eastspring investments

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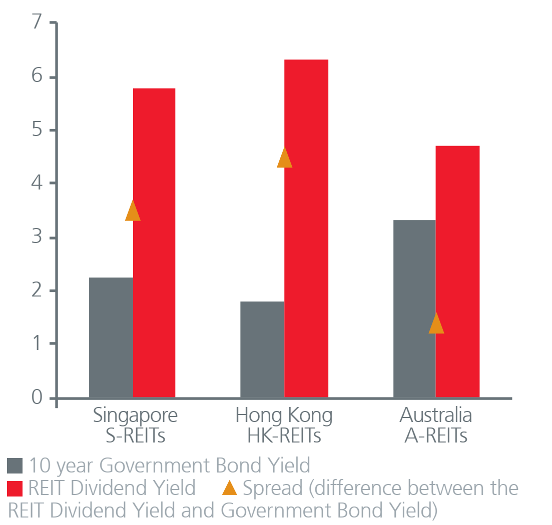
FUND INSIGHTS

REAL ESTATE INVESTMENT TRUSTS (REITs): ATTRACTIVE YIELD OPPORTUNITIES

EASTSPRING INVESTMENTS – ASIAN PROPERTY SECURITIES FUND ("THE FUND")
OCTOBER 2014

Since the start of quantitative easing in various parts of the world, low interest rates have pushed investors to hunt for yield in various ways. One of the asset classes that have benefitted from this trend has been REITs. Most REITs are required by law to distribute a bulk of their taxable earnings to shareholders. Given this feature, investors have been embracing REITs in recent years for their attractive yields. In fact, dividend yields offered by REITs based in Singapore, Hong Kong and Australia continue to exceed their respective government bond yields (refer to Fig.1).

Fig.1. Yields of REITs versus Government Bonds (%)

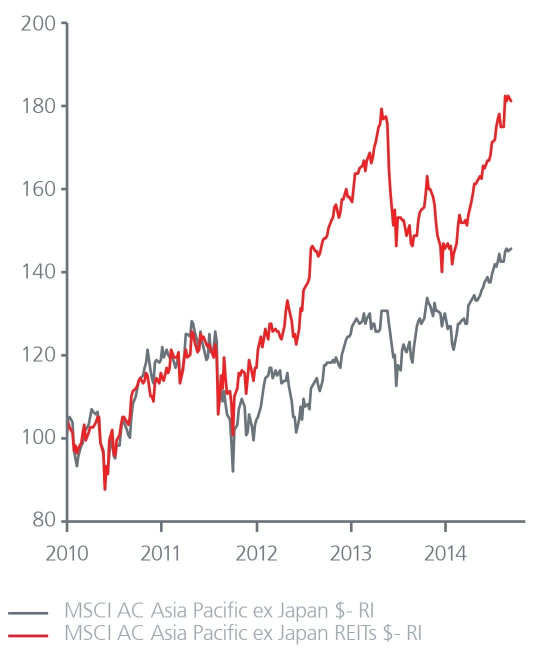


Source: Bloomberg, 13 October 2014.

INTEREST RATE FEARS ARE OVERDONE, WE THINK

In 2013, REITs hit a speed bump. The same fears about the US Federal Reserve tapering and interest rate increases that triggered a sell-off in bonds hit REITs (refer to Fig.2).

Fig.2. Performance of Asia Pacific REITs versus Asia Pacific Equities



Source: MSCI from Thomson Reuters Datastream. MSCI AC Asia Pacific ex Japan Total Return Index and MSCI Asia Pacific ex Japan REITs Total Return Index as at 13 October 2014.

Investors were projecting the end of the era of low rates. The question uppermost on their minds was, "Will the yields offered by REITs continue to remain attractive in the face of rising rates?"

A hike in interest rates increases a REIT's borrowing cost and could potentially affect their payouts. While we acknowledge that this is a valid concern, it is equally important to note that interest rate hikes are normally accompanied by better economic growth. Furthermore, REITs are usually able to soften the impact by having diversified funding sources and duration.

Higher growth in turn will likely push up the demand for commercial real estate, improve occupancy rates and rental income. Hence, any increase in cost of borrowing may be offset by the landlord's ability to raise rental rates.

REITs IN THE CONTEXT OF A PROPERTY SLOWDOWN

In recent years, Asia's large population and its growing middle class have been propping up demand for residential and commercial property. At the same time, low interest rates coupled with excessive liquidity in the financial system, globally, have caused residential property prices in the region to rise beyond sustainable levels. Many countries like Singapore, Hong Kong and China have had to impose stringent measures to curb their residential property speculation and manage property prices. Property developers have been negatively affected by these measures.

Yet a key point to note is that the operating dynamics of the various property segments differ significantly and in general have low correlation. A slowdown in the residential segment does not necessarily imply a slowdown in the commercial segment. Increasing tourism has been fuelling retail demand throughout Asia, particularly in the prime shopping centers. China's CapitaRetail China Trust (CRCT) is a case in point.

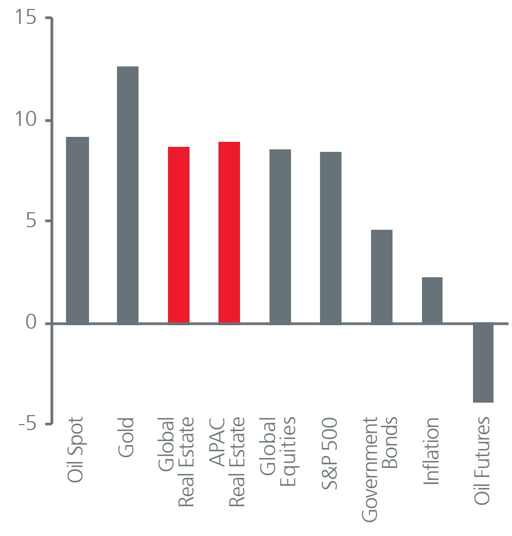
CRCT's portfolio comprises of ten income-producing shopping malls in China, of which 80% of income comes from Tier 1 cities. Amidst news flow of China's economic growth slowdown, the market has under-appreciated the growth in retail rentals. Although slowing down, retail sales still remain high at 13% year-on-year according to the latest statistics from China's Bureau of Statistics. In the second quarter of 2014, CRCT was able to increase its distribution per unit by 8% from the quarter before due to strong rental growth from its malls in Beijing.

REITs proven to offer attractive returns over the long term.

Another key strength is that long term returns offered by REITs remain attractive despite bouts of market volatility.

Over ten years, real estate outperformed the other major asset classes – global equities and bonds. A long term investor benefits from the compounding effect of real estate price appreciation and dividend income of REITs.

Fig.3. Annualised compound returns by asset class (Jan 2004 - Aug 2014) (%)



Source: Indices all in USD, except Global Bonds is in LC. Source: FTSE, EPRA, NAREIT, Citi, S&P, Thomson Financial DataStream, UBS estimates as at 25 September 2014. Returns from January 2004 to August 2014. The chart above is included for illustrative purposes only. Past performance is not necessarily indicative of the future performance.

EASTSPRING INVESTMENTS – ASIAN PROPERTIES SECURITIES FUND: FOCUSED ON VALUATION

The Fund invests in both REITs and property developers in the Asia Pacific region.

The Fund has been a consistent outperformer since inception (bid-bid basis).

This has been driven by successful stock selection underpinned by our disciplined, value-oriented process.

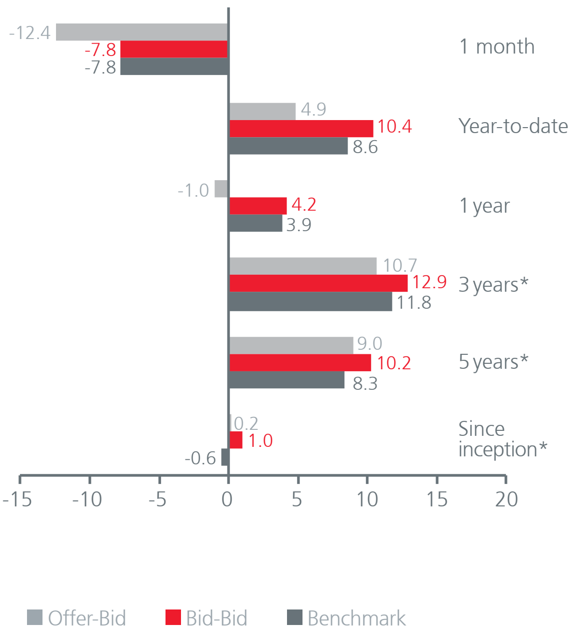
In the near term, uncertainty about the pace and extent of interest rate rises may continue to put pressure on interest-rate sensitive equities that include REITs. Thus, the quality of the management of REITs and the relative valuations are two important factors in our stock selection process for this Fund. With a strong eye on relative valuations, the Fund has been able to maintain a higher yield than the benchmark average.

Generally speaking, REIT valuations, particularly in Singapore, are attractive because the market seems to have priced in many concerns about rising global interest rates, as reflected by their carry yields. REIT carry yields in Singapore remain attractive compared with long-term government bond yields. The Fund is also invested in Singapore's high-dividend stocks but is underweight residential property due to the downside risks to residential prices.

The strong performance of Australian REITs and property stocks has made their valuations less compelling. Our portfolio manager is reducing the overweight in Australian REITs and looking into smaller names that offer higher relative dividend yields.

The portfolio manager is convinced that underlying residential prices in Hong Kong will remain robust and that developer balance sheets are strong enough to take advantage of landbanking and healthy asset turns.

Fig.4. Fund performance as of 30 September 2014 (%)



Source: Eastspring Investments (Singapore) Limited; USD; Net income reinvested; Offer-bid includes 5% sales charge. Prior to 01 Aug 12, Initial Sales Charge was 5.75%. Inception Date: 28/02/2007 (Class A). Benchmark: GPR – Customised Asia Pacific (Ex-Japan) Property Index. From inception to 31 December 2012, the Fund was benchmarked against MSCI. Prior to 1 May 2012, the MSCI AC Asia Pacific REIT Index returns were on a Gross Dividend basis and thereafter, the benchmark returns were on a Net Dividend basis up till 31 December 2012. The series are chain-linked to derive the longer period benchmark returns. This change will have no impact on the portfolio or how it is managed. *Annualised.

Declines in average selling prices are factored into our models. Declines are occurring already in the market and valuations remain compelling. The Fund remains overweight in Hong Kong.

The pricing of ASEAN positions has been volatile due to capital outflows driven by political concerns and swings in sentiment about interest rates. Our portfolio manager holds select ASEAN equities because the long-term outlook for the region's income and asset price growth is attractive, given the structural growth of urbanisation.

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