

For investors seeking a diversified source of income the global real estate markets are hard to beat. First State's Andrew Nicholas reveals where the opportunities lie within property securities

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Andrew Nicholas, who runs the First State Global Property Securities fund with Marco van Bussel, has a very simple goal: To be the best in the sector by producing a good, long-term performance for clients rather than trying to hit the ball out of the park.

"We have a great investment process and a thorough, bottom-up approach that has been proven to work," he says. "Any prospective investors can see that we have a very strong track record of delivering solid returns to our clients both over the past 3 and 5 years."

In the current environment he is very much in favour of Real Estate Investment Trusts (REITs) as he maintains they offer good value relative to other financial assets with underlying balance sheets being in far better shape than they were even just a few years ago.

"They were not that attractive three years ago during the financial crisis," he says. "They had a lot of debt on board, as well as some spurious business models and pretty bad management, but that all got sorted out during the aftermath of the crisis. Their balance sheets are currently okay, their operating earnings are good, and both the management and business models have been sorted out which is good news for us."

The aim of the First State Global Property Securities fund, which was launched just over five years ago, is to achieve a combination of income and capital growth through investing in a broad selection of securities that have been issued by REITs or companies involved in real property around the world.

The fund currently holds 69 holdings, is benchmarked against the UBS Global Real Estate Investors Index, and has a spread of exposures to the main property sub sectors.

For example, retail has been the most favoured area, currently accounting for 31.4 per cent of its portfolio, offices 20.6 per cent and residential 15.4 per cent. Also covered are industrials (9.5 per cent), hotels (5.4 per cent) and diversified (15.3 per cent), while 2.3 per cent is in cash, according to the latest fund fact sheet.

On a regional basis, North America has the largest allocation of 57 per cent, followed by Asia Pacific ex Japan on 18.6 per cent. Other areas covered include Europe ex UK with 10.8 per cent, the UK with 5.1 per cent, Japan with 4.0 per cent and Latin America/EMEA on 2.1 per cent.

A key part of the investment philosophy that guides the fund is the strength of the markets and regions in which it invests. Issues relating to corporate governance are also taken into account, as are the qualitative structures within the REITs themselves.

"We look at the sub markets in the context of the underlying fundamentals within their regions as the REITs and property securities that have high quality assets are more immune from the worst excesses of the cycle," says Mr Nicholas. "We select companies in those regions where the level of economic activity can underwrite the target income."

In other words, the fund manager looks for good, well-managed and well-financed companies supported by solid economic infrastructure.

Within the portfolio there are both REITs and other property companies. The key characteristics of the former include the fact they typically produce a rental income a large portion of which is distributed to investors and their returns are taxed in the hands of the beneficiary rather than at source. Property companies, meanwhile, may enjoy some rental income but could also be involved in areas such as development and so have a different risk profile.

"Liquidity is one of the main benefits of REITs," explains Mr Nicholas. "Property assets tend to be big and expensive with high transaction costs so REITs give investors an opportunity to buy into an asset quickly and easily through the equity route."

As far as stocks are concerned, the team buys those that look good value relative to their peers. "When a stock price moves up by a considerable amount, we will look to sell out and buy something that is cheaper in comparison," he explains. "Everything usually has a catalyst and it is our job to find it."

"When a stock goes down substantially it may start to look attractive and produces a buy signal, subject to the qualitative characteristics which we need to see in order to make an entry," adds Mr Nicholas. "We construct our portfolio around a number of principles, such as how much we can own in a specific stock and the amount we hold in particular regions."

"We have a good process, carry out our own research and know the holdings in great detail"

In contrast, when a particular stock looks expensive and the team can't see any strong reasons for further upside - and maybe sees better value elsewhere - the decision will be made to crystallise gains by taking some profits.

While there are no particular themes within the fund, the focus is on quality assets - although that does not mean the fund manager will be lured into paying any price for them. "Generally we are drawn to regions that have been doing well," he explains. "For example, we have been underweight parts of Europe - active in France, Germany and Finland, but not exposed to Southern Europe."

Outside of Europe, the managers favour strong, robust economies such as Canada, Brazil and Australia. "We remain cautious about the US but are no longer underweight there because we do not wish to get caught out," he adds. "A lot of property assets in the US are in dire straits but the REITs over there are in pretty good shape due to the high quality of many of their underlying assets and it is our job to invest in the best we can find."

Elsewhere, Japan is seen as a difficult market and the fund has no exposure to China. "We acknowledge it has got a promising future, but the Chinese market currently seems pretty inflated to us, driven by policy. Beijing continues to take measures to cool things down and it is hard to predict whether their efforts are going to have the desired effect."

Mr Nicholas emphasises again that in an environment characterised by high volatility and uncertainty, his stock allocation is driven in large part by economic strength of underlying regions.

For example, the fund gets its exposure to the office sub-sector through gateway markets or large international financial centres - such as London, New York, Boston, Melbourne and Hong Kong. "When it comes to retail we look at regions with high quality offering where it is supported by economies" he adds. "Even in the US malls have are doing quite well despite the subdued economic environment and depressed consumer spending."

Mr Nicholas says that it is also important to avoid markets where developers have gone build-crazy. "Places such as Dallas, Chicago and Atlanta have vacancy rates in offices of around 20 per cent, whereas Sydney is around six per cent," he adds. "Lower vacancy rates mean you do not have the added pressure of trying to fill buildings."

So what are the attractions of property securities and REITs in particular as far as investors are concerned?

The first is diversification, argues Mr Nicholas. "REITs have not been available for a long time in the UK, whereas they've been in the likes of Australia for a much longer period."

The fund manager says that the asset class is able to generate a high yield in a low growth world. Beside that "there is the liquidity argument in favour of the sector, while from our perspective we have a fund that is very well constructed and which has enjoyed a strong performance."

The plan for the future is to deliver more of the same. "We have a good process, carry out our own research and know the holdings in great detail," he adds. "The fund can tap into a lot of experience with people in different regions, and the three year track record has simply been outstanding."

Andrew Nicholas is manager of the First State Global Property Securities Fund. He will speak at the Alpha Generators roadshow taking place in the UK in January and February 2012.

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