REITWAY REVIEW – EDITION 10

By Grant Lowton, CFA
October 2015

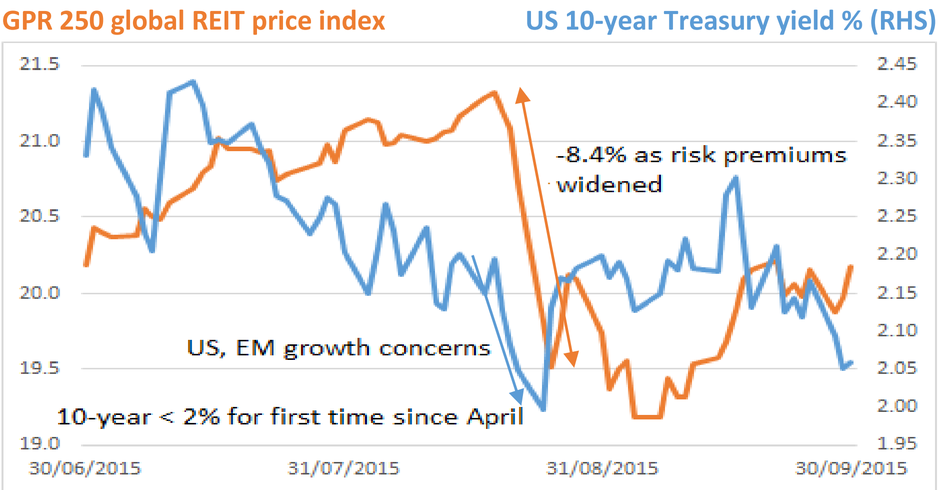
MARKET OVERVIEW

A flight to safety followed by a REIT recovery

Global REITs returned 0.93% in US Dollar (USD) terms during the third quarter (3Q15) – but it didn't come easily. This relatively flat figure in isolation disguises the sharp price movements that occurred during the quarter.

From mid-August, financial markets became fixated with the potentially slower US growth outlook and emerging market weakness. This resulted in the US 10-year Treasury yield falling below 2% for the first time since April this year, as markets went into risk-off mode and risk premiums widened.

Risky assets sold off and global REITs followed suit, notwithstanding the fact that a lower 10-year yield is usually supportive of REIT prices (assuming unchanged fundamentals and cash flow forecasts). This can be seen in the graphic below.



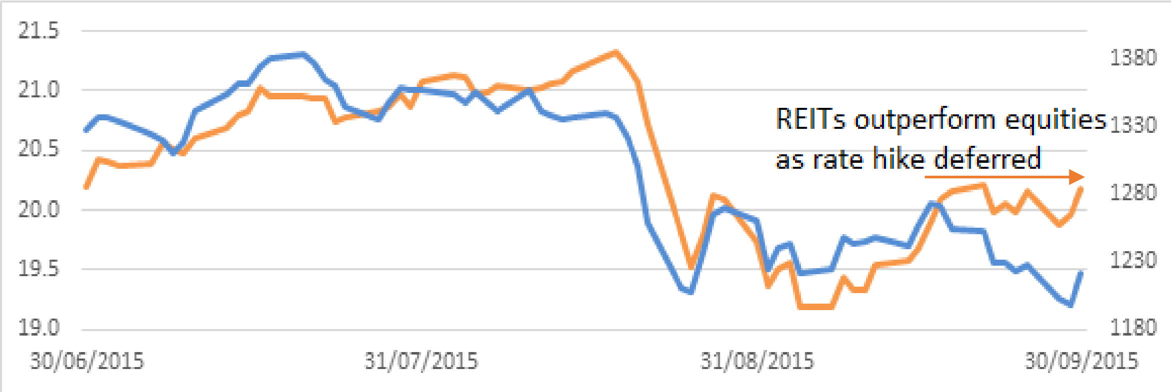
Source: Thomson Reuters Datastream

After bottoming out in early September, global REITs recovered somewhat as investors viewed REITs as displaying value.

The chart below shows that global equities fared similarly to REITs during the quarter, up until 17 September. This was of course when the US Federal Reserve announced that it would be holding off on a Federal Funds rate increase. The 10-year yield then dropped significantly, with global REITs (which are more sensitive to interest rate movements than equities) subsequently outperforming global equities up until quarter end.

GPR 250 global REIT price index

FTSE global 100 equity index (RHS)



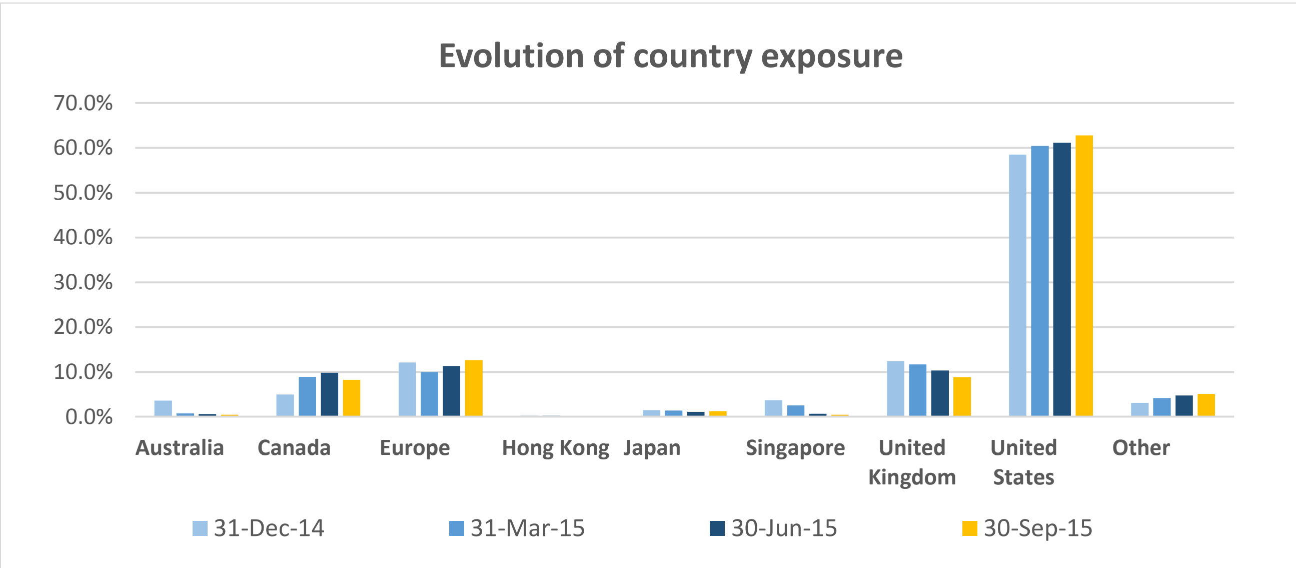
Source: Thomson Reuters Datastream

PORTFOLIO POSITIONING

Geographic exposure

The chart below shows the evolution of our portfolio's geographic exposure over the 12 months to 3Q15. There have been no dramatic changes over the last quarter.

Evolution of geographic exposure during the past 12 months



Source: Reitway Global

Australia

At the beginning of the year we viewed Australian REITs (A-REITs) as exhibiting little investment attractiveness for USD-orientated investors. This was due to Australian 10-year bond yields being high relative to A-REIT dividend yields. In addition, there was significant downside potential for the Australian Dollar (AUD) versus the USD.

Given the decline in Australian bond yields without corresponding dividend yield compression, A-REITs currently display better value relative to Australian bond yields than was previously the case.

Further, even though the Australian 10-year bond yield is exceptionally low relative to the US 10-year bond yield, AUD/USD is pricing in a differential between these two sovereign yields that is in fact significantly lower than current levels. Therefore it is reasonable to deduce that the AUD may be undervalued relative to USD.

AUD/USD also appears to be pricing in iron ore significantly below current levels. This, without falling into the trap of attempting to forecast the iron ore price.

These scenarios indicate that A-REITs are more attractive for USD investors than was previously the case. We are at present assessing the valuation landscape in order to determine an optimal entry point for investment into this region.

Canada

Oil price concerns adversely impacted the outlook for Canadian economic growth, which severely dampened sentiment towards risky assets. Canadian REITs have performed poorly this year as a result.

However, this is an insignificant period of time within a multi-year investment horizon. In addition, REITs exhibit a relatively high degree of certainty with respect to future cash flows. Therefore investors tend to be rewarded for buying undervalued REITs and selling those that are expensive, with much less risk of falling into value traps or missing out on too much upside.

Consequently, even though some of our holdings have suffered as a result of the negative sentiment that has plagued Canadian public listings, we have maintained our overweight allocation towards Canada. We have focused on high quality REITs with good management and solid track records.

The meaningful discrepancy between public and private Canadian real estate prices provides additional backing to our view on Canadian REITs (C-REITs). Publicly listed C-REITs trade at 15-20% discounts to their private peers. They are also priced at significant discounts to net asset value (NAV). An example of a C-REIT trading well below NAV is our holding Boardwalk REIT, which traded at a 19.4% discount to NAV at the end of 3Q15.

Europe and the UK

Europe and the UK continue to be the top performing global REIT markets YTD, but underperformed the US REIT market during 3Q15. Relative to bonds there are indications that European and UK REITs remain fully priced, particularly those in the UK. It should be noted, however, that the UK is one of the regions where REITs are less subject to bond yields compared to global peers.

We continue to monitor the prospects for our individual holdings as well as other candidates, in an attempt to make optimal investment decisions.

Asia

Real value has emerged in some locations such as Singapore after sentiment devastated listings, primarily due to negative news out of China.

We are scrutinising these areas closely and assessing individual prospects that could offer sufficient USD returns for our investors.

United States

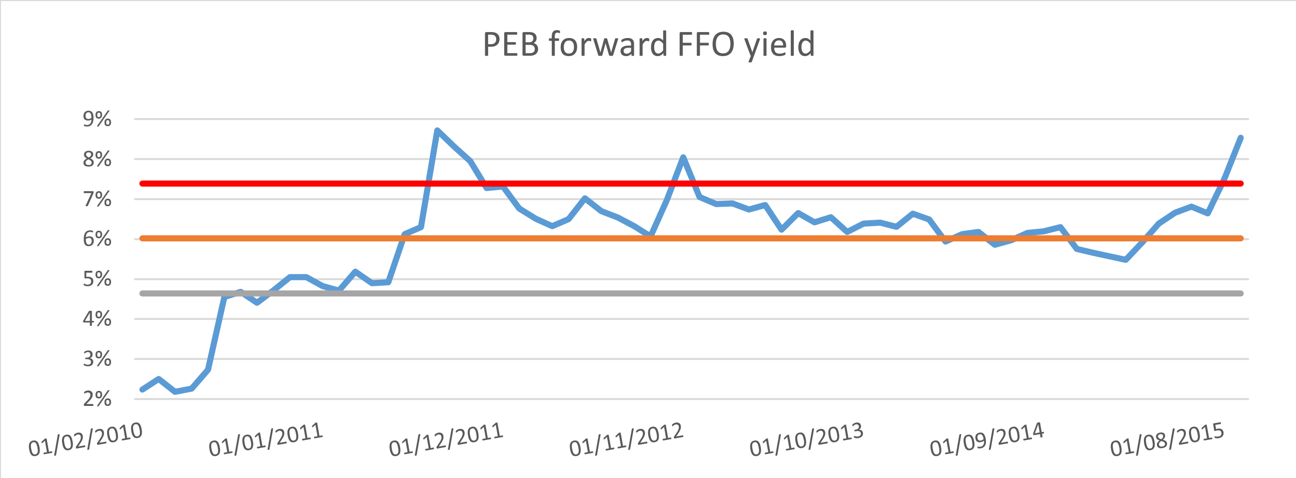
US REITs exhibited the highest USD-denominated performance of all major global regions in 3Q15 as bond yields declined. Notwithstanding their solid performance during the quarter, US REITs still exhibited value at the end of 3Q15. This is due to the abovementioned lower bond yields as well as expectations of sustained solid dividend growth.

The stronger USD, AirBnB (an online accommodation booking service) concerns, a weaker global economic growth outlook and the calendar shift because of Labour Day in the US, all resulted in US Lodging REITs being sold off significantly during the quarter.

Notwithstanding best-in-class management and high quality assets, our US lodging REIT holding, Pebblebrook Hotel Trust (PEB), wasn't spared during the quarter.

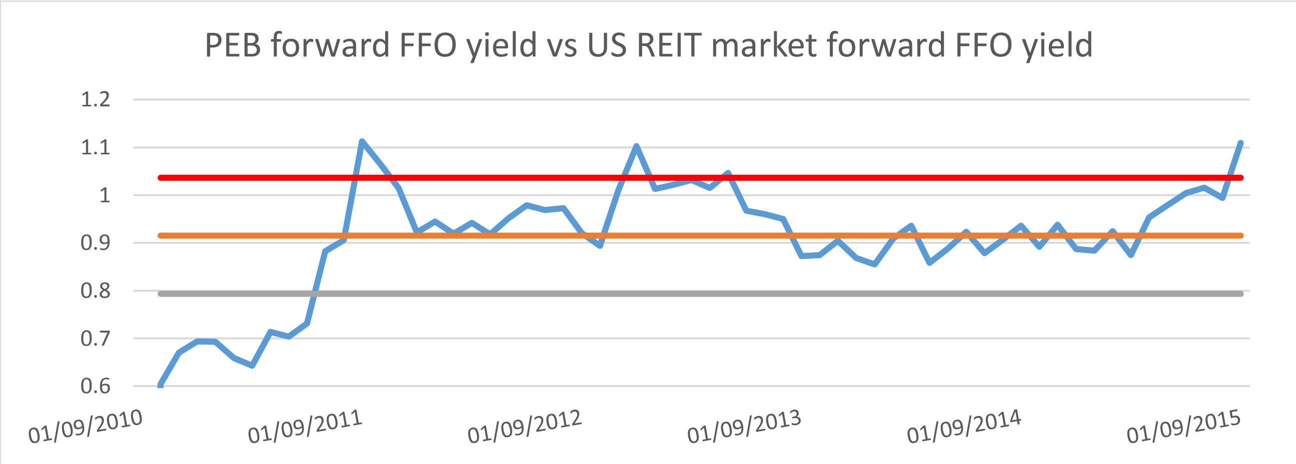
After the dramatic fall in the price of PEB, the forward yield relative to its history as well as relative to the market, makes PEB look attractive. This can be seen below.

PEB forward FFO yield **Average** **-1 standard deviation** **+1 standard deviation**



Source: Thomson Reuters Datastream

PEB forward FFO yield relative to market forward FFO yield **Average** **-1 standard deviation** **+1 standard deviation**



Source: Thomson Reuters Datastream

Follow us on LinkedIn and Facebook

Lodging industry management teams are highly confident that demand versus supply dynamics are still favourable. This lends further support to our thesis that PEB is an exciting investment prospect from these levels.

Conclusion

Global REITs sold off during the quarter and subsequently recovered as investors saw value with bond yields at low levels.

We are cognisant of the fact that certain regions have run harder than others and we continue to monitor the value propositions presented by specific opportunities.

Regards,
The REITWAY team

For more information about the performance of our funds and investment methodology, please visit our website at www.reitwayglobal.com.