New GICS sector - a tailwind for listed property?

By Mark Mayer, B.Com (Hons) - July 2016

On Thursday, 1 September 2016, the newly created *Real Estate* sector will begin recording its first set of trades. REITs (Real Estate Investment Trusts) are the most widely used and globally acceptable form of listed Real Estate and they will be among those assets which will form part of the historic carve-out.

Let's examine the change that is coming, how it will effect popular indices and then at how this notable event provides a meaningful boost for REIT investments.

GICS who? And what is happening exactly?

If you haven't heard of GICS (Global Industry Classification Standard), you are most likely not alone. The last time this industry taxonomy, developed by MSCI and Standard & Poor's (S&P), made any changes to their structure was in 1999 - when it was first developed.

This structure consists of 10 sectors, 24 industry groups, 67 industries and 156 sub-industries into which all major listed companies have been categorised.

In November 2014 a revision to the current structure (which would give Real Estate its own sector) was proposed and subsequently approved. At the end of trading on 31 August 2016, an official 11th sector will be born. Incidentally, *Copper* will also be added as a new sub-category at this time. The "before and after" shots of this makeover to the 10 headline sectors can be found in the table below:

GICS Real Estate Sector Changes

Current GICS Sectors	*New GICS Sectors*
1. Energy	1. Energy
2. Materials	2. Materials
3. Industrials	3. Industrials
4. Consumer Discretionary	4. Consumer Discretionary
5. Consumer Staples	5. Consumer Staples
6. Health Care	6. Health Care
7. Financials (which includes) • **REITs** • **RE Management & Development**	7. Financials
8. Information Technology	8. Information Technology
9. Telecom Services	9. Telecom Services
10. Utilities	10. Utilities
	11. **Real Estate** • **Equity REITs** • **RE Management & Development**

Source: MSCI and Standard & Poor's.

REITs will get a new home and this will have far-reaching effects, which will include more visibility in several prominent indices, greater exposure for the REIT asset class and even volatility and equity correlation upshots for the Real Estate asset class.

MSCI and S&P Dow Jones Indices changes shines spotlight on Real Estate

The S&P will conduct its annual index rebalancing at the end of September this year and this is why the date for the introduction of the new sector has been set for the same day. All S&P Dow Jones and MSCI indices will be affected by this alteration and it will result in far more clarity around the position REITs occupy in the various indices.

In the past, it was entirely possible for a fund manager to ignore real estate in part or even completely and simply pick banks and insurers from the Financials sector. The moment Real Estate assets have their own grouping, investors will have a far clearer comprehension of their overweight/underweight/neutral exposure to the sector.

In the lead up to the reshuffle, a lot of questions are being asked about Real Estate and where a morning meeting at a generalist fund manager may have taken place without a mention of REITs in the past, the news around the GICS development has meant that professionals are now taking notice.

In the words of Michael Knott, director of U.S. REIT research for Green Street Advisors, "It is a proper recognition that the public Real Estate arena is large enough and distinguished enough from Financials to be staked to its own sector…[it is a] momentous event for the industry"

At this juncture, it must be said that most commentators are not expecting a 10% plus green day for REITs on 1 September 2016. However, a steady demand for REITs up until the change and for some time thereafter, is expected by many due to the spotlight that is now on the asset class.

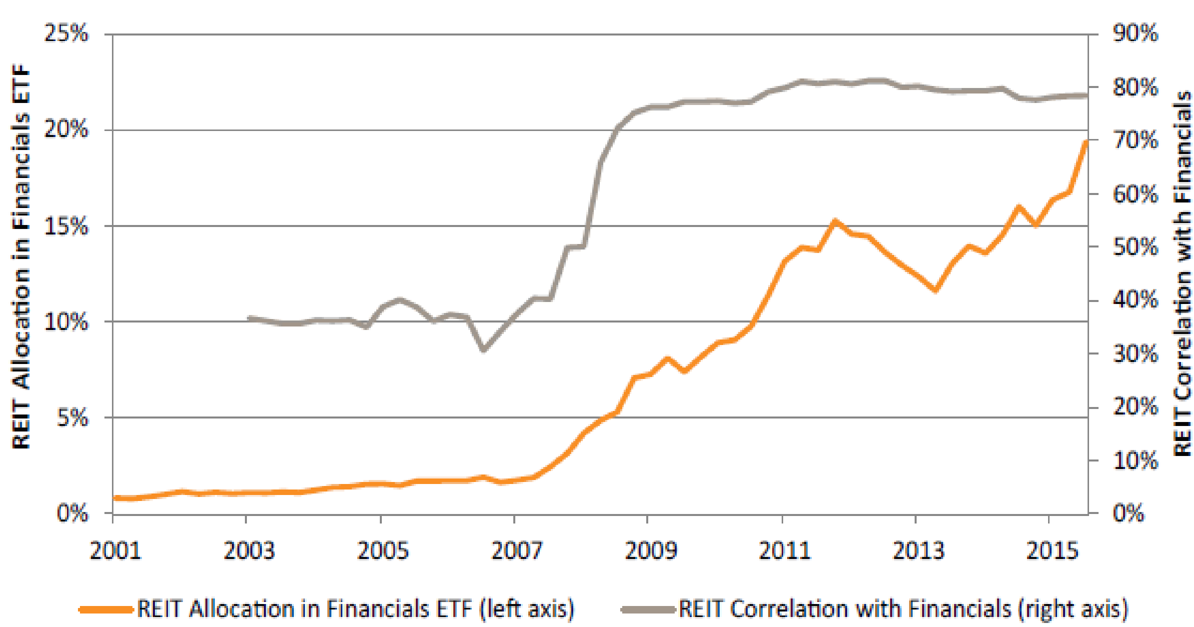
In addition to the added exposure, REIT bulls are also citing positives in 1) the expected reduction in volatility once Real Estate assets are freed from the company of banks and insurers and 2) the overwhelmingly underweight position of generalist fund managers that would need to be addressed. Both of these items are covered below.

Volatility and correlation metrics for REITs to improve following carve-out

The inclusion of REITs in the Financials sector has subjected REITs to higher volatility. This is mainly as a result of investors using multiple Financials ETFs to express a view on the non-REIT components of the Financials sector and REITs simply get swept up with the ensuing frenzy.

The following graphic illustrates just how much correlation has grown between REITs and Financials as the REIT allocation to Financials ETFs have grown over the years. Prior to 2007, when this allocation was less than 3% the correlation between the two was less than 40%. The allocation of REITS to these Financials ETFs has grown to over 22% since and the correlation continues to climb – now at almost 70%.

REIT Correlation with Financials Driven by Financial ETFs



Source: Bloomberg. Correlation uses MSCI US REIT Index and S&P 500 Financial Sector Index monthly values. REIT allocation in Financial ETFs uses iShares Financials ETF (IYF) from 9/30/01-6/30/09, and SPDR Financial ETF (XLF) from 9/30/09-3/31/16

It is thought that following the separation of REITs from Financials, REITs may begin to trade more on their own fundamentals, rather than on speculation of non-REIT Financials companies and for good reason. REITs tend to possess more visibility around future cash flows and are approached quite differently in terms of valuations. In addition, there is often more transparency regarding the values of their underlying assets - in this case – properties. It could very well transpire that REIT volatility will begin to move back toward pre-ETF days when volatility was lower than traditional equities.

Rebalancing of underweight managers could translate to strong demand for REITs

Christopher Hudgins and Todd Rosenbluth released a report in early June 2016 which showed how only 2 of the largest 20 core funds in the United States have more than 2.9% exposure to REITs (the percentage that would constitute a neutral weighting in the popular SPDR S&P 500 ETF (SPY) managed by State Street Global Advisors Ltd.

Mutual fund exposure to REITs

Mutual fund	Trading symbol	AUM ($M)	Exposure to REITs (%)
Fidelity Strategic Dividend & Income Fund	FSDIX	4,410.8	15.31
T Rowe Price Dividend Growth Fund	PRDGX	5,088.5	3.99
SPDR S&P 500 ETF		183,702.4*	2.90
Vanguard Growth & Income Fund	VQNPX	6,266.2	2.83
Fidelity Series All-Sector Equity Fund	FSAEX	9,804.6	2.78
MFS Massachusetts Investors Trust	MITTX	6,145.2	2.26
MFS Research Fund	MFRFX	4,837.8	2.11
JPMorgan Disciplined Equity Fund	JPIEX	8,160.9	1.92
Janus Growth & Income Fund	JNGIX	4,125.4	1.82
Oppenheimer Main Street Fund	MSIGX	7,078.9	1.67
Columbia Contrarian Core Fund	SMGIX	7,507.1	1.57
ClearBridge Appreciation Fund	SHAPX	5,510.0	1.48
American Funds Fundamental Investors Inc.	ANCFX	74,280.3	1.38
Fidelity Strategic Advisers Core Fund	FCSAX	23,805.3	1.22
JPMorgan US Equity Fund	JMUEX	12,306.4	0.84
Fidelity Dividend Growth Fund	FDGFX	7,455.2	0.79
Oppenheimer Rising Dividends Fund	OARDX	4,965.9	0.77
GE RSP US Equity Fund	GESSX	4,807.6	0.61
American Funds Investment Co. of America	AIVSX	75,059.8	0.41
Fidelity Series Growth & Income Fund	FTBTX	9,053.5	0.34
Fidelity Growth & Income Portfolio	FGRIX	6,212.8	0.33

Data includes largest 20 mutual funds with exposure to REITs. SPDR S&P 500 ETF included for reference.
Data as of latest holdings available.
* Data as of June 2, 2016.
Data compiled on June 2, 2016.
Source: Thomson Reuters Lipper

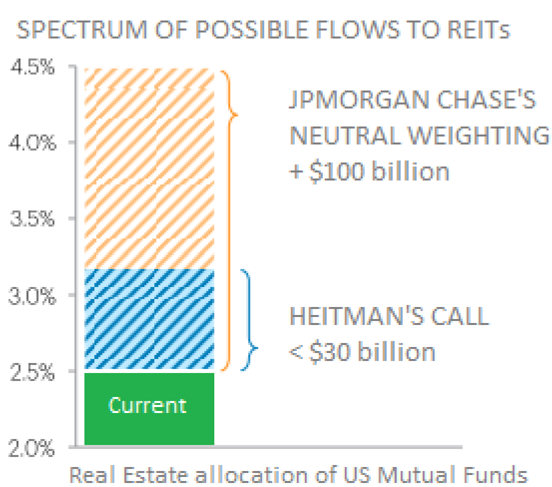
As one begins to take a look beyond the top 20 funds (featured in the above table), an even more interesting picture emerges. A total of 18 of the 40 largest U.S. large-cap core mutual funds, based on fund size, had no exposure to REITs at all. Of course these funds could continue to ignore this asset class following the GICS change, but investors may start asking why, especially considering how attractive REITs are from a diversification, liquidity, yield-enhancing and risk-reduction point of view.

From a portfolio construction standpoint, REITs have a permanent part to play according to Thomas Bohjalion (Executive Vice President of Cohen and Steers Investment Managers) who says “Real estate has a long history of helping investors build and protect wealth, while generating relatively steady dividend income that tends to grow with inflation.”

Further, when it comes to US REITs’ track record, managers may want to consider the potential consequences of being underweight in an asset class that has outperformed the S&P 500 over the trailing 10-, 20- and 30-year periods, as well as in 7 of the past 10 calendar years.

If generalist managers were to bring their weighting from the current underweight position to neutral in order to mimic the SP500, JPMorgan Chase & Co has calculated that north of $100 billion would need to be directed at the newly formed sector.

This would represent almost 10% of the total equity REIT market capitalisation and would give the sector a massive boost. However, that is just the calculation to bring managers up to neutral weight, expectations are that in the shorter term, managers will direct less than this. At Heitman (a Real Estate Investment Management Firm with over $37 billion under management), the view is that the impact will most likely be under $30 billion as the GICS change will not affect Russell index classifications whose indices are used as benchmarks by approximately 40% of the $5 trillion under management referred to earlier.



Conclusion

The GICS' move to add an 11th sector where Real Estate will now sit recognises the importance of the asset class. While professionals debate the degree of impact this will have, there appears to be a unanimous consensus around the positivity of the move for REITs.

Gone are the days when REITs were considered a niche area of investment. This move formalises and confirms what experts in this area have already known for some time now - that **Real Estate is an important building block for wealth creation.** It is also apparent that Real Estate has its own unique characteristics that justify it being distinguished from Financials and other sectors.

This is a coming of age story for Real Estate and investors would do well to take notice.

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

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