages of recovery from an extraordinary financial and economic crisis that caused the deepest recession since World War II. The investment landscape has been altered significantly. Only massive state intervention in global capital markets has helped stabilize economic growth and restore investor confidence.

Our 2007 paper advocated the case for an allocation to global real estate securities (GRES) in a mixed-asset portfolio, arguing that GRES provided investors with liquid, transparent, well-benchmarked access to institutional-quality real estate that increased diversification and the potential for attractive risk-adjusted returns. In this paper we revisit and extend the scope of our historical analysis to 1990, the starting point for the global index for GRES. Further, we include commercial private real estate total returns in the analysis<sup>1</sup>. For many institutional investors, listed real estate forms a piece of a broader allocation to real estate. Our analysis thus attempts to capture the additional benefit of including global listed real estate within a broader mixed-asset allocation that includes private real estate.

Our conclusion is that an allocation to GRES still achieves the investment objective of improving returns of an otherwise diversified portfolio without raising risk in a liquid, transparent, well-benchmarked asset class. This conclusion holds true despite higher volatility that equities including property companies have seen over the past several years.

### Long-term Performance for Global Real Estate Securities

Despite the negative returns for GRES between 2007 and 2009, long-term performance of the asset class remains compelling. Over the 19-year period of our analysis, global listed real estate securities provided the second highest per annum total return within a universe of five asset classes. In addition, GRES total returns provided the second highest risk premium relative to the yield from U.S. 10-year Treasury Bonds. This suggests that investors have been to some degree compensated for the higher volatility in listed property stocks in recent years. Exhibit 1 examines the difference between annual average yields from the 10-year U.S. Treasury Bond and the annual rate of total returns from the five asset classes included in our universe.

<sup>1</sup> There is no robust global index that measures commercial private real estate total returns as of yet. Therefore, we have created a synthetic weighted index utilizing annual total return data from Australia, the U.K. and the U.S. These three countries were chosen specifically for the quality and depth of data available, the size of the markets and the reliability of the data.

**Exhibit 1: Average Annual Total Returns and Spread over Risk-free Rate 1991-2010**

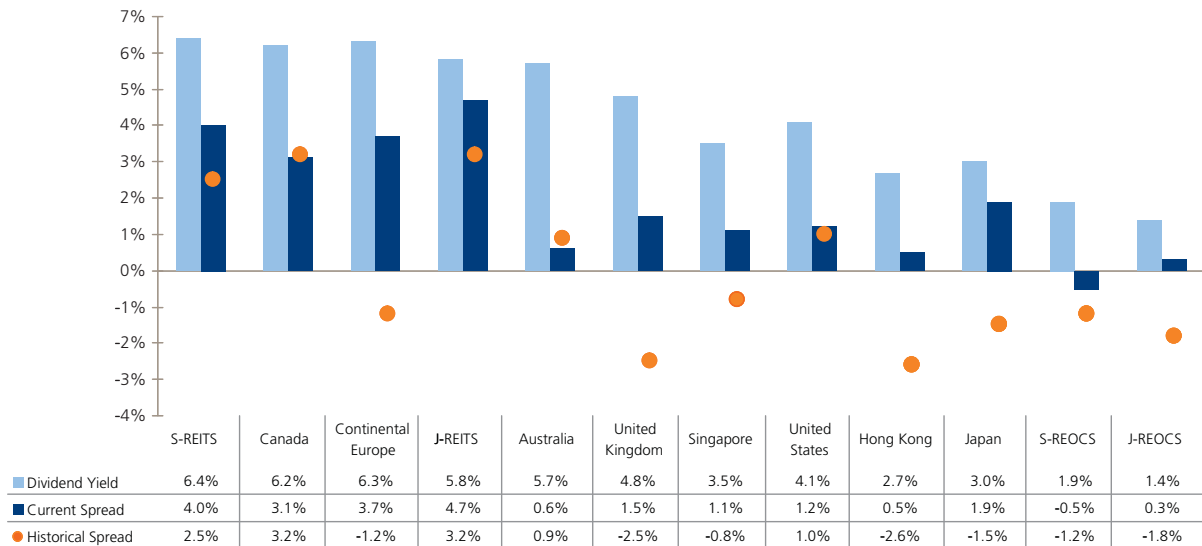
	FTSE EPRA/NAREIT Developed Index	MSCI World Equity Index	JP Morgan Global Bond Index	NASDAQ	Private Real Estate
<b>Total Annualized Return</b>	12.2%	9.4%	7.6%	14.4%	7.2%
<b>U.S. 10-Year Treasury Yield</b>	5.4%	5.4%	5.4%	5.4%	5.4%
<b>Risk Premium</b>	6.8%	4.0%	2.2%	9.0%	1.8%

Source: FTSE EPRA/NAREIT, Bloomberg, NCREIF, IPD, ING Clarion Real Estate Securities, as of 03/31/2010. Average annual total returns are for the period 1Q 1991 through 1Q 2010. Private real estate returns are a weighted average of the U.S. NCREIF Index, U.K. IPD Index and the Australian IPD Index.

### Competitive Dividend Yields

Although total returns are clearly an important consideration when investors make an asset allocation decision, yield is a critical element for income-oriented investors. In our 2007, paper we identified dividend yield as an important attribute of the asset class. The current dividend yields offered in key listed real estate markets globally are in most cases higher than the relevant government bond yield (Exhibit 2). Additionally, the spread between real estate dividend yields and long-term government bond yields generally remains above long-term average spreads among major geographies suggesting relative value.

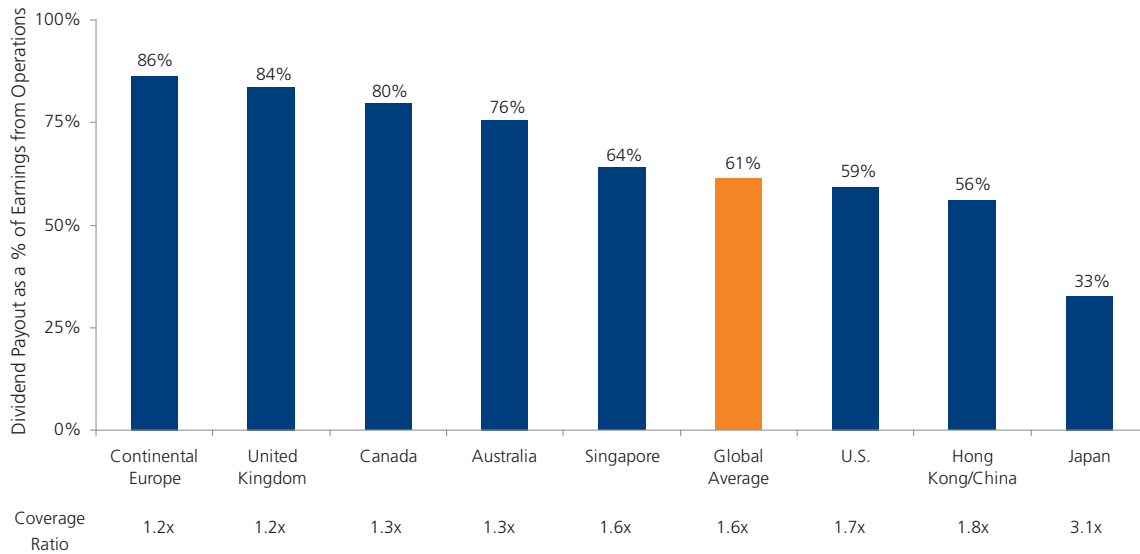
**Exhibit 2: Attractive Dividends Relative to Historical Spreads**



Source: Source: ING Clarion Real Estate Securities, FactSet and Bloomberg as of 06/30/2010.

During the recent credit crisis induced recession, in an effort to preserve cash, some real estate companies reduced dividend payments or offered investors stock in lieu of cash. For income-oriented investors, this raised concerns that that yields would be permanently lowered if dividend coverage ratios came under pressure. However, with values recovering, dividends have upward bias, with the small number of companies that substituted cash dividends for stock returning to cash, and with other companies signaling prospective increases in dividends. Moreover, an analysis of coverage ratios within the major listed real estate markets suggests that there is sufficient cash flow for companies to pay out dividends (Exhibit 3).

**Exhibit 3: Dividend Payout and Coverage of Earnings from Operations**



Source: ING Clarion Real Estate Securities. Dividend payout and coverage ratio data as of 06/30/2010.

**Diversification Benefits**

In our earlier studies, we demonstrated how global listed real estate securities helped diversify a portfolio in two ways: through lower correlation across different markets as well as through lower correlation to other asset classes. These attributes continue to make GRES attractive. Since 1990, as Exhibit 4 shows, the local listed real estate equity indices in major markets across the world have generally displayed low to moderate correlation levels with each other. This modest correlation across different markets makes intuitive sense since real estate remains an inherently local business with different economic and property cycles.

**Exhibit 4: Correlation of Annual Total Returns, Major Markets, 1990-2010**

	U.S.	Hong Kong	Japan	U.K.	Australia	Singapore
U.S.	1.00					
Hong Kong	0.16	1.00				
Japan	0.31	0.39	1.00			
U.K.	0.70	0.21	0.62	1.00		
Australia	0.62	0.35	0.30	0.67	1.00	
Singapore	0.13	0.72	0.45	0.36	0.51	1.00

Source: FTSE EPRA/NAREIT, ING Clarion Real Estate Securities, as of 06/30/2010. Total return calculations in U.S. dollars.

Another important form of diversification that GRES offers is low to moderate correlation to other asset classes (Exhibit 5). Global listed real estate is virtually uncorrelated with global fixed income and has a very low level of correlation with private real estate over the time period in our analysis. For yield-oriented investors, the low correlation between global real estate and global bonds is an important investment consideration when constructing a mixed asset portfolio.

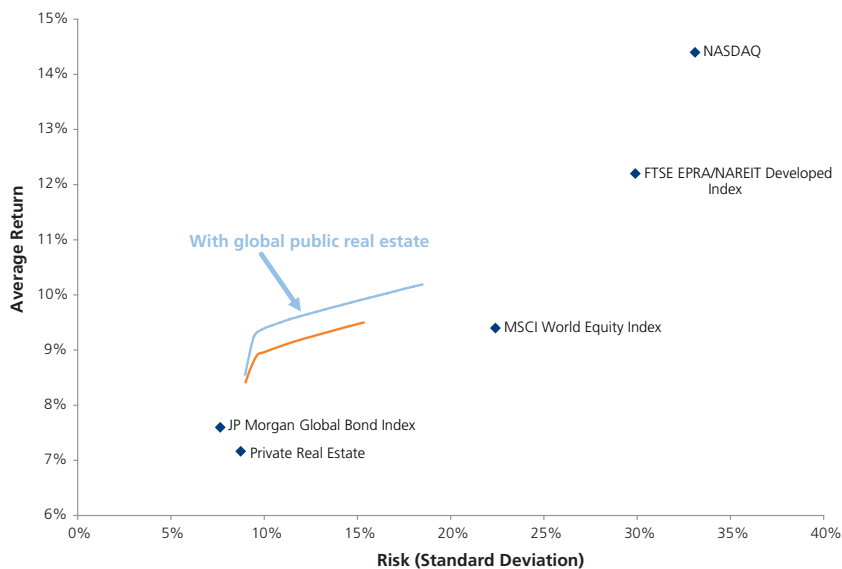
**Exhibit 5: Correlation of Annual Total Returns, Major Asset Classes, 1991-2010**

	FTSE EPRA/ NAREIT Developed Index	JP Morgan Global Bond Index	MSCI World Equity Index	NASDAQ	Private Real Estate
FTSE EPRA/ NAREIT Developed Index	1.00				
JP Morgan Global Bond Index	-0.09	1.00			
MSCI World Equity Index	0.77	0.00	1.00		
NASDAQ	0.42	-0.05	0.83	1.00	
Private Real Estate	0.32	-0.10	0.33	0.15	1.00

Source: FTSE EPRA/NAREIT, Bloomberg, NCREIF, IPD, ING Clarion Real Estate Securities, as of 03/31/2010.

Generally low correlation along with a solid return profile enables an allocation to GRES to improve the efficient frontier of returns for an otherwise diversified mixed-asset portfolio. In order to determine an optimal allocation to global real estate securities, we employ Markowitz’s Modern Portfolio Theory and mean variance framework. We construct a hypothetical portfolio consisting of GRES, global equities, global bonds, U.S. technology stocks and private real estate. We establish a 15% constraint on global listed real estate and private real estate. Exhibit 6 shows that an allocation of real estate securities to a global mixed-asset portfolio would have increased returns without raising the overall risk of the portfolio and thereby improved the efficient frontier or the optimal allocation. A 15% allocation to global real estate securities in an otherwise diversified portfolio would have led to an additional 30 basis points (0.30%) in annual total return while reducing portfolio risk by approximately 20 basis points (0.20%). Further, a portfolio including global real estate securities produces a Sharpe Ratio of 0.55 compared to a Sharpe Ratio of 0.51 for a portfolio without global real estate securities. While the improvement in the efficient frontier is not as dramatic as in our previous studies, an allocation of an otherwise diversified portfolio nonetheless continues to benefit from an allocation to GRES.

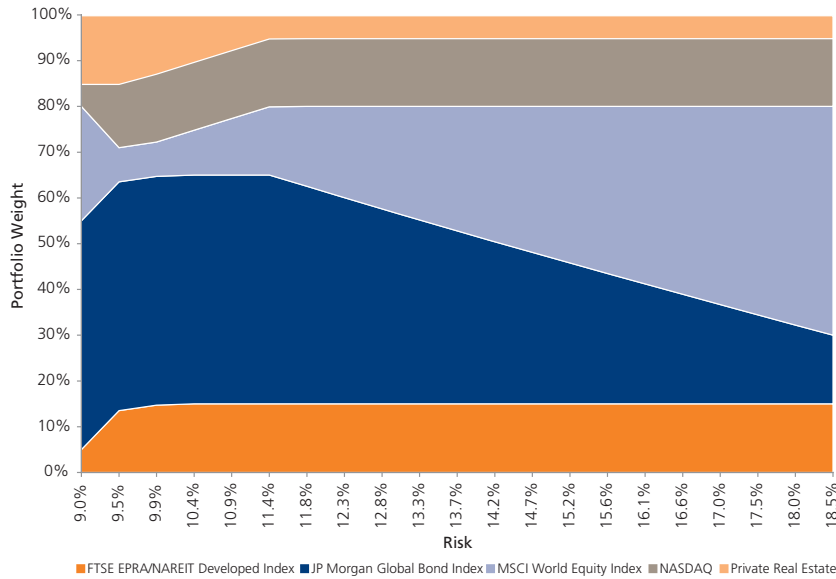
**Exhibit 6: Global Real Estate Securities Enhance the Efficient Frontier**



Source: FTSE EPRA/NAREIT, Bloomberg, NCREIF, IPD and ING Clarion Real Estate Securities as of 03/31/2010.

As might be expected, at the lowest level of risk, the portfolio is heavily tilted towards global bonds and private real estate and at the higher level of risk, the asset allocation shifts towards technology oriented stocks and global real estate securities (Exhibit 7). Global listed real estate is notably given a steady allocation across the risk spectrum. An optimized portfolio would include allocations to global listed real estate, global equities and technology stocks.

**Exhibit 7: Optimal Mixed-asset Portfolio**



Source: ING Clarion Real Estate Securities as of 03/31/2010.

**Conclusions**

Many asset classes including commercial real estate suffered significantly from the dislocation of global credit markets and the subsequent recession. Since they are highly liquid, GRES bore the initial brunt of the correction in real estate values. However, since March 2009 there has been a remarkable revival in values for listed real estate worldwide as capital markets re-opened. *(Please refer to the Appendix for further discussion.)*

The short-term dislocation to listed real estate, however, has not fundamentally altered the case for an allocation to GRES in a mixed-asset portfolio in a liquid, transparent and well-benchmarked asset class. Long-term absolute performance remains compelling anchored by dividend yields, which continue to provide investors with investment characteristics that ultimately contribute to GRES’ diversification benefits. Our re-examination of the key tenets of the asset class over a meaningful time period suggests that an allocation to GRES adds value within a mixed-asset portfolio.

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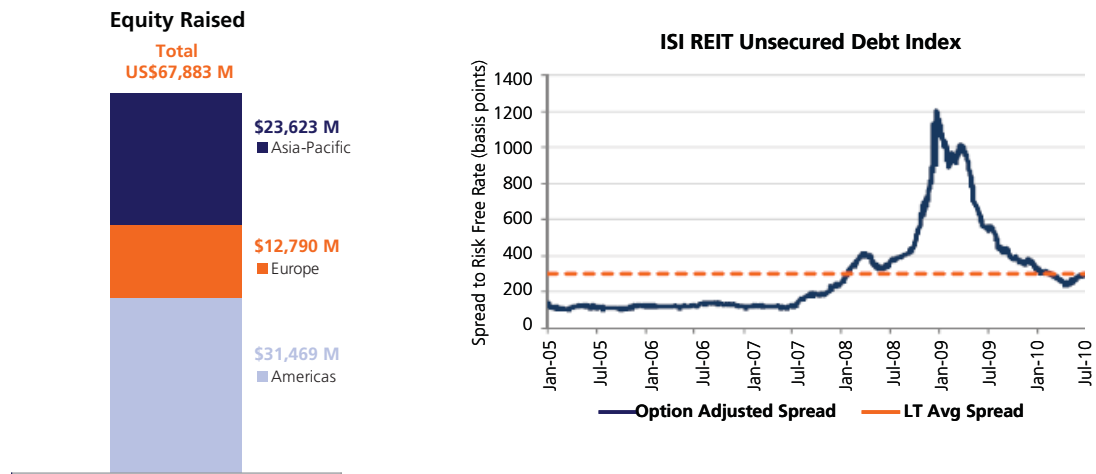
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# Appendix

## The Re-Capitalization of Global Real Estate

Over the past year, access to capital has emerged as a clear differentiator between private and public sponsors of commercial real estate. Public real estate companies have successfully raised over \$67 billion in equity capital globally while a sharp decline in borrowing costs has provided public companies access to debt capital (Exhibit 8). This is occurring at a time when refinancing and loan originations to privately held real estate from financial institutions have been challenging. The re-opening of the capital markets has been the catalyst behind a dramatic recovery in market values in listed real estate and has helped alleviate some questions on debt rollovers. In addition, the fresh capital raised has helped provide investors visibility and confidence on the steps being taken to address the debt maturities that real estate companies will need to meet over the coming years.

**Exhibit 8: Global Equity Raising and Debt Spread Compression**



Source: ING Clarion Real Estate Securities, as of 6/30/2010. Equity raised is from the time period October 2008 to June 2010. The ISI REIT Unsecured Debt Index is an index of 30 unsecured bonds with an average amount outstanding of \$330 million and an average maturity of 5.8 years. ISI REIT Unsecured Debt Index data is of June 30, 2010.

The recapitalizations have accomplished a number of objectives depending on the company. For some companies, raising equity represented a “defensive” move to reduce leverage ratios and improve interest coverage ratios. For other companies, raising fresh equity represented an “offensive” move to bolster capacity to take advantage of potentially attractive pricing looking forward. The magnitude and success of new capital raised in recent months provide resounding evidence that listed property companies are proactively repositioning balance sheets.

Though the recapitalization activity has come at a price of diluted earnings per share and value per share, it has attracted new capital to the values in listed real estate. The improved valuations (or multiples of earnings) that come in the wake of improving the leverage picture have far outweighed the dilution “pain” of raising capital and these lower valuation levels. The capital raised has also led to declining leverage across global listed real estate securities. Globally, leverage levels have declined from 48% at the end of 2008 to 41% at the end of the second quarter of 2010 (Exhibit 9).

**Exhibit 9: Leverage of Global Real Estate Securities**

	World	United States	U.K.	Continental Europe	Hong Kong	Japan	Australia
<b>12/31/2006</b>	30.9%	35.0%	30.0%	32.6%	14.3%	28.1%	27.0%
<b>12/31/2007</b>	35.5%	42.8%	47.4%	42.3%	11.5%	42.5%	27.1%
<b>12/31/2008</b>	47.9%	51.9%	63.4%	50.8%	26.1%	60.6%	41.7%
<b>12/31/2009</b>	40.5%	46.8%	48.4%	47.9%	20.0%	53.2%	35.4%
<b>06/30/2010</b>	41.0%	45.0%	51.9%	49.2%	21.4%	56.1%	35.4%

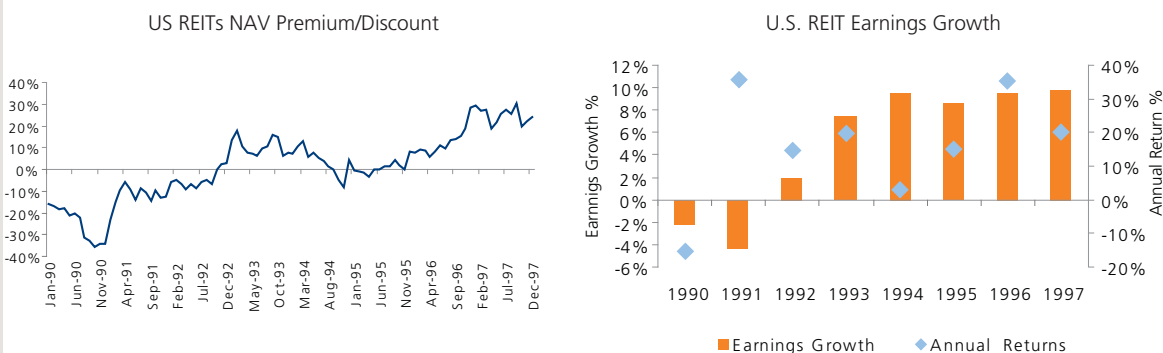
Source: ING Clarion Real Estate Securities, as of 06/30/2010.

Access to capital has emerged as an important differentiator between public and private sponsors of commercial real estate in the recovery cycle thus far. Listed real estate companies, having lowered leverage on their balance sheets and with access to equity and debt capital are well positioned to benefit from any investment opportunities that may arise.

There is historical evidence of listed real estate companies taking advantage of superior access to capital relative to private sponsors of real estate. In the early 1990s, the U.S. commercial real estate market was in severe distress with values having fallen sharply and the credit market in a state of disarray – very similar conditions that have existed since 2008. Listed real estate companies however were able to access the public markets as the real estate cycle showed signs of improvement and the mid-1990s witnessed the emergence of the modern REIT era in the U.S. As Exhibit 10 below shows listed real estate companies delivered positive earnings growth and strong total returns coming off the deep real estate crisis of the early 1990s.

While historical patterns may not necessarily be repeated this time, we believe the early to mid-1990s experience of the U.S. REITs provides some indication as to how listed real estate companies grow during the early stages of the next real estate cycle.

**Exhibit 10: U.S. REIT Market Post S&L Crisis and Recession**



Source: Green Street Advisors, NAREIT, Goldman Sachs, ING Clarion Real Estate Securities.

## Important Disclosures

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Investing in real estate securities involves risks including the potential loss of principal. Real estate equities are subject to risks similar to those associated with the direct ownership of real estate. Portfolios concentrated in real estate securities may experience price volatility and other risks associated with non-diversification. While equities may offer the potential for greater long-term growth than most debt securities, they generally have higher volatility.

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