20/20 vision: the outlook for global property equities

Tim Gibson
Co-Head of Global Property Equities | Portfolio Manager

Guy Barnard, CFA
Co-Head of Global Property Equities | Portfolio Manager

Guy Barnard and Tim Gibson, Co-Heads of Janus Henderson's Global Property Equities Team, review the sector's performance over the year and discuss the key opportunities and risks for investors in 2020.

Key Takeaways

- While listed property equities have performed well this year, returns have varied across cities, countries and sectors, highlighting the need for an active investment approach.
- Looking forward, the biggest risks to property equities is likely to be a pickup in growth and inflation expectations.
- The team remains positive on sectors benefiting from technological and demographic tailwinds such as datacentres, cell towers, manufactured housing and student accommodation.

Global property equities have delivered strong returns in 2019 year to date. Overall, the sector has kept pace with wider equity markets in the last two years (chart 1), but has additionally also provided a 'smoother ride' for investors, with the sector seeing relatively lower drawdowns.[1]

However, averages can be misleading and within the sector we have seen high levels of dispersion, reflecting the differing real estate market fundamentals we see across different cities, countries and, most importantly, sectors. For example, US manufactured housing REITs have gained over 50% this year whereas US mall REITs are down 17%[2]. These differentials in real estate returns provide a supportive backdrop for us, where the team's active management approach seeks to make a real difference to returns. We expect this trend to continue in 2020, albeit the spread of returns may narrow somewhat.

Chart 1: Relative performance: global property equities versus general equities since 2018

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Source: Bloomberg, Janus Henderson Investors. Global property equities (FTSE EPRA/Nareit Developed Total Return USD Index) versus general equities (MSCI AC World Total Return Index) weekly data to 6 December 2019 rebased to 100 at 29 December 2017. Past performance is not a guide to future performance.

Is the sector expensive now?

Despite gains of around 20% year to date, annualised returns of 8% and 6% over the last three and five years (more than half of which has come from dividends)[3] look fair to us and reflect the underlying returns generated from the properties held by the companies we invest in.

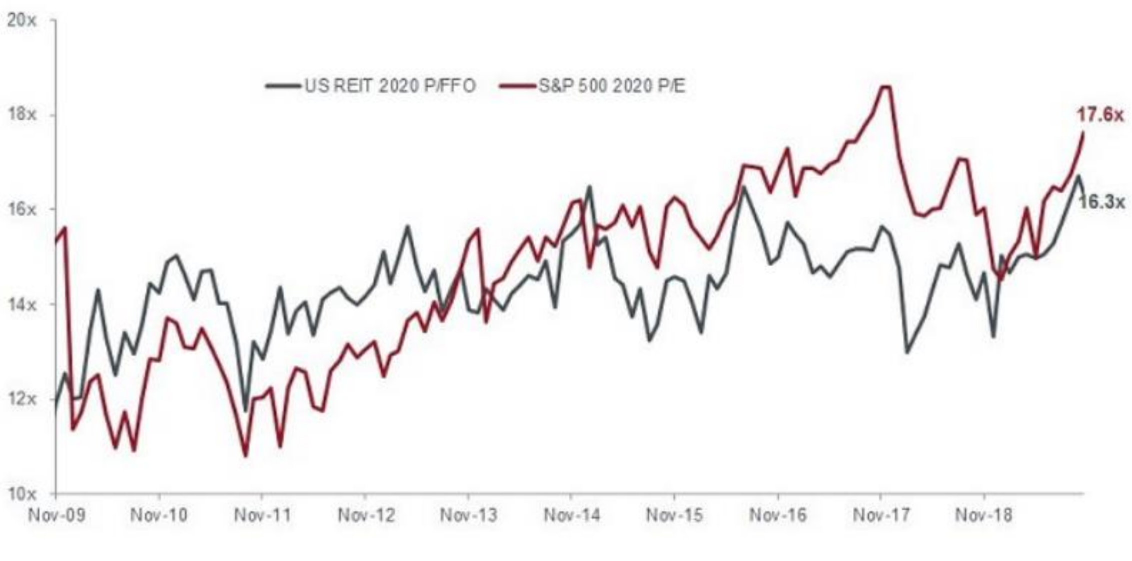
Comparing the valuations of public to private real estate markets (see chart 2), the discount to net asset value (NAV) has narrowed over the year and now looks to be largely in line with private markets. This is broadly in the middle of what we consider to be the 'fair value' range and suggests that returns from here will come from income and growth rather than re-pricing.

Chart 2: Global property companies have been trading at discounts to NAV in recent years

Source: UBS, Janus Henderson Investors. FTSE EPRA/Nareit Developed Total Return Index, monthly data from September 2003 to September 2019. Past performance is not a guide to future performance.

If we focus on earnings multiples in the US, even after US REITs have returned more than 25% year to date[4], the multiple is still lower than that of the S&P500 Index today and back to a similar level as the US REIT index was five years ago, implying the sector is not expensive (see chart 3).

Chart 3: REITs appear to be fairly valued versus general equities



Source: Capital One Research as at 15 November 2019.P/FFO is similar to the price-to-earnings ratio commonly used to value a stock. Price-to- fund from operations provides a more accurate valuation of real estate stocks taking into consideration non-cash factors such as amortisation and depreciation. Past performance is not a guide to future performance.

A new decade brings new opportunities

The real estate sector, like most others, is evolving. A series of powerful structural forces are shifting the landscape. The pressure on traditional retail property serves as a stark reminder that no sector is immune to the changing tide. While we still find opportunities across all sectors, a healthy dose of reality is required when projecting future returns in sectors facing headwinds such as retail.

By contrast, we remain positive on sectors benefiting from technological and demographic tailwinds. While the industrial and logistics sectors have performed well, we believe that limited supply, coupled with substantial demand driven by the growth of e-commerce and retailers' need to compete on services, is likely to continue to drive values higher. We also see ongoing opportunities in specialist sectors such as datacentres, cell towers, gaming, manufactured housing and student accommodation.

Building blocks

Finally, while we have no strong macro views, as we move into the later stages of the economic cycle, it is reasonable to assume that there will be periods of market volatility and drawdown. In this environment REITs are doing their job. Offering low correlations to many other asset classes, a lower beta[5] in an equity market context and having typically held up better in down markets in the last ten years.

The biggest risk to property equities in the coming year may actually come from a pickup in growth and inflation expectations. Any short, sharp rise in bond yields and cyclical rotation would likely cause the sector to underperform.

With a balanced, but uncertain outlook, we believe listed real estate has a role as a core 'building block' within a diversified portfolio, where it has the potential to reduce risk and enhance returns. In this way the sector may help those of us without perfect 20/20 vision to navigate through the year ahead.

Notes:
[1] Bloomberg as at 30 September 2019. Sector refers to FTSE EPRA/Nareit Developed Total Return Index.
[2] Bloomberg US Real Estate Index by grouping as at 12 December 2019.
[3] Morningstar. FTSE EPRA/Nareit Developed Total Return USD Index returns to 30 November 2019.
[4] Nareit, FTSE Nareit US Real Estate Index year-to-date returns to 11 December 2019.
[5] Sources: low correlations to other asset classes - European Public Real Estate Association (EPRA) as at 30 September 2019; low beta comparison FTSE EPRA/Nareit Developed Total Return Index versus MSCI World Index.

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