Active manager outperformance most noticeable in the REIT space

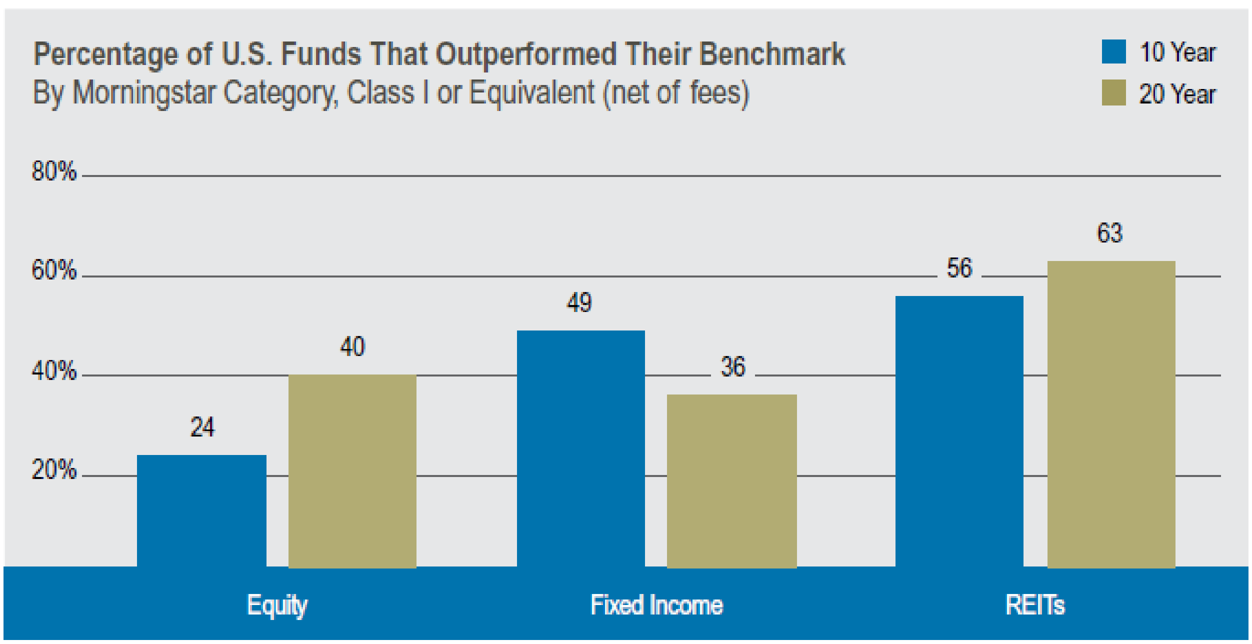
By Mark Mayer, B.Com (Hons) – January 2017

Sometime in the middle of this year (2016) I came across a well written research note by Thomas Bohjalian of *Cohen & Steers* titled “REIT Managers and the Active Advantage”.

This article highlights the effectiveness of active managers in the REIT space relative to their equity and fixed income manager counterparts. I want to hone in on this outperformance and where the advantage originates from.

Active REIT Managers have performed well versus their respective benchmarks

Bohjalian’s research suggests that it is best to first determine whether a passive or active manager should be utilised per asset class. A focus on the U.S. fund manager industry over the last 20 years reveals the following telling results:-



Number of Funds Represented (10 Year / 20 Year)

	Equity	Fixed Income	REITs
Total Funds	194 / 111	469 / 228	39 / 16

At December 31, 2015. Source: Morningstar and Cohen & Steers.

Performance data quoted represents past performance. Past performance is no guarantee of future results.

In the decade spanning 2006 to 2015, the majority (56%) of active REIT managers outperformed their benchmarks. This is a remarkable figure considering that slightly less than 1 in 4 active equity managers were able to outperform their respective benchmarks.

Put simply, active U.S. REIT managers, over the last 10 years, have been more than twice as successful at generating alpha as their active equity manager peers. 60% of active equity managers were unable to beat their benchmark index over 20 years suggesting that picking a passive index tracker unit trust would have yielded a higher probability of better performance than selecting an active manager, at least in the equity space. This would be true again of the fixed income asset category especially over the 20 year period where as a whole active fund managers performed worse than over the shorter 10 year period versus their respective benchmarks.

A standout quote from the *Cohen & Steers* piece reads **"When more than 50% of active managers in a given market outperform, "in-line" returns from ETFs equate to "below average"."** Well, this was the case in only 1 of the three asset classes depicted in the illustration above… REITs. The implicit takeaway then is that a passive index tracker fund would have been a better bet for both the equity and fixed income asset classes, but that an active manager in the REIT category would have fared better than the average index tracker fund.

Of course, further filtering in each category can then be undertaken to improve the results of the active asset manager and one such filter, proposed by Thomas Bohjalian, is that one only consider 4 and 5 star funds as rated by Morningstar. This extra layer of screening results in an improvement from 56% of active managers outperforming their benchmarks (over 10 years) in the REIT category, to a whopping 81%.

Where does this advantage originate from?

According to the Head of U.S. Real Estate for Cohen & Steers, the advantage enjoyed by active REIT managers in respect to generating alpha beyond that of the benchmark index has historically come from three areas:

1) **Recognising how property sub-categories behave differently in specific economic environments:**

    Construction cycles, lease durations and economic drivers differ between sub-sectors of real estate. For instance, a Hotel REIT has lease periods of as little as one night, whereas a purpose built Health Care REIT building may have a lease in place of over 20 years.

    New housing starts, an economic driver closely correlated with performance of an Apartment REIT, would be less relevant to a shopping mall, where for example increase/decrease in consumer spending is of more importance.

    Ultimately, this dispersion in economic variables and the reaction to them, allows active REIT managers to rotate between sub-sectors in search of higher growth, better earnings and accretive performance where an index cannot.

2) **Unlocking opportunity when separating weighting decisions from the default market capitalisation used in many benchmark indexes:**

   The majority of indexes are constructed using a weighting in favour of market capitalisation (share price x volume of shares issued). Therefore, there is a bigger concentration or leaning toward larger companies. While this may be a rational way of representing market movements, it is by no means the most beneficial way of constructing a portfolio and this is known full well by active managers who control a high level of "active share" (*active share* is a measure of the percentage of stock holdings in a manager's portfolio that differ from the benchmark index).

3) **Identifying REITs that are undervalued, using fundamental research that is superior to that carried out by the rest of the market:**

   Specialist REIT managers focus their working hours on uncovering and understanding property fundamentals. Analysis very often includes site visits, talks with management and even tenants to get an "on the ground" feel for the operations of the REIT in question. The result is more accurate forecasts, better quality research and the potential for quicker adjustments to positions which the REIT manager needs in order to maintain an information advantage.

Conclusion

It appears that certain active fund managers may be operating in an asset class that historically favours outperformance of their benchmark relative to peers who manage active portfolios in other asset classes. Specifically, active REIT managers have benefited from carrying out superior fundamental research, recognising how differently the underlying real estate sectors can behave and how prudent management of a significant active share has led to outperformance.

The implications for the positioning of passive and active managers in a portfolio is intriguing. The answer to that puzzle leads to the use of both active and index tracking funds, specifically, a push toward employing an active REIT manager in the real estate component of the portfolio.

Disclosure: The author is currently invested in global REITs through the Reitway BCI Global Property Fund. You are most welcome to contact him at markm@reitwayglobal.com

References:

REIT Managers and the Active Advantage, Thomas Bohjalian:
https://www.cohenandsteers.com/assets/content/resources/insight/REIT_Managers_and_the_Active_Advantage.pdf