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IPD Global Quarterly Property Fund Index

4Q 2013 results report
March 2014

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RESEARCH

Introduction

The IPD Global Quarterly Property Fund Index results improved in the fourth quarter of 2013 with fund-level returns of 2.9% quarter-on-quarter. This left the 2013 returns at 10.7% for the year to December, exceeding returns from listed real estate and returns from fixed income investments.

The UK market saw the strongest finish to the year, which offset further disappointment in the rest of Europe. Thanks to the UK's return to form, European funds saw stronger performance than North American funds for the first time in over three years by the fourth quarter of 2013.
The standout sector remained the industrial sector, which outperformed on a quarterly and annual basis. Residential, or multi-family, continued to lag commercial real estate over the last 12 months, but still outperformed all other sectors on a five-year basis.

Ivo de Wit, from CBRE Global Investors, comments that; "we continue to see strong performance across all regions in our low risk mandates. In the US, investments are benefitting from the continued search for good quality assets resulting in strong performance especially in the logistics sector. In Asia-Pacific performance is mainly driven by Japan with strong tenant demand in the office and logistic sector. The logistics sector in Australia and Hong Kong have also been strong performers. Europe, the UK and Ireland have been the strongest performers as a result of improving fundamentals especially in the office sector. Other countries show a more mixed picture, with values slightly improving but the main part of the return still coming from income".

At a glance - IPD Global Quarterly Property Fund Index

Background

The governance of commingled funds improved in the wake of the Global Financial Crisis. Because most institutional investors benefit from the commingled structure, there has been renewed interest in such exposure, particularly for core funds. This parallels a growing interest in cross-border real estate as investors broaden and diversify the geographic scope of their exposure. The IPD Global Quarterly Property Fund Index, currently under development, is designed to facilitate the measurement of such fund performance against a reliable benchmark. The consultative period for developing the index began in 4Q 2012 and continues through the end of 2014. This article analyzes the Index results development as of the end of 4Q 2013.
(Note: The index is not frozen, therefore historical numbers will change when new funds are added to the sample.)

Measurement criteria

- Open-end funds
- Core strategy
- Transparency
- Quarterly asset appraisals
- Gross asset value (GAV) > $100 million
- 85% of GAV in real estate
- Leverage < 60% of GAV

Timeline

- 4Q 2012 - consultative period begins; initial performance results issued
- 4Q 2013 - consultative period continues; more funds incorporated
- 4Q 2014 - consultative period scheduled to end; formal index expected to be launched

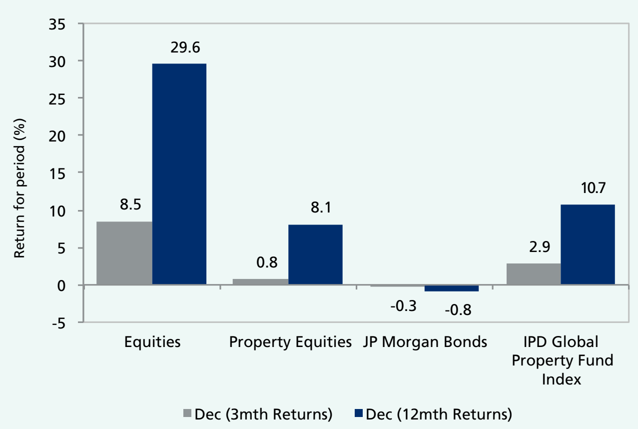
Real estate performance at the asset level in 4Q 2013

The IPD Global Quarterly Property Fund Index can be analysed at the asset level, not just at the fund level. This gives all stakeholders in the index the opportunity to understand the drivers of returns and risk exposures.

The 5,884 assets included in the index produced a total return of 2.7% for the fourth quarter of 2013. This was an improvement on the previous quarter and capped off a strong year with a return of 10.4% per annum. In 2013, capital appreciation provided a boost to income returns in North America, Asia Pacific, and the UK, with only Continental European assets failing to achieve an increase in values.

Income returns averaged 5.8% per annum to end 2013 across the whole sample, which represents a healthy cash flow compared to that of other asset classes. Ten-year government bond yields ended 2013 around 100 basis points higher than they were when the year started for the UK, U.S., and Australia. France and Germany experienced far less of an uplift compared to the previous three nations, and Japan saw very little change from the low yields typically experienced. This general increase in fixed-income yields eroded fixed-income returns and the JP Morgan Bond Index ended 2013 with a return of -0.8% per annum. Government bond yields vary greatly, as do their corporate-bond counterparts, but in the majority of cases each nations' real estate market still enjoyed a yield premium to fixed income, despite the increase in real estate prices over the last 12 months.

IPD Global Property Fund Index versus other asset classes



Source: IPD, MSCI, JP Morgan

The capital appreciation achieved by global real estate, although good in context of its own history, was a long way behind that of global equities. According to the MSCI Global Equities Index, equities achieved a return of 30% per annum in 2013 and 9% in the fourth quarter alone. However, real estate equities showed a more subdued rate of growth, returning 8% per annum in 2013 according to the MSCI Global Real Estate Equities Index, having already seen much of the improved sentiment filter through into performance in prior periods.

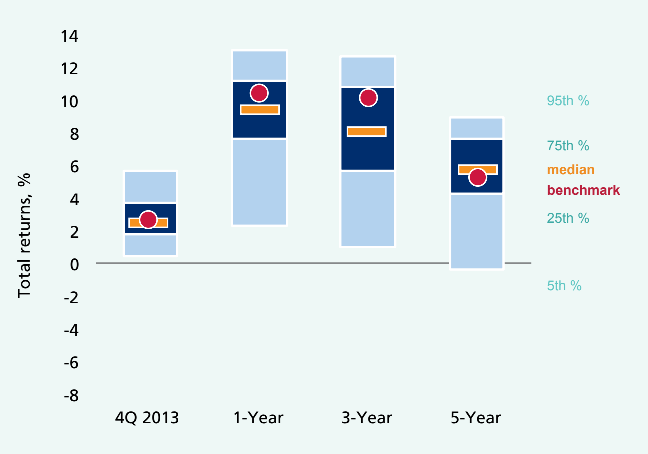
The standout trend in returns for 2013 was the rise of the UK market. The UK sample achieved 4.4% in the fourth quarter, outstripping the other regions by some margin. The boost to the UK market was largely thanks to capital appreciation in light of an improving economic outlook. Much of the largest improvements came outside of Central London in a reversal of its usual role when compared to past trends. Outer London, the South East of England, and beyond finally saw increased investor interest.

The improvements in the UK outweighed the lacklustre returns in the rest of Europe, which continued to disappoint. Values fell across Continental Europe in the fourth quarter by 0.6%, offsetting much of the 1.6% quarter-on-quarter return earned through income. North America continued to perform strongly ending the year with returns of 11.4% for the year – the highest of all regions – and Asia Pacific ended on a quieter note with returns of 9.4% per annum.

The IPD Global Quarterly Property Fund Index asset-level returns can be aggregated by sector as well as by region. The fourth quarter of 2013 saw industrial assets produce the highest average return at 3.4% quarter-on-quarter and residential or multi-family assets produce the lowest return at 2.1% quarter-on-quarter. The attraction of real estate has increasingly become its stable high-levels of income, relative to fixed income, above other attributes. This plays to the strengths of industrial assets, with generally higher yields compared to its peers, and also hints toward why low-yielding residential may be falling behind the pack. This trend was evident throughout 2013 with industrial assets outperforming and residential assets underperforming. That said, residential assets still outperformed all others when one takes a five-year view.

Real estate is a heterogeneous asset class and the range of returns is almost as important as the averages in understanding the trends in performance. The range of returns is large for any given period, underlining the need to analyze the index components at the asset level. For perspective, the range of fund returns at the asset level – from the 5th percentile to the 95th percentile – was around 525 basis points in the fourth quarter of 2013. This was larger than the previous quarter, which had a range closer to 400 basis points.

Comparative real estate performance as of 4Q 2013



Source: IPD

Considering 2013 as a whole, the weighted-mean return was 10.4% per annum, as already stated. Furthermore, the median return for that period was 9.4%, the upper-quartile return was 11.2% and the lower-quartile return was 7.7% per annum.

The gap between the mean (which is weighted by capital value) and median returns highlights the higher returns generated by larger assets and vice versa. The popularity of larger lot sizes has been evident across the global market. A number of reasons have been put forward to explain this trend. First, larger assets were preferred targets for most large global investors, particularly large pension plans and sovereign wealth funds, seeking real estate exposures with economies of scale. The chase for 'trophy' assets in large cities has caused yields for such assets to compress more than the average.

Second, larger assets also tend to be newer, better located, and built to a higher specification, thanks to developers building progressively larger assets over past cycles. This has led to such assets benefiting from stronger fundamentals, manifested as lower vacancy rates and stronger rental performance, whilst demand for space remained limited and focused on high-quality space.

And yet, larger assets have not always outperformed. Many suffered from particularly scarce liquidity during the financial crisis. At its peak, large assets were seen by lenders as too risky, as any fresh lending or refinancing would remain on their balance sheets while the securitised debt markets remained inactive. Such deals represented large and concentrated exposures to real estate at a time when many traditional lenders wished to reduce their real estate portfolios. The net effect of this cyclical trend can be seen in the five-year averages. The five-year weighted-average return stands at 5.3% per annum, below the median of 5.7% per annum, so larger assets have underperformed over this period. Today, most traditional lenders have noted the fundamental strength of large core or prime assets and have targeted lending toward this cohort once more.

So far, all returns reported in this report have been in the asset domicile's local currency. Global investors have to consider currency effects whether such effects are hedged or not. At IPD, asset returns can be reproduced in any major currency to fully understand the impact of currency movements on time-weighted returns. For example, the median return for Continental Europe increases from 4.8% per annum in local currencies to 9.3% per annum in USD, thanks to favourable currency movements for euro-denominated assets against the U.S. dollar. Conversely, the median return for the Asia Pacific region declines sharply from 9.7% per annum in local currencies to -5.3% per annum in USD. The additional exposure to currency movements can greatly alter an investor's return in the short-term as well as increase volatility. In this case, European assets (UK and Continental Europe) outperformed Asia Pacific and North American assets from the perspective of an unhedged U.S.-based investor.

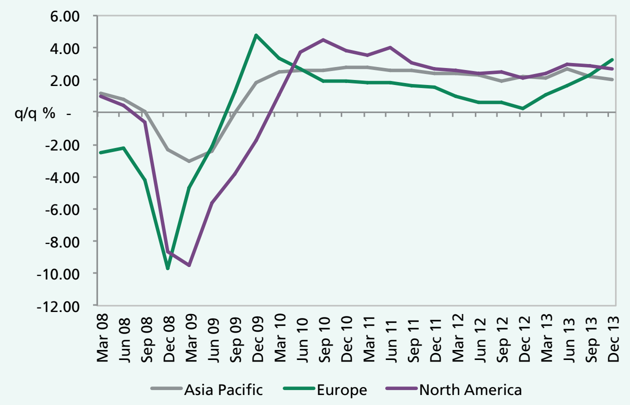
Differentiating performance at the fund level

Fund-level returns consider the impact of vehicle-level components such as cash and leverage. This is particularly important for global comparisons, as cash and leverage levels vary from region to region. The UK funds in the sample have very little leverage – many have no leverage at all – and hold relatively high amounts of cash. North American and Continental European funds have higher levels of leverage, with North American funds also holding low amounts of cash, at around 2% of gross asset value (GAV). Asia Pacific funds have low levels of leverage, typically around 15% of GAV and the lowest cash levels of all the regions.

The strong performance of the UK-domiciled funds' assets translated into fund-level returns of 4.0% quarter-on-quarter in the fourth quarter of 2013. This is slightly below the direct asset performance due to the cash drag and low levels of leverage. North American funds benefited from leverage accentuating the boost from capital appreciation and bridged some of the gap to the UK funds by returning 3.1%, above the global average of 2.9% quarter-on-quarter.

Continental European funds' assets saw values decline and once leverage was also factored into the equation, fund-level returns lagged behind their asset-level returns. Asia Pacific funds returned 2.0% quarter-on-quarter in line with their direct returns, as expected given the minor levels of cash and leverage in use.

IPD Global Quarterly Property Fund Index - fund-level return



Appendix

At the end of 2013, the index included performance data for 85 funds with a GAV of USD 243 billion spread across 5,884 individual assets. The index is still under development (a "consultative" phase), and the number of funds included in the index continues to expand.

The sheer scale of the North American market and the large average size of its funds mean that it is heavily weighted in the IPD Global Quarterly Property Fund Index. More than half (59%) of the capital value of the index lies in North America, with the remainder nearly evenly split between Europe and Asia Pacific regions.

The Index includes property specific funds as well as those diversified by property type. The office sector (35%) and retail sector (26%) together comprise nearly two-thirds of the combined capital value of the participating funds. Industrial properties account for 20% of the index, and residential properties make up about 15% of global fund holdings in real estate.

Funds differ regionally in their allocations to property sectors. Residential, for example, tends to be a less common portfolio component outside of North America where they make up nearly one-quarter (24%) of fund values. Offices are the preferred property sector of funds domiciled in the Asia Pacific region as well as those domiciled in North America. European funds prefer the retail sector with remaining real estate investments split fairly evenly across office and industrial properties.

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