REITs have delivered where direct property funds have failed

After repeated suspensions and dismal performance from many open-ended direct property funds, U.K. investors may benefit from warming up to the potential of better returns, risk diversification and liquidity with real estate securities.

by Rogier Quirijns

KEY TAKEAWAYS

Better track record
Pan-European REITs have returned 5.6% annually after inflation (7.3% nominal) over the past decade, three times that of the median U.K. direct property fund.

Broader diversification
REIT funds may spread real estate risk across a wide investment universe, including property types benefitting from secular tailwinds and markets with different economic cycles.

Inherent liquidity
Open-end REIT funds remained open for trading throughout the pandemic, Brexit and the global financial crisis, without the need for large cash reserves to meet redemptions.

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The beatings continue for direct property fund investors

As the pandemic abates, U.K. real estate investors are finally getting some relief after being trapped in open-ended direct property funds for more than a year. Back in March 2020, these funds were forced to suspend trading on £11 billion in U.K. customer assets due to their inability to accurately price and trade their property holdings. Now, after months of raising cash and selling assets at depressed prices, these funds are reopening the gates.

This should come as no surprise to anyone. Time and again, periods of economic turmoil have exposed the structural flaw of offering the illusory promise of daily liquidity in funds that own illiquid assets. Worse yet, many of these funds have struggled to deliver returns above inflation, with Morningstar's EAA Fund Property – Direct U.K. category providing a median real return of just 1.9% over the past decade, or 3.6% in nominal terms (Exhibit 1).

EXHIBIT 1
Same asset class, different results
Real estate securities have significantly outperformed U.K. direct property funds over the past decade

Inflation-adjusted returns in £, annualised (%)

Many investors appear to have had enough, leading to an exodus of capital from direct property funds despite the prospect of a recovery in real estate fundamentals. However, investors need not abandon the asset class. Based on the data, a better real estate solution is in front of them.

Funds that invest in real estate investment trusts (REITs) and other real estate securities offer potential advantages across three key areas: a) significantly stronger historical returns, b) the ability to diversify risk across many sectors and geographies, and c) daily liquidity in the underlying assets, which has allowed REIT funds to remain fully open for trading even in times of severe economic stress. It's a solution we believe U.K. investors can no longer afford to ignore.

(1) 18 March 2020, Financial Times, “All property funds expected to gate ‘within hours’ as £11bn trapped”.

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A history of strong REIT returns

The recovery in property fundamentals as economies have reopened has led to substantial returns for listed real estate over the past year, largely offsetting the pandemic-induced selloff in early 2020. Over the longer term as well, REITs in the U.K. and Europe have, on average, outperformed most open-ended U.K. direct property funds (Exhibit 1, pg. 2).

For the past decade, European REITs have delivered three times the real return of the median U.K. direct property fund. As for consistency, European REITs have outperformed the median U.K. direct property fund in 90% of rolling three-year periods and in 97% of rolling five-year periods. Investors should also consider that active REIT managers may further enhance potential outcomes through strategic and tactical allocations, as seen above in the 10-year 380 basis-point excess return of the Cohen & Steers SICAV European Real Estate Securities Fund relative to the European REIT index.

The compound effect of this outperformance has been substantial: A £10,000 investment made 10 years ago in the median U.K. brick-and-mortar open-ended fund would have grown to about £12,000 in inflation-adjusted value, compared with about £17,000 for European REITs (Exhibit 2). For income-focused investors, listed real estate has historically delivered comparable yields to direct property investment, with a 10-year average yield of 4.0% and a current 12-month yield of 3.0%, equal to the current-year average yield of the top five U.K. direct property funds.

EXHIBIT 2
Compounded benefits
Inflation-adjusted growth of £10,000 over 10 years

<table>
<thead>
<tr>
<th></th>
<th>£10,000</th>
<th>£17,060</th>
<th>£24,108</th>
</tr>
</thead>
<tbody>
<tr>
<td>European REITs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cohen &amp; Steers SICAV</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>European RE Secs I</td>
<td></td>
<td></td>
<td>£24,108</td>
</tr>
<tr>
<td>U.K. direct property</td>
<td>£11,966</td>
<td></td>
<td>£17,060</td>
</tr>
<tr>
<td>fund median</td>
<td></td>
<td>£10,000</td>
<td></td>
</tr>
</tbody>
</table>


Data quoted represents past performance, which is no guarantee of future results. Returns stated are net of fees and include change in share price and reinvestment of all distributions. Current performance may be lower or higher than the performance quoted. The investment return and the principal value of an investment will fluctuate and shares, when redeemed, may be worth more or less than their original cost. Periods greater than 12 months are annualised. Returns are historical and include change in share price and reinvestment of all distributions. An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. See page 8 for index associations, definitions and additional disclosures.

(1) 10 years ended 31 May 2021. Source: Morningstar Direct, Cohen & Steers analysis. European REIT outperformance vs. median return in Morningstar EAA Fund Property – Direct U.K. category: 3-year rolling periods: 76 of 84 monthly observations; 5-year rolling periods: 58 of 60 monthly observations. See page 8 for additional disclosures.

(2) At 31 May 2021. Source: Morningstar Direct, fund factsheets, Cohen & Steers analysis. Yield based on FTSE EPRA Nareit Developed Europe Index and a simple average of the five largest U.K. direct property funds based on assets under management. See page 8 for additional disclosures.
Why have REITs succeeded where so many direct property funds have fallen short?
We believe there are several fundamental reasons, providing a strong foundation for their continued potential outperformance:

<table>
<thead>
<tr>
<th>Continuous evolution</th>
<th>REITs in the U.K. and Europe have become increasingly sophisticated in their business practices over the past decade, seeking to bring performance more in line with the relatively mature U.S. REIT market. Many companies have adopted better business models, capital-raising practices and corporate governance, prompted in part by Cohen &amp; Steers' strong advocacy efforts since 2010, which have contributed to a stronger European REIT universe today.</th>
</tr>
</thead>
<tbody>
<tr>
<td>ESG practices</td>
<td>Oversight by a board of directors, by regulators and, most importantly, by the invisible hand of the public market provide a feedback loop that tends to reward value-adding management decisions with higher valuation multiples. REITs also tend to have ample resources to remain on the front foot from a sustainability and social point of view.</td>
</tr>
<tr>
<td>A wider field of opportunity</td>
<td>REITs encompass a broad investment universe, providing fund managers access to a wide selection of economies, alternative sectors and company management teams for identifying opportunities to generate potential returns.</td>
</tr>
<tr>
<td>Property specialisation</td>
<td>Many listed real estate companies focus their entire business on a single property type, building best-in-class platforms in that specialty, thereby creating the potential for superior revenue realisation, cost efficiencies and returns on capital.</td>
</tr>
<tr>
<td>Active investment</td>
<td>Most modern REITs are not passive asset owners with a dividend yield, but rather actively seek to drive cash flow growth, focusing on total return through a balance of direct income return and indirect net asset value return.</td>
</tr>
<tr>
<td>Alignment with investors</td>
<td>REIT management teams typically have financial incentives, through significant equity ownership stakes and performance-based compensation, to make strategic decisions that they believe will generate long-term shareholder value.</td>
</tr>
</tbody>
</table>
Diversifying opportunity and risk

Property funds focused solely on the U.K. provide access to a relatively limited investment universe and run the risk that the local property market may be richly valued or at an unattractive point in its fundamental cycle. This has been the case recently, as the U.K. has been in the lower half of European listed property markets over the past decade amid Brexit uncertainty and a sluggish economy.

By broadening a portfolio’s scope with a REIT allocation, investors gain access to property markets with different return profiles and divergent economic and monetary cycles, which could potentially reduce a portfolio’s economic risk (Exhibit 3). The REIT market’s size and depth, coupled with the divisibility of owning shares rather than a whole building, mean that funds investing in real estate securities can achieve much greater geographic and sector diversification than traditional direct property funds. For investors concerned about currency risk, some REIT managers offer hedged share classes.

Investing in new alternative sectors

If investors are going to allocate to the U.K., we believe they should own some of the country’s best opportunities, such as self storage, industrial, health care and student housing. Alternative property types are well represented in the European REIT market, whereas most direct property funds have significant exposure to secularly challenged office and retail assets (Exhibit 3). A REIT portfolio may also include digital infrastructure property, such as cell towers and data centres. Alternative sectors have been important contributors to the growth of the U.K. and European real estate markets over the past decade, and we expect the success of focused sectors will lead to further specialisation.

EXHIBIT 3
An expansive universe
REIT funds can provide access to more markets and property types, helping to diversify sources of income and return
Portfolio weights (%)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Top 5 U.K. direct property fund average(a)</th>
<th>European REIT index</th>
<th>Cohen &amp; Steers SICAV European RE I</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial</td>
<td>33.6</td>
<td>10.8</td>
<td>22.0</td>
</tr>
<tr>
<td>Office</td>
<td>25.9</td>
<td>9.9</td>
<td>6.1</td>
</tr>
<tr>
<td>Retail</td>
<td>19.4</td>
<td>8.7</td>
<td>10.9</td>
</tr>
<tr>
<td>Diversified</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residential</td>
<td>21.2</td>
<td>30.9</td>
<td>18.9</td>
</tr>
<tr>
<td>Industrial office</td>
<td></td>
<td>25.7</td>
<td>24.3</td>
</tr>
<tr>
<td>Health care</td>
<td></td>
<td>6.1</td>
<td>3.6</td>
</tr>
<tr>
<td>Self storage</td>
<td></td>
<td>3.5</td>
<td>5.8</td>
</tr>
<tr>
<td>Specialty</td>
<td></td>
<td>2.1</td>
<td>6.1</td>
</tr>
<tr>
<td>Hotel</td>
<td></td>
<td>1.7</td>
<td>0.3</td>
</tr>
<tr>
<td>Cell tower</td>
<td></td>
<td>0.5</td>
<td>0.7</td>
</tr>
</tbody>
</table>


(a) Simple average of the largest U.K. direct property funds by assets under management, as reported in their latest factsheet; portfolios focused primarily on U.K. property, but may invest some unspecified portion in non-U.K. assets. The mention of specific securities or sectors is not a recommendation or solicitation for any person to buy, sell or hold any particular security in a sector and should not be relied upon as investment advice. See page 8 for index definitions and additional disclosures.
Daily liquidity

Throughout the pandemic, Cohen & Steers real estate securities funds, like other REIT funds, remained open for trading despite extreme uncertainty about how global quarantines would affect property values. Our funds also remained open during the Brexit referendum, the European debt crisis, the global financial crisis and every other economic calamity since our founding in 1986.

REIT shares can typically be bought or sold at any time, allowing fund managers to invest new monies with ease and raise cash quickly to meet redemptions. As a result, most REIT funds maintain minimal cash reserves (generally less than 1% of assets) and can offer daily liquidity even under challenging market conditions. This makes REITs ideally suited to the retail investor market and defined-contribution investors, as well as to fund-of-fund and model-portfolio managers who need to rebalance with frequency.

This is a stark difference from direct property funds, which typically maintain high levels of cash (often 10–20%) to fund potential withdrawals. Investors must consider the cost of maintaining these liquidity buffers, both in terms of lost performance potential due to the low returns on cash equivalents, as well as the fee paid to managers for holding cash at the bank. This potential cash drag could become meaningful in the near term, as some direct property funds are building up substantial cash reserves in preparation for lifting trading restrictions.(1)

Listed market volatility may create arbitrage opportunities

Returns for open-ended direct property funds may appear smoother than those of real estate securities. For long-term equity investors, however, short-term volatility can be a gift.

In any given period, a REIT or listed real estate security may trade at a premium or discount to the value of its property holdings and expected cash flows. A REIT manager who understands the market may arbitrage mispriced securities to potentially generate outperformance. Concurrently, listed companies themselves may arbitrage as well, perhaps issuing new shares at a premium to net asset value and creating value through acquisitions or development, or buying back shares at a discount to net asset value. This double arbitrage opportunity is something that direct real estate investing cannot replicate and, if executed correctly, it has the potential to enhance shareholder value.

Zero: Number of times Cohen & Steers funds have suspended trading in 35 years

(1) 30 April, 2021. Ignites Europe, “Aegon extends property fund suspension.”
Closing thoughts: Embracing facts

Following the collapse of the open-ended direct property fund sector in 2008, it seemed inconceivable that these funds would return to prominence. History repeated itself in the liquidity crunch that followed the Brexit referendum. Will this time be any different? Will U.K. investors finally follow the path of other developed investment markets, which have embraced real estate securities as an effective vehicle for allocating to real estate?

The facts in our view are clear:

- **European REITs have a stronger performance track record**, outperforming the median U.K. direct property fund by 370 basis points annually over the past decade (Exhibit 1). Active managers can further enhance this return advantage: Since May 2013, when the current portfolio manager of the Cohen & Steers SICAV European Real Estate Securities Fund took over, the fund has outperformed its benchmark by more than 500 basis points per year. (1)

- **REIT funds tend to be more diversified than the typical U.K. direct property fund**, with access to more markets and alternative property types such as self storage, health care and student housing.

- **REITs are liquid**, with a history of remaining fully open for trading, even during economic crises. (This includes Cohen & Steers funds.)

There is no need to wait for regulators to “fix” the structure of daily dealing open-ended direct property vehicles. An alternative within the real estate sector exists, represented by a £1.4 trillion global real estate securities market. What happens next is up to investors.

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**EXHIBIT 4**

**Sustained excellence**

Cohen & Steers SICAV European Real Estate Securities Fund category rank

<table>
<thead>
<tr>
<th>Performance (%)</th>
<th>1 year</th>
<th>3 years</th>
<th>5 years</th>
<th>10 years</th>
<th>Since inception 10/02</th>
</tr>
</thead>
<tbody>
<tr>
<td>SICAV European RE I</td>
<td>29.05</td>
<td>11.21</td>
<td>10.33</td>
<td>11.27</td>
<td>9.50</td>
</tr>
<tr>
<td>Category median</td>
<td>24.43</td>
<td>4.35</td>
<td>4.14</td>
<td>7.32</td>
<td>7.89</td>
</tr>
<tr>
<td>Benchmark(2)</td>
<td>26.52</td>
<td>4.51</td>
<td>4.18</td>
<td>7.66</td>
<td>7.78</td>
</tr>
<tr>
<td>Funds in category</td>
<td>193</td>
<td>170</td>
<td>143</td>
<td>102</td>
<td>41</td>
</tr>
</tbody>
</table>


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(a) European REIT funds represented by Morningstar’s EAA Fund Property – Indirect Europe category, which invests principally in the securities of European real-estate companies, including those of REITs. These funds invest at least 70% of total assets in equities and invest at least 50% of equity assets in real-estate securities, with at least 75% of equity assets invested in Europe. The category will include fund legal structures such as open-end, SICAV and unit trust funds from all share classes and foreign currencies. Funds may be governed under various regulatory regimes that impose different constraints and limitations on their investment policies.

(b) FTSE EPRA NAREIT Developed Europe Index through Feb. 2005; FTSE EPRA NAREIT Developed Europe Index (Net) through Sept. 2020, and FTSE EPRA NAREIT Developed Europe UCITS Capped Net Tax Index thereafter.

Cohen & Steers SICAV European Real Estate Securities Fund (the “Fund”) implements fair value pricing when the daily change in a specific U.S. market index exceeds a predetermined percentage. In the event fair value pricing is implemented on the first or last day the period, the Fund’s return may diverge from the performance of its benchmark index, which is not fair valued. The divergence is usually reduced on the day following the implementation of fair value pricing by the Fund, as the value of the securities in the index that are held by the Fund typically move closer to the Fund’s fair valued price when the market reopens.

(1) 1 May 2013 to 31 May 2021. Fund annual return (Class I): 13.4%; benchmark annual return: 8.3%. See page 8 for information on fund fees and other disclosures.
**About the author**

**Rogier Quirijns**, Senior Vice President, is Head of Europe Real Estate and a senior portfolio manager and oversees the research and analyst team for European real estate securities. He has 21 years of investment experience. Prior to joining Cohen & Steers in 2008, Mr. Quirijns was a senior real estate equity analyst with ABN AMRO in Amsterdam, where his coverage included France, Scandinavia and the Benelux region. Previously, he was a direct real estate portfolio manager with Equity Estate and an analyst within the real estate corporate finance team at Arthur Andersen. Mr. Quirijns holds a degree in business economics from the University of Amsterdam and is based in London.

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**Index Definitions / Important Disclosures**

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. **European REITs**: FTSE EPRA Nareit Developed Europe Index is an unmanaged market-capitalisation weighted total-return index, which consists of publicly traded equity REITs and listed property companies from the Europe region. **U.K. REITs**: FTSE EPRA Nareit Developed U.K. Index is an unmanaged market-capitalisation-weighted total-return index, which consists of publicly traded equity REITs and listed property companies domiciled in the U.K. Source: London Stock Exchange Group plc and its group undertakings, including FTSE International Limited (collectively, the “LSE Group”), European Public Real Estate Association (“EPRA”), and the National Association of Real Estate Investments Trusts (“Nareit”) (and together the “Licensor Parties”). © LSE Group 2021. FTSE Russell is a trading name of certain LSE Group companies. “FTSE®” and “Russell®” are a trade mark(s) of the relevant LSE Group companies and are used by any other LSE Group company under license. “Nareit®” is a trade mark of Nareit, “EPRA®” is a trade mark of EPRA and all are used by the LSE Group under license. All rights in the FTSE Nareit EPRA index(es) or data vest in the Licensor Parties. The Licensor Parties do not accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company’s express written consent. The Licensor Parties do not promote, sponsor or endorse the content of this communication. **Benchmark**: The benchmark for the Cohen & Steers SICAV European Real Estate Securities Fund was the FTSE EPRA Nareit Developed Europe Index through Feb. 2005; FTSE EPRA Nareit Developed Europe Index (Net) through Sept. 2020, and FTSE EPRA Nareit Developed Europe UCITS Capped Net Tax Index thereafter. **Data quoted represents past performance, which is no guarantee of future results.** These materials are provided for informational purposes only and reflect sources believed by Cohen & Steers to be reliable as of the date hereof. No representation or warranty is made concerning the accuracy of any data compiled herein, and there can be no guarantee that any forecast or opinion in these materials will be realised. There is no guarantee that any historical trend illustrated herein will be repeated in the future, and there is no way to predict precisely when such a trend will begin. There is no guarantee that any market forecast made in this commentary will be realised. This is not investment advice and may not be construed as sales or marketing material for any financial product or service sponsored or provided by Cohen & Steers, Inc., or any of its affiliates or agents. **Risks of investing in real estate securities.** The risks of investing in real estate securities are similar to those associated with direct investments in real estate, including falling property values due to increasing vacancies or declining rents resulting from economic, legal, political or technological developments, lack of liquidity, limited diversification and sensitivity to certain economic factors such as interest rate changes and market recessions. Foreign securities involve special risks, including currency fluctuations, lower liquidity, political and economic uncertainties, and differences in accounting standards. Some international securities may represent small- and medium-sized companies, which may be more susceptible to price volatility and be less liquid than larger companies. No representation or warranty is made as to the efficacy of any particular strategy or fund, or the actual returns that may be achieved.

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(1) Citywire Fund Manager Ratings measure performance across all the funds run by a given manager. The fund manager will need to beat his or her benchmark over a three-year period. The top 10% of managers in this elite group will gain the highest AAA rating.

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