First State Investments

# Global Property Securities

## Quarterly Review and Outlook

As at December 2015

### Key Highlights

- Global property securities performed well in the December quarter. REITs remained popular with investors against a background of very low returns from other income-producing investments such as bonds and term deposits.
- The US Federal Reserve increased interest rates by 0.25%, as anticipated. The decision was supported by further improvement in labour markets. Rising employment, combined with improving economic activity levels, augurs well for commercial property markets. US REITs advanced during the quarter against this background.
- The outlook for global property securities remains divided along macroeconomic lines, with robust economic growth in the US and UK likely to buoy property securities in those markets. However the impact of lower commodity prices are expected to overshadow property securities in Australia and Canada, while European property securities are expected to remain hampered by anaemic economies, despite government stimulus measures.
- In Asia, we remain positive on Hong Kong landlords with Central office exposure for their improving fundamentals, healthy balance sheets, investment grade portfolios and favourable medium-term earnings growth outlooks while maintaining our extremely selective approach to J-REITs is unchanged.

### Market Insights

Global property securities performed well in the December quarter. REITs remained popular with investors against a background of very low returns from other income-producing investments such as bonds and term deposits.

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A-REITs also performed quite well, completing a year where they comfortably outperformed the broader Australian share market. Data showed that the pace of Australian GDP growth accelerated to 2.5% in the September quarter. October retail sales figures also rose, which provided support to retail stocks.

The main news in Europe was an announcement that the European Central Bank (ECB) will extend the scale of its existing Quantitative Easing program. Asset purchases will be extended until the end of March 2017 (from the previously-flagged end of September 2016) or beyond, if necessary.

### Performance Review

Strategy returns were behind the benchmark in the December quarter. Positions in stocks including US-based Brookdale Senior Living and Sumitomo Realty & Development in Japan acted as a drag on performance as they underperformed peers. Both remain in the portfolio, however, as we believe they remain well placed to deliver positive shareholder returns over time.

Relative performance was positive in 2015 as a whole, however, thanks to favourable stock selection in the first half of the year.

### Strategy Activity

In the US, new positions were established in mall owner General Growth Properties and data centre operator Interxion.

While the likely path of US interest rates remains higher, the expected path of tightening thereafter has moderated, as have the Federal Reserve's views on the long-term neutral interest rate. Lower rates for longer, combined with discounted US REIT valuations and a healthy earnings growth outlook, have increased the appeal of US REITs.

A new position was also established in Monogram Residential, a multifamily US REIT with interests in 55 communities and nearly 16,000 units. Monogram is particularly compelling among US apartment REITs based on its young portfolio, discounted valuation and attractive geographic exposures. Accounting for 30% of net operating income, California is among the company's largest markets.

On the sales side, we sold the position in Allied Properties REIT and most of the strategy's holding in Canadian shopping centre operator First Capital. We see better opportunities elsewhere given Canada's weakening economic growth outlook.

## Market Outlook and Portfolio Positioning

The outlook for global property securities remains divided along macroeconomic lines, with robust economic growth in the US and UK likely to buoy property securities in those markets. However the impact of lower commodity prices are expected to overshadow property securities in Australia and Canada, while European property securities are expected to remain hampered by anaemic economies, despite government stimulus measures.

A decline in direct property valuations from their current high levels could represent a headwind to listed property markets. However the growing pricing anomalies within listed markets suggest that these markets will continue to present appealing investment opportunities to discerning investors.

Nearly 58% of the strategy's assets are invested in the US, making it an important driver of performance. The prospects for coastal apartments, Class A malls and gateway city office buildings appear particularly favourable in our view and the strategy is invested accordingly. These areas of the market have robust earnings growth outlooks and significant exposure to the improving US economy.

The strategy continues to have limited exposure to Continental Europe. The ECB's stimulus and the continued low interest rate environment has fuelled keen investor appetite for a wide range of leased property assets, resulting in very high valuations, despite weak underlying property fundamentals. These valuations, combined with a difficult operating environment and limited net tenant demand are likely to represent headwinds for European property securities in the coming year.

In Asia, we remain positive on Hong Kong landlords with Central office exposure for their improving fundamentals, healthy balance sheets, investment grade portfolios and favourable medium-term earnings growth outlooks. We have a less positive view on the Hong Kong housing market, where imminent mortgage rates and low affordability are likely to exert downward pressure on price and transaction volumes this year.

In Japan, our extremely selective approach to J-REITs is unchanged, although recent price performance has meant that valuations have become more reasonable in some cases.