ALTERNATIVES

Global Listed Real Estate: A Key Building Block

November 2, 2017

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Many investors are quite content to stay within their home country's market, and many think having exposure to both stocks and bonds is enough to diversify one's portfolio. However, there are compelling reasons to consider adding a third, alternative building block, says Wilson Magee, director of Global Real Estate and Infrastructure Securities, Franklin Real Asset Advisors. He says global listed real estate securities can offer many potential benefits to an investor's portfolio. And, he says current fundamentals look appealing for the asset class.

While global equity market performance has been quite strong this year, we believe there is a case for building a well-diversified investment portfolio that includes real estate securities.

The asset class offers a number of attractive qualities for investors. These include stable and consistent dividends, steady earnings growth and capital appreciation over the longer term. We acknowledge there is near-term risk should interest rates rapidly rise. But our research indicates the sector can continue to perform well even as global central banks start to normalize monetary policy over the coming years.

Current valuations and underlying fundamentals in the asset class look appealing to us. Furthermore, real estate securities have the potential to give investors access to quality properties and companies led by some of the world's leading real estate entrepreneurs and executives. And since listed markets are liquid and transparent, investors have access to these investments in real time.

Enhanced Portfolio Outcomes

It's true global equities have been outperforming global real estate as an asset class recently. However, in the past, adding global real estate securities to a portfolio of stocks and bonds has generally had a positive effect on its risk and reward characteristics. Real estate has increased portfolio returns meaningfully, while slightly increasing risk (volatility). The result has been an improvement of the portfolio's Sharpe ratio (risk-adjusted return). Even taking into account the recent performance of equities, including global real estate in a traditional balanced portfolio of stocks and bonds would have increased the capital growth of a portfolio by more than 25% since 2000.[1] (See chart below)

Adding Global Real Estate to a Balanced Portfolio Increased Returns More than It Increased Risk

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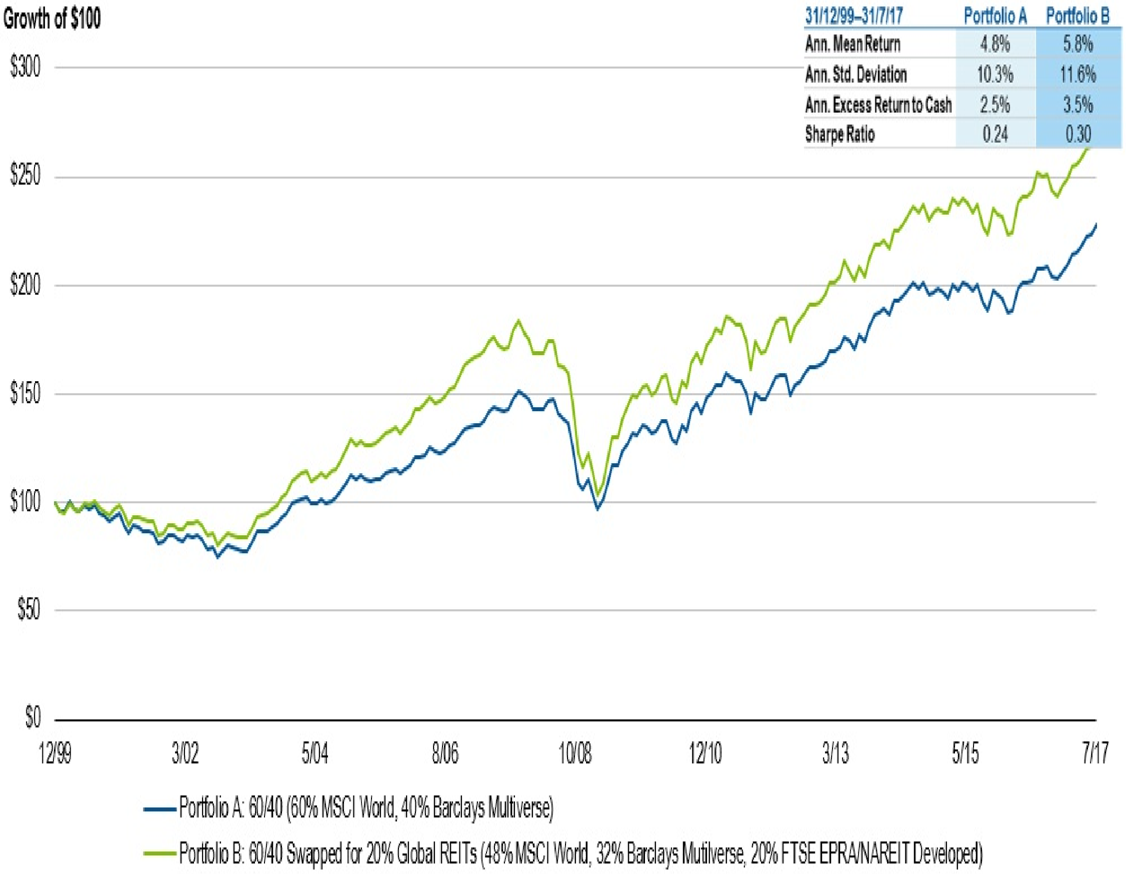
As at July 31, 2017



31/12/99–31/7/17	Portfolio A	Portfolio B
Ann. Mean Return	4.8%	5.8%
Ann. Std. Deviation	10.3%	11.6%
Ann. Excess Return to Cash	2.5%	3.5%
Sharpe Ratio	0.24	0.30

Calculations by Franklin Templeton Multi-Asset Solutions using data sourced from Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** For illustrative purposes only and not reflective of any Franklin Templeton fund.

Standard deviation is considered a measure of volatility, representing deviation of a set of data from the mean. The Sharpe ratio represents a risk-adjusted return.

Great Properties Deliver Attractive Yields with Ample Room for Growth

We believe that high-quality real estate assets currently provide attractive yields. And, there is opportunity to funnel more cash to shareholders as these assets are better able to increase rents and occupancy levels over time. Listed real estate companies have historically provided investors with a sizeable component of total return in the form of dependable dividends. In many jurisdictions, minimum distributions of income are either legally required or an industry standard.

During the past decade, with the exception of the 2007–2008 Global Financial Crisis, dividend yields have ranged from 3.5% to 4.5% on global real estate securities. At the end of August 2017, global real estate securities, as measured by the FTSE EPRA/NAREIT Developed Index, had a dividend yield of 3.8%.[2] This yield compares favourably to the 2.4% yield for the MSCI World Index and 2.0% yield for the S&P 500 Index.[3] Global real estate securities are currently trading at a dividend yield consistent with the average for the past 10 years despite the yield spike during the global financial crisis. (See chart below)

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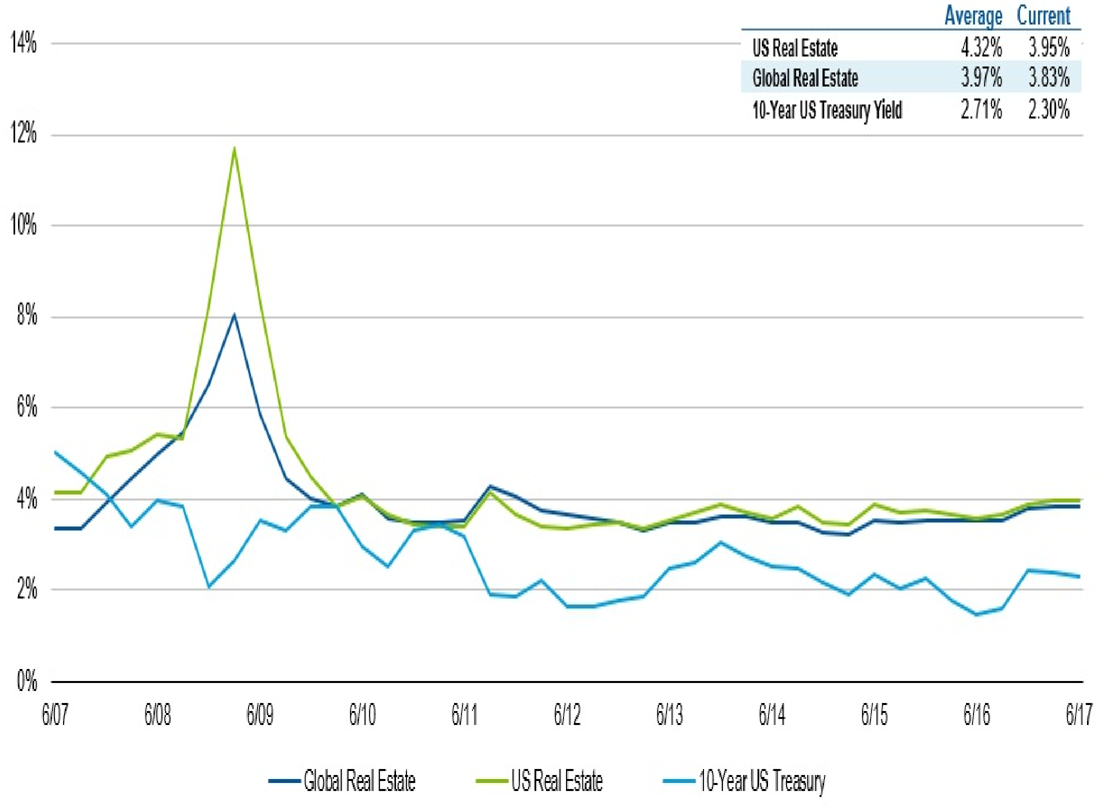
Global Real Estate Boasts Attractive Yields

Global Dividend Yields vs. 10-Year Treasury Yields
As at June 30, 2017



	10-Year Average	Current
US Real Estate	4.32%	3.95%
Global Real Estate	3.97%	3.83%
10-Year US Treasury Yield	2.71%	2.30%

Source: FactSet. For illustrative purposes only and not reflective of any Franklin Templeton fund. Global real estate represented by FTSE EPRA/NAREIT Developed Index; US real estate represented by FTSE NAREIT All Equity REITs Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.

Moreover, we think real estate yields look appealing when compared with sovereign bond yields around the world. While the spread varies by country, overall, the requirements that real estate securities return cash to shareholders underscore the income benefits of owning real estate in a diversified portfolio relative to bonds.

And, unlike fixed income coupon payments, which do not increase over time, dividends for real estate companies typically grow along with underlying cash flow per share. Indeed, from 1994 through 2016, US REIT dividends have grown at an average annual rate of 7.9%, significantly outpacing inflation.[4] Over the past three years, dividend growth has averaged 9.1%.[5]

Rising Rate Concerns Misplaced

In our estimation, general underperformance of global real estate in recent quarters can be tied in part to concerns about the rising interest-rate environment, particularly in the United States. In the back half of 2016, US 10-year Treasury yields climbed from 1.35% to 2.46%. Treasury yields have since pulled back as concerns about slower growth and stubbornly low inflation raise questions about how quickly rates will rise.

While a turn in the US interest-rate cycle may have a negative near-term impact on global real estate securities prices, we have found that the asset class has historically performed well over the duration of rising-rate periods. We reviewed the past 25 years of interest-rate history (as measured by the 10-year US Treasury note) and studied periods in which interest rates increased by more than 1% (100 basis points [bps]). After identifying 10 such periods, we then examined the corresponding returns of global real estate securities, global stocks and global bonds. Global real estate securities returns averaged 8.1% over these periods, with positive returns in eight of the 10 periods.[6]

One reason for real estate's strong performance, even in a rising rate environment, is that rising interest rates tend to coincide with periods of greater economic growth. As economic activity gathers pace, it creates more jobs. And, in turn, wages increase. Demand for real estate tends to move higher as well.

This virtuous cycle suggests to us that any near-term pressure on real estate securities may be short-lived. Of note, there is also a tendency for the real estate cycle to be much longer than the business cycle. Since peak and trough periods are nearly impossible to predict, our findings suggest to us that a steady allocation to global real estate securities could prove advantageous during periods of interest-rate uncertainty.

Valuations Look Attractive

On a price-to-earnings (P/E) basis, global real estate is trading at what we believe to be attractive levels.[7] Compared with global equities, global real estate has traditionally traded at a premium. Since peaking in early 2015, this relationship has changed. Global real estate has a P/E ratio that is now only slightly higher than that of global equities and the spread between the multiples is now below the five-year average by over one standard deviation.[8] See chart below.

Relative P/E of Global Real Estate to Global Equities

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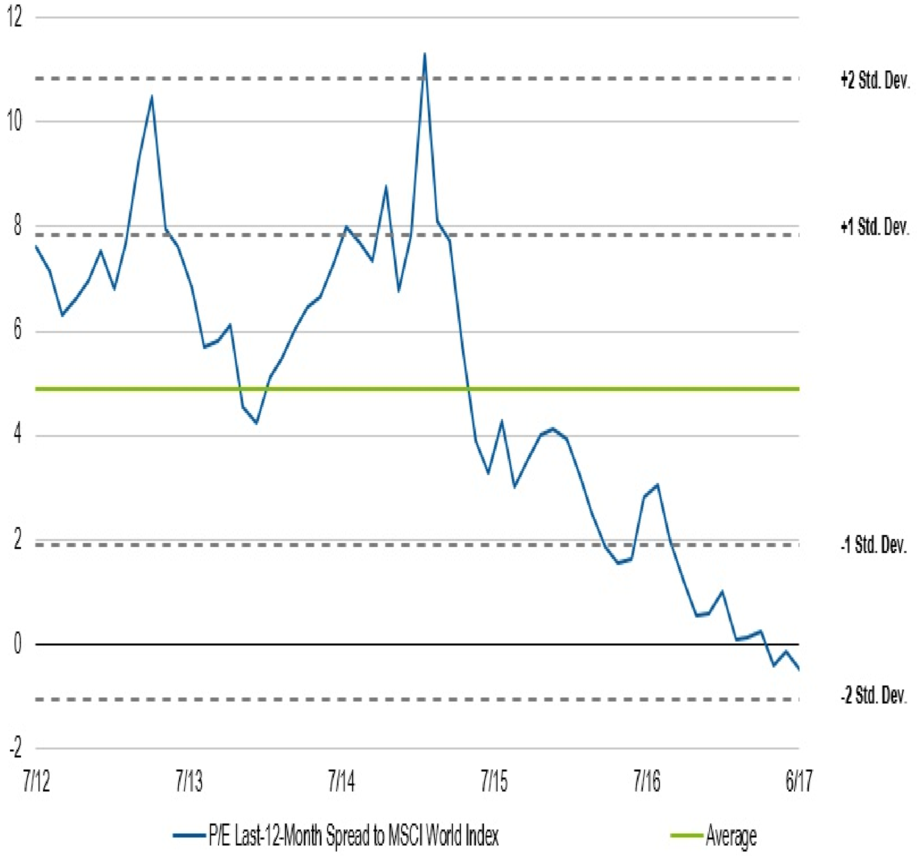
Spread to MSCI World Index
As at June 30, 2017



Source: FactSet. For illustrative purposes only and not reflective of any Franklin Templeton fund. Global real estate represented by FTSE EPRA/NAREIT Developed Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.

P/E = price/earnings ratio. The P/E ratio is a valuation multiple defined as market price per share divided by annual earnings per share. Std. Dev. = standard deviation. Standard deviation is considered a measure of volatility, representing deviation of a set of data from the mean.

Furthermore, continued cash-flow-per-share growth, in our opinion, supports a relatively higher valuation. Real estate valuations also look attractive when compared with fixed income securities. The average spread between US REIT dividend yields and US BBB-rated corporate bond yields suggests to us real estate securities are cheap relative to these credit bonds.

Worth a Closer Look in Any Market Environment

An allocation to global listed real estate has been shown to provide attractive diversification potential when included alongside global equities and fixed income.[9] We think yields appear attractive in the current interest-rate environment, and valuations are also favourable.

A turn in the global interest-rate cycle may indeed pose some short-term headwinds for real estate securities. However, history suggests that over the longer term, investors can benefit from the potential for favourable total returns, yields and diversification. For investors with existing allocations, as well as those actively considering an allocation, we think now is an opportune time to consider the attractions of global real estate.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Investing in real estate securities involves special risks, such as declines in the value of real estate and increased susceptibility to adverse economic or regulatory developments affecting the sector. Investments in REITs involves additional risks. Since REITs typically are invested in a limited number of projects or in a particular market segment they are more susceptible to adverse developments affecting a single project or market segment than more broadly diversified investments. Foreign investing, especially in emerging markets, involves additional risks such as currency and market volatility, as well as political and social instability.

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1. Past performance is not an indicator or guarantee of future performance. Calculations by Franklin Templeton Multi-Asset Solutions using data sourced from Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

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3. Ibid.

4. Source: FactSet, NAREIT, Barclays and Franklin Real Asset Advisors. Past performance is not an indicator or a guarantee of future performance.

5. Ibid.

6. Source: FactSet, Morningstar. Global real estate securities represented by FTSE EPRA/NAREIT Developed Index; global stocks represented by MSCI World Index; global bonds represented by Bloomberg Barclays Global Aggregate Bond Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future results.

7. The P/E ratio is a valuation multiple defined as market price per share divided by annual earnings per share.

8. Source: FactSet. Global real estate represented by FTSE EPRA/NAREIT Developed Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future results. See www.franklintempletondatasources.com for additional data provider information. The P/E ratio is a valuation multiple defined as market price per share divided by annual earnings per share. Standard deviation is considered a measure of volatility, representing deviation of a set of data from the mean.

9. Diversification does not guarantee profit nor protect against risk of loss.