

Legg Mason Australian Equities Perspectives The Wisdom of an A-REIT Angler



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Market attention has recently turned to global Real Estate Investment Trusts (“REITs”) and whether Australian REITs (“A-REITs”) have a role to play within a balanced portfolio. Within the “hard” asset space of property, going global does widen the playing field for managers from an opportunity and diversification perspective.

However, Legg Mason’s research suggests that while global REITS offers deeper and more liquid oceans in which to fish, when the nets are hauled-in the catches have been relatively disappointing. Add to this the currency and macro volatility storms that global investors must weather and one begins to question the logic of going completely global. This white paper highlights that the smoother local waters of the A-REIT pond are not as well fished. For its size, the A-REIT market consistently throws up a fruitful catch that shouldn’t be ignored.

This paper is divided into two sections and examines:

1. the case for A-REITs; and
2. an approach to property allocations from a balanced portfolio manager’s perspective.

The conclusion is that the A-REIT market is an attractive asset class for balanced investors due to the:

1. relatively high yield on offer;
2. investor protection from local inflation;
3. comfort that comes from investing in Australian assets; and
4. liquidity and clear pricing of investing in listed securities

From both a beta and alpha perspective, an allocation to A-REITs within a balanced portfolio has strong merit. Accordingly, when making allocations to property within a balanced portfolio, a weighting of at least 50% to A-REITs provides the clear path forward for investors.



The case for A-REITs

Alpha opportunities in the A-REIT market

When assessing the merits of one investment sector over another, a sensible framework is to first examine the quantum of opportunity within a market and then determine if those opportunities can be consistently captured.

If we compare opportunity and manager skill across the asset classes, the clear message is that despite more opportunities in global markets, active management is rewarded most at the domestic level.

Manager opportunity can be delineated as a function of each sector's average benchmark index weight. Dividing one by the average index weight gives us a strong proxy for the number of possible active positions across each asset class. Put simply, the larger the number of possible active positions, the greater is both manager choice and opportunity to add value in that asset class.

Commensurately, **manager skill** can be defined as the difference between the median manager and the benchmark return. If the median manager is outperforming the benchmark over a reasonable time frame then that signals manager skill within that sector.

Manager Opportunity Measure = $1 \div$ Avg index weight			Skill (Median Manager vs Benchmark) 3 years to June 09	
	Avg. Index Weight	No of Possible Active Positions		Value Added % p.a.
A-REITs	3.85%	26	A-REITs	+1.1%
Australian Equities	0.50%	200	Australian Equities	+1.5%
Small Cap Australia	0.52%	194	Small Cap Australia	+3.9%
Global Property	0.45%	223	Global Property	-0.6%
Global Equities	0.04%	2,317	Global Equities	-1.3%
EM Equities	0.13%	743	EM Equities	-0.0%

Source: Iress, Factset, UBS Limited

Source: Mercer Survey Data

In examining the Australian and global REIT sectors, the conclusion is that A-REIT managers capture more alpha than global REIT managers despite a tighter opportunity set. In other words, while "opportunity" exists within the Global REITs (and this is put forward as its greatest selling point) it is not translating into alpha.

So why are A-REIT managers capturing this opportunity in performance terms? I believe that local managers have an information edge over their offshore counterparts. They employ their own "backyard" knowledge within the A-REIT market, which is critical when local factors drive property fundamentals.

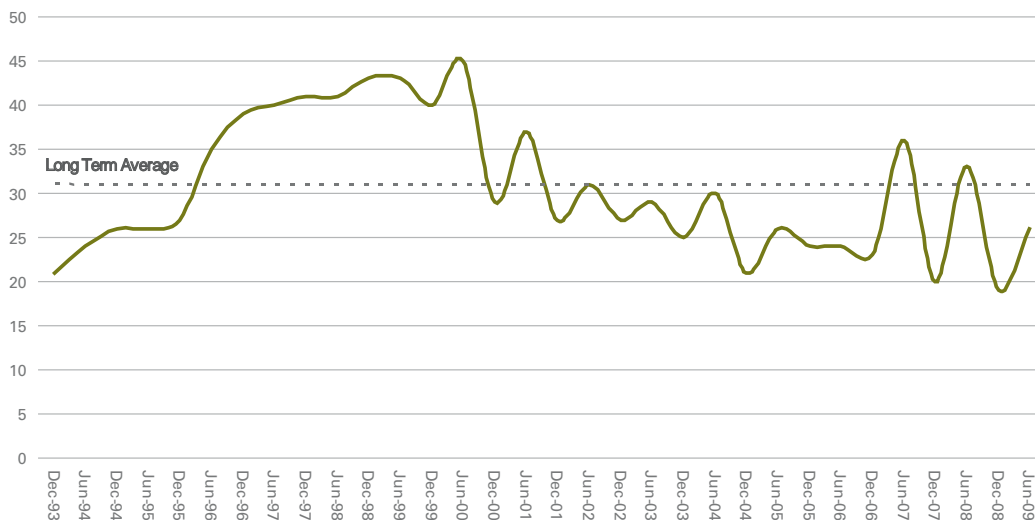
Interestingly, global managers struggle across the asset classes. Along with dealing with the informational disadvantage against their local competitors, they face significant organisational challenges in capturing insights quickly and consistently. For example, it is difficult to compare U.S. equities to Japanese equities when they have vastly different drivers. Additionally, noise from such factors as currency and diverse macro economic events can swamp manager effort.

This analysis (based on Mercer Surveys) is verified by the Standard & Poor's Indices Versus Active ("SPIVA") Funds Scorecard research. The SPIVA data adjusts for survivorship bias and uses after fees, asset-weighted peer group returns. This data demonstrates clear manager skill in the A-REIT space over three and five years. For reference, I have provided an excerpt from this report at the end of this White Paper, while the full independent report can be found at the following address:

<http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/3,1,1,0,1204848544865.html>

Examining the A-REIT universe over longer periods reveals quite a level of cyclicity to our opportunity measure. This is highlighted in the following chart, which stretches back over 15 years, and shows the number of possible active positions as measured by the inverse of the A-REIT average index weight in each period. The recent measures of A-REIT opportunity are in-line with the sector's long run history and post the global financial crisis it is trending back from its December 2008 low. This is indicative of an improved environment for active managers to add value and is also reflected in Legg Mason's investment signal, which suggests a well above average opportunity set.

A-REIT Opportunity: No. of possible active positions measure is quite cyclical



Source: S&P/ASX 200 A-REIT Index, ASX Property Securities Index prior to 2000

This work raises questions around the allocation of the beta versus alpha budget, which I will address in more detail later. Suffice to say, one doesn't want active risk or alpha exposure to an asset class if there is limited manager skill in that arena. Intuitively, global portfolios have high weightings to the most efficient markets like the U.S. Naively, from an alpha perspective, this suggests that investors should stay at home when making allocations within a balanced portfolio. Equally, balanced portfolio allocations are not purely about seeking alpha. For example, we don't direct 100% of our monies to the small companies' space, where the largest opportunities lie and portfolio manager skill is the highest. As in all things in life, one needs a balance and indeed a balanced approach.

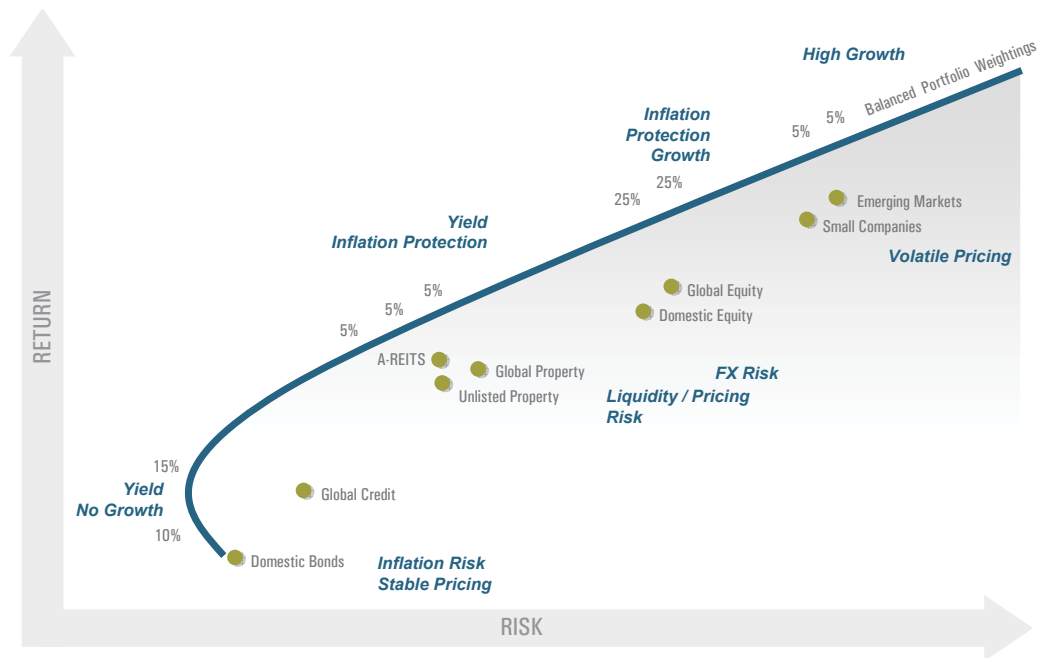
A preference for global REITs?

This leads into some interesting discussions around overall property portfolio allocations. But let us go a little further into the issues around investing in global property.

Differentiating returns between equities and bonds

First it's important to highlight that we make allocations to property to differentiate returns between volatile equities and inflation exposed bonds. Below I have outlined a conceptual efficient frontier covering the spectrum of asset classes and typical balanced portfolio weightings.

At the bottom left of the chart we have low risk domestic bonds and global credit, which offer stable yield but no growth, and importantly no protection from inflation. Towards the higher end of the risk spectrum we have higher risk and higher growth equities, which do offer protection from inflation. However, equity volatility can lead to undesirable return outcomes, particularly when foreign currency exposures are introduced.



Source: Legg Mason

In the middle we have the “hard” assets space of property, which offers both a stable yield and protection from inflation. So why is an inflation hedge important? Because investors want stable, low risk returns that beat inflation so they can retire in comfort. Yet it is an inflation hedge to the Australian domestic economy, not global, which is important. For example, falling prices in New York won’t help you maintain spending power if you are retiring in Sydney and face a local rising price environment.

Equally, investors seek yield to match their cashflow needs as they age. From this perspective the relatively high yields on offer in Australia have strong appeal.

Domestically focused investments avoid the potential macro and currency pitfalls of going into offshore property. As we have recently seen across many of the global REIT investment products, distributions have had to be suspended due to unrealised losses in currency hedge books. The fact that global REIT fund distributions have been frozen in such a way raises ongoing questions about how well Global REITs can fulfil their role of providing stable yield. In reality, faced with these often dominating effects and high levels of global volatility, investors may be better off in global equities than global REITs.

It also shouldn’t be underestimated how much the Australian REIT market suits investor comfort levels. It is nice sleeping at night with the knowledge of how and where one’s hard earned is invested; next time you’re out buying the groceries you will most likely be standing in an A-REIT owned shopping centre.

Finally, in contrast to unlisted investments, the listed A-REITs offer liquidity and clear pricing when investors need it most.

At least a 50% A-REIT allocation is our answer

To date diversification into global property has not worked, as the following table highlights. The right hand table shows only minor differences between global and A-REIT correlations to balanced returns.

Going forward I expect correlations to return to more normal levels, such as those observed prior to the global financial crisis (left hand table), and the REITs will have a strong role to play in diversification terms.

The Benefits of Diversification into REITs: Correlation of returns to a balanced portfolio Pre & Post the GFC

Pre Global Financial Crisis: to Sept 05		Post Global Financial Crisis: to June 09	
Australian Equities	0.85	Australian Equities	0.88
Bonds	-0.25	Bonds	-0.18
A-REITS	0.20	A-REITS	0.60
Global Property	0.18	Global Property	0.54
Global Equities	0.85	Global Equities	0.84
EM Equities	0.81	EM Equities	0.82

Source: Legg Mason

Putting all of this into context I believe some diversification into global REITs is justified, but this needs to be balanced by exposure to a locally biased portfolio. Accordingly, I think it is appropriate to establish at least a 50% allocation to A-REITs when making sub-allocations to property. Interestingly, it is no accident that we observe a 50% global / 50% domestic allocation within the equity allocation across many balanced mandates.

Concentration issues overplayed

Another topic receiving headlines has been the issue of concentration within the A-REIT sector, with particular reference to Westfield Group. From my perspective, this has been overplayed and it should be stressed that within balanced mandates, benchmark allocations to BHP Billiton are nearly 4% versus Westfield at 3.9%. Yet, I see little issue made over concentrated exposures to BHP Billiton.

With over a decade of looking at the A-REIT market, my experience tells me that there is significant cyclicity to index weights, the number of names within the universe and overall opportunity. This cyclicity was highlighted across 15 years of data in the chart I provided earlier on A-REIT opportunity. Undeniably, we are already seeing this cyclicity begin to unwind with Westfield's index weight having reached a peak in February 2009.

Around the world, listed markets exist as they offer efficient pricing, liquidity and transparency. Over time I see the A-REIT concentration issues diminishing as I believe that the listed market will ultimately provide liquidity for many frozen unlisted property assets. Indeed, investors need exposure to A-REITs to participate in these future opportunities.

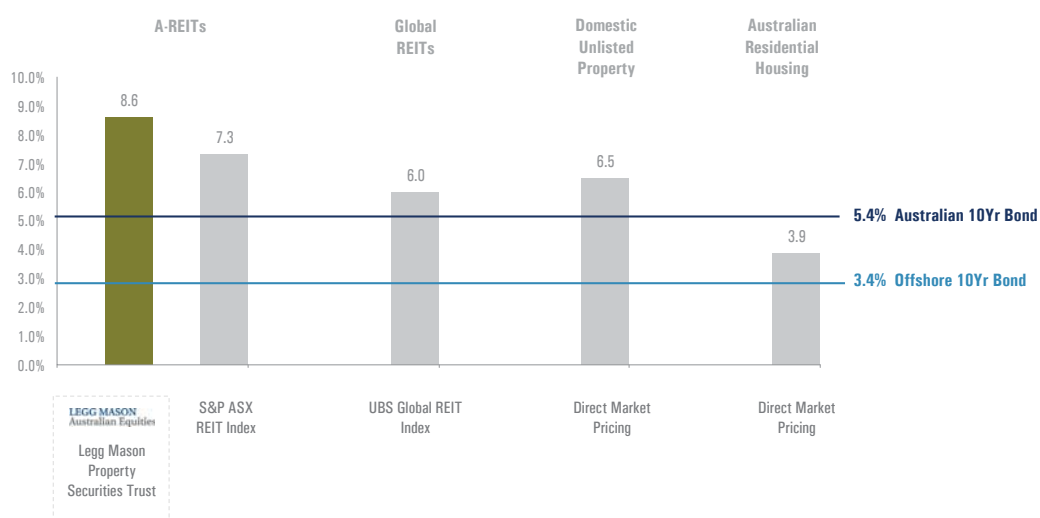
Finally, when drawing comparisons to the unlisted market, it is worth highlighting that Westfield's portfolio offers a dramatically more diversified exposure of property than any one unlisted property fund. When you buy into a portfolio of A-REITs you gain an exposure to not only Westfield, but an additional twenty odd stocks each of which offer their own highly diversified portfolio. To put this into context, Westfield currently has a portfolio of 119 assets around the globe, optimised by one of the global leaders in shopping centre management. Comparatively, the leading unlisted retail fund Australian Prime Property Fund Retail (APPF Retail), managed by Lend Lease has a portfolio of 12 shopping-centre assets.

Domestic Property in the context of a Balanced Portfolio

A tactical opportunity presents in A-REITs

I currently see a strong tactical opportunity in the A-REIT market. This is reflected in market implied asset rental yields across the A-REITs at 7.3%, global REITs at 6.0% and domestic unlisted property at 6.5%. These are outlined in the following table, where to put the A-REIT opportunity in context I have also included the net rental yield for Australian residential housing at 3.9%. These implied asset yields can then be compared against Legg Mason's long-term view of normal yield pricing and also the relevant risk free bond rate. To explain these yields a little further, across each market they represent net rent received against asset value purchase price. This is the yield on the asset before debt interest costs.

Cap Rates: market implied asset rental yields as at August 2009



Source: Legg Mason

Significantly this chart shows the implied asset yield of the Legg Mason Property Securities Trust which sits at 8.6%, this is 20% cheaper than the overall A-REIT market at 7.3%. Contrast these yields to the unlisted direct commercial market asset yield of 6.5%; if we were to price the Legg Mason Property Securities Trust at current unlisted levels it would be 35% undervalued.

Within the Legg Mason portfolio we select the most attractively priced A-REITs, after taking into account expected rental growth and determining whether each A-REIT has appropriate levels of borrowings. The attractive opportunities at the stock level are reflected in over four times the normal dispersion in Legg Mason's investment signal. With high market risk aversion, the flight to quality trade has become extremely crowded and the opportunity to add active return at the stock level is very high.

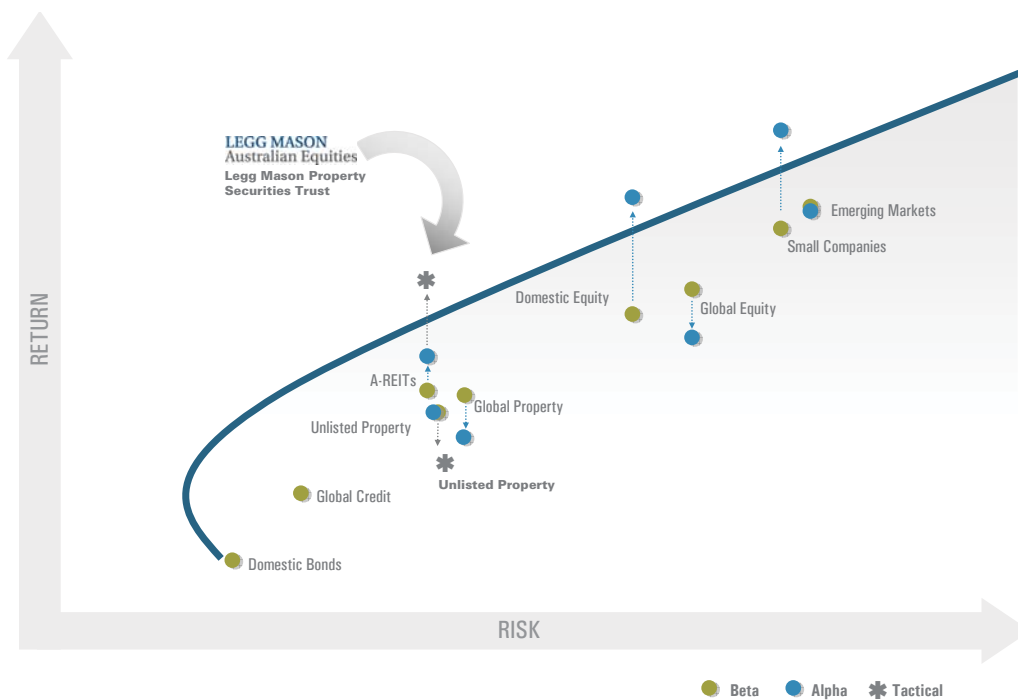
It is also important to contrast the low yields on offer from offshore at 6.0% with those same metrics here in Australia. Additionally, if one takes the ten year bond rate as a proxy for future growth, it also raises questions around the outlook for offshore economic growth. This is a concern given global REIT markets' lower yields, current market assumptions around higher growth within those markets and their reliance on future growth to deliver a total return to investors.

A combined view of the Opportunities...

If I then overlay my earlier findings on opportunity and manager skill across the asset classes, where I highlighted that active management is rewarded most at the local level, we begin to build a picture of where the opportunities lie.

In the following chart, I have highlighted with the blue dots where managers have proven skill to deliver alpha. Again, I would emphasise that it does not make sense to take active risk in an asset class where there is limited investment edge and where the median manager struggles to add value.

The final point of interest in this chart is the grey star above the blue efficient frontier, which underscores the tactical opportunity that is currently on offer in the A-REIT market through the Legg Mason Listed Property Securities Trust. Market dislocation and the crowded flight to quality have created a significant opportunity to add active alpha, with the active return of the Trust at four times its normal level.



Source: Legg Mason

An approach to property allocations from a balanced portfolio manager's perspective

Allocating the beta and alpha Budget

As I mentioned earlier, my work on opportunities and skill raised a number of questions around the allocation of the beta and alpha budget.

To summarise, I don't think it's appropriate to use a black box optimiser (which lacks transparency in decision making) to determine allocations within a balanced portfolio. Rather, I have employed Markowitz's Modern Portfolio Theory as a basis for analysis but taken this in Sharpe's direction of a division between alpha and beta. Accordingly, here I examine property allocations' key characteristics of expected return, risk and correlations in the context of a beta and alpha budget.

In looking at a balanced portfolio and focusing in on the hard property assets that sit between low risk bonds and riskier equities and using a building block approach (expected return, risk and correlations) to beta and alpha, I make the following observations.

Beta Budget

In terms of the beta budget, the domestic A-REITs offer strong yield so they get three ticks of merit, as does the unlisted domestic property sector. While global REITs receive only one merit tick given its lower outright yield and uncertainty of distribution characteristics. Equally the growth outlook for A-REITs is robust, while concerns around global growth, as reflected by offshore bond yields, persist. This sees a stronger expected overall return from domestic A-REITs relative to global.

Beta Budget			
	Yield	Growth	Expected Return
A-REITs	✓✓✓	✓✓	✓✓
Global Property	✓	✓	✓
Unlisted Property	✓✓✓	✓✓	✓✓

Beta Risk

Looking next at beta risk, A-REITs receive one demerit cross, which is actually better than global REITs, where foreign currency and unpredictable macroeconomic factors create undesirable volatility. In the unlisted property market, frequency of measurement and transparency of pricing issues raise unanswered questions around the true volatility characteristics of that sector. The wider property sector offers strong inflation protection, but importantly the A-REITs and Australian unlisted property rank best given their hedge against Australian inflation.

Beta Risk		
	Volatility	Inflation Protection
A-REITs	x	✓✓✓
Global Property	xx	✓
Unlisted Property	x*	✓✓✓

* Frequency of measurement and transparency of pricing issues.

Beta Diversification

From a beta diversification perspective, property asset classes are good diversifiers and therefore all receive ticks. Global property measures up well here, as the sector is less correlated to balanced returns than the local A-REIT market.

Diversification	
	Correlation to Balanced
A-REITS	✓
Global Property	✓ ⁺
Unlisted Property	✓ [*]

* Frequency of measurement and transparency of pricing issues.

Alpha Budget and Alpha Risk

Drilling down to the alpha budget and alpha risk levels, as previously discussed there is clear skill (or value add) in the A-REIT manager space. Add to this the tactical one-in-twenty year return opportunity I have identified and expected alpha outlook from the A-REIT market is very strong. Balanced against a relatively low A-REIT manager active risk profile, investors benefit from a higher information ratio (of active alpha relative to tracking error) in the A-REIT space.

While in global REITS, despite taking on relatively high levels of active risk, the median manager is yet to demonstrate any skill in adding alpha against benchmark. Within the direct property arena, alpha is so massively dispersed both in the positive and negative direction that is if difficult to draw any firm conclusions on median manager skill.

This is illustrated in the table to the right.

	Alpha Budget			Alpha Risk
	Skill	Tactical	Expected Return	Tracking Error
A-REITS	✓	✓✓✓	✓✓	x
Global Property	x	✓	-	xx
Unlisted Property	??	xx	??	xxx

Alpha Correlation

The correlation of alpha across the listed REIT markets (both local and global) to balanced returns is relatively high, while the unlisted property sector offers benefits here. Additionally, global REITS offer concentration and liquidity benefits over the A-REIT market.

Diversification		
	Correlation to Balanced	Concentration/Liquidity
A-REITS	xx	x
Global Property	xx	✓
Unlisted Property	✓✓✓	xxx

Conclusion...

So what does this all mean?

The compelling conclusion is that the A-REIT market is an attractive asset class for balanced investors.

- A-REITs deliver across all of the key areas with:
 - relatively high yield on offer;
 - investor protection from local inflation;
 - comfort that comes from investing in Australian assets; and
 - liquidity and clear pricing of investing in listed securities

- from both a beta and alpha perspective, an allocation to A-REITs within a balanced portfolio allocation has strong merit.

Accordingly, when making allocations to property within a balanced portfolio, a weighting of at least 50% to A-REITs provides the clear path forward for investors.

The A-REIT fishing nets have been cast and the catch is expected to be bountiful.

Beta		Alpha	
	Allocation within Balanced		Allocation within Balanced
A-REITS	✓✓✓	A-REITS	✓✓
Global Property	✓	Global Property	×
Unlisted Property	✓✓	Unlisted Property	??
			TOTAL
		A-REITS	✓✓✓
		Global Property	✓
		Unlisted Property	✓

Allocating the beta and alpha Budget....

	Beta Budget			Beta Risk		Diversification	Beta
	Yield	Growth	Expected Return	Volatility	Inflation Protection	Correlation to Balanced	Allocation within Balanced
A-REITS	✓✓✓	✓✓	✓✓	x	✓✓✓	✓	✓✓✓
Global Property	✓	✓	✓	xx	✓✓	✓+	✓
Unlisted Property	✓✓✓	✓✓	✓✓	x*	✓✓✓	✓+	✓✓

	Alpha Budget			Alpha Risk	Diversification		Alpha
	Skill	Tactical	Expected Alpha	Tracking Error	Correlation to Balanced	Concentration /Liquidity	Allocation within Balanced
A-REITS	✓	✓✓✓	✓✓	x	xx	x	✓✓
Global Property	x	✓	-	xx	xx	✓	x
Unlisted Property	??	xx	??	xxx	✓✓✓	xxx	??

* frequency of measurement and transparency of pricing issues

	Total Return		Total
		Expected Return	Allocation within Balanced
A-REITS		✓✓	✓✓✓
Global Property		✓	✓
Unlisted Property		-	✓

Standard & Poor's Indices Versus Active (SPIVA) Funds Scorecard research

Report 4: Asset-Weighted Peer Group Returns to 30 June 2009

	Year to date (%)	One Year (%)	Three Year (Annualised %)	Five Year (Annualised %)
S&P/ASX 200 Accumulation Index	9.08	-20.14	-3.82	6.86
Australian Equity General	9.63	-14.43	-3.41	6.31
S&P/ASX Small Ordinaries Index	23.22	-28.58	-6.38	5.58
Australian Equity Small Cap	19.57	-20.56	-4.63	5.94
MSCI World Ex Australia Index	-8.40	-15.66	-10.25	-2.63
International Equity General	0.02	-5.46	-6.26	0.46
UBS Composite Bond Index 0+Y	-1.05	10.82	6.36	6.05
Australian Bonds	0.06	8.96	5.27	5.18
S&P/ASX 200 A-REIT Index	-12.90	-42.27	-22.66	-8.40
Australian Equity A-REIT	-8.37	-37.90	-21.20	-7.26

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