REITS (Newsletters Spring 1999, Winter 1998/1999, Fall 1998)

Inoculation Against the Flu?

The Asian flu; Japan caught it first and rapidly infected its geographic and economic neighbours. As the contagion spreads, oozing outwards like some miasmic smog, stockmarkets cough, hack, falter and sometimes fail. Australia and New Zealand, their economies tied to the Far East, are now enveloped in its clammy embrace. Our own dollar has lost 11% of its value since the year began, measured against the U.S. greenback ... prompting some American artists at this year's busker festival in Halifax to pitch for more generous tips to meet their shortfall. Ah well, we'll only ask half of them back next year.

It's also caused the Kondratieff believers amongst our readers to proclaim that the end is nigh. Nikolia Kondratieff was a Russian economist who in 1920, postulated the existence of a "long wave", a underlying economic cycle with a length usually cited as 50 to 60 years and averaging 54 years. Superimposed on this long wave is a medium length cycle averaging 17 years ... and on top of that is the normal business cycle with a duration of four to five years. The troughs grow progressively deeper as each coincides. The big bang occurs when all three cycles hit bottom together: an event roughly scheduled to coincide with the end of this millennium, [Newsletter Vol. 2 No. 52]. Nikolia was a man of considerable integrity and astonishing imprudence. Upon discovering that communism, not capitalism was fatally flawed he relayed the important news to Stalin ... and was promptly incarcerated. But we digress, Ken Giffin CA (1-902-468-1273), our long wave guru hints that Atlantic Canada, buoyed by the recent oil and gas discoveries may surf through. If he is willing to share his thoughts with us, we'll pass them on to you. In the meantime let's take stock ... well maybe not stock ...

Thanks to the Asian flu, the stock market presents what Garth Turner (no relation), would have us believe is a great "buying opportunity" ... and what Kondratieff fans regard as the gathering clouds of the big storm. How can you inoculate yourself against the latter whilst still enjoying the fruits of the former? We're going to tell you. So turn off the phone, close those files, stand and face North Street, Halifax, promise to utilise our services exclusively in the future ... and read on.

The Efficient Frontier

The risk/return tradeoff is a simple concept, the greater the risk, the higher the return investors demand as compensation. In 1952 Harry Markowitz developed a model to accommodate risk in a portfolio setting and thus gave birth to a host of acronyms the most prominent of which are MPT (modern portfolio theory) and CAPM (capital asset pricing model). Since risk is defined as the volatility of the return, it is possible to diversify away non-systematic risk by spreading your money over at least 14 stocks, choosing investments that are counter-cyclical. So you need to select investments whose returns are negatively correlated ... as the return on one investment declines, the return on another increases. That way you maximise your return for a given degree of risk. The various investment portfolios which produce the greatest return for each given degree of risk can be plotted on a line called the efficient frontier. You then select the portfolio mix lying on this "efficient frontier" which meets your personal risk/return trade-off. But of course you know all that! The trick is to create a portfolio which lies on the efficient frontier. Be patient, we're getting there! In 1994 University of British Columbia professors, Stan Hamilton and Robert Heinkel investigated the role of real estate in a pension portfolio. They looked at data from the fourth quarter 1972 to the fourth quarter 1992, a period which covered the high growth 1970s, the recession in the early 80s, the stock market crash in 1987 and the property market meltdown in 1990. They discovered that investment quality real estate was negatively correlated with bonds ($R = -0.154$), and marginally negatively correlated with stocks

($R = - 0.022$ with TSE300 Total Return Index). [Perfect correlation is stated as $R = \pm 1$]. They concluded that Canadian pension funds, which currently have less than 4% of their assets in commercial real estate, could reduce their risk by increasing this allocation to between 5% and 15%. Their data actually showed 5% (conservative), 23% (risk tolerant) and 31% (aggressive), but perhaps mindful of the recent market meltdown they opted for the more judicious recommendation.

Hamilton and Heinkel also looked at Real Estate Investment Trusts focusing on American data, since REITs were not yet a Canadian phenomena. Although REITs are a real estate investment vehicle, the units transact on the stock exchange not the real estate market, and they exhibit the characteristics of the former rather than the latter. REITs are quite highly correlated with stocks ($R = 0.72$), though less so with bonds ($R = 0.45$). They don’t have the same potential as real estate in the raw, to reduce risk in an investment portfolio. The good doctors indicated portfolio allocations of 1% (conservative), 14% (risk-tolerant) and 28% (aggressive).

The Hamilton Heinkel study is available from the Bureau of Asset Management, U.B.C. (ISBN 0-88865-522-3). Don’t be cheap, buy it! We can’t loan you our copy, its overdue ... The event omitted by their study is the buying opportunity afforded by the 1990 market meltdown. If you are a Garth Turner adherent or a Kondratieff fan you will wish to leave us at this point. However if, like the late Andrew Sarlos, you believe that real estate has already taken its kicks, whilst the stock market is in the last leg of this bull, you may want to read on ...

Ah! There is Life After Death

It is tempting to dismiss Canadian Reits as a reincarnation of the real estate mutual fund industry that briefly flourished in the 1980s ... and all but perished in the 1990 property collapse. After all RIOCAN Reit was begat of Counsel Real Estate Fund; MD Realty is now CREIT; Roycom Summit Fund, SUMMIT Reit and so on ... However there are important differences. The 1980s style real estate pooled funds basically came in two guises, both fatally flawed. The closed end pool had a fixed life, typically 10 to 15 years. Money from the sale of investment units was used to acquire real estate assets. Investors either held their investment for the fixed life of the fund, when the properties were sold, or attempted to sell their investment units privately. Liquidity was low, and the fixed life of the fund ignored the reality of property market cycles. By contrast the open ended pool had no fixed life. Investment units were continually offered for sale by the promoter and the fund pursued a program of real estate acquisition or sale, concomitant with market conditions. The investors could redeem their units at any time based on the appraised value of the real estate assets in the fund. The open ended pool thus had the virtue of liquidity its closed-end sibling lacked ... and since the value of the investment units was a mirror of the underlying real estate asset value, they were negatively correlated with the stock market. Unfortunately they suffered from "appraisal lag". Because appraisers formulate their opinions using historic data, they underestimate values when the market is rising and overestimate them when it is falling ... In any event the 1990 market meltdown was so sudden and severe the pools were overwhelmed with redemptions and most had to re-organise as closed-end pools. They have re-emerged as Reits. However the investment units are now sold on the stock exchange at prices which reflect their risk/return tradeoff versus competing stocks and bonds. To a very large degree therefore the value of the investment unit has been "uncoupled" from the worth of the underlying real estate asset and only reflects its immediate cash flow generating capability. Reits therefore focus on acquiring property whose cash flow is "accretive" i.e. produces a higher return than that demanded by the Reit’s own investors in the stock market. They have been aided in this quest by the 1990 property market collapse. The renaissance in rental rates, riding on the country’s economic recovery east of the Rockies, has created an ideal investment climate for the Reits and they have taken full advantage of it.

The Real Estate Race

"In 1992, Germans used 170 million condoms, Britons used 160 million. The French used 100 million. We can catch up, but we must go faster."

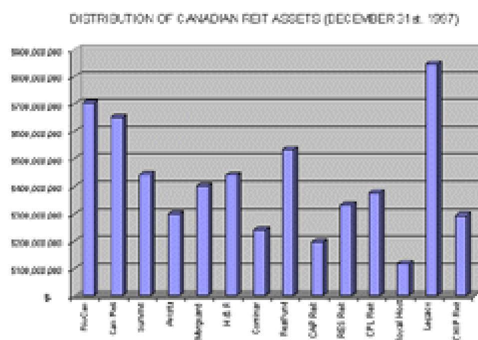
Philippe Douste-Blazy, France’s Health Minister.

And that is probably a sentiment too, shared by many Reit acquisition managers. The past three years have presented buying opportunities the like of which we may never witness again. However as the economy recovers and pension funds accept that the sky is not falling, real estate will, we believe, return to its appointed position in the firmament. Public real estate companies have invested heavily in Canadian real estate, though Reits are still in the vanguard in Atlantic Canada. This is who they are, what they do, when, why and where they do it ...

Reits, The Five Ws

The growth of Canadian Real Estate Investment Trusts has been meteoric. As at the 31st December 1997 their assets totalled approximately $6.8 billion (we’ve cheated a little by including Cominar Reit which did not commence operations until 31st March 1998). Several of the Reits were formerly closed end mutual funds and thus started with portfolios diversified by asset class and location. Two, CAP Reit and RES Reit, focus on apartment properties since they are less risky: the loss of a tenant does not have the same impact on cash flow as would be the case with a retail, office or industrial property, and demographics rather than the economy dictate rental levels. By contrast, Royal Host, CHIP and Legacy specialise in hotels. Legacy affords investors the opportunity to buy part of a Canadian heritage property such as the Royal York Hotel in Toronto, but Royal Host and CHIP mix it up with mid-market hotels. These are higher risk properties which should offer superior returns. RIOCAN is the only Reit that specialises in retail: President Edward Sonshine waxes lyrical that this is "almost a magical time" and indeed the happy juxtaposition of low interest rates and a depressed property market have provided buying opportunities that we have not witnessed during the past thirty years. We have detailed the 14 Canadian Reits in the table below and have illustrated their assets graphically in the bar chart.

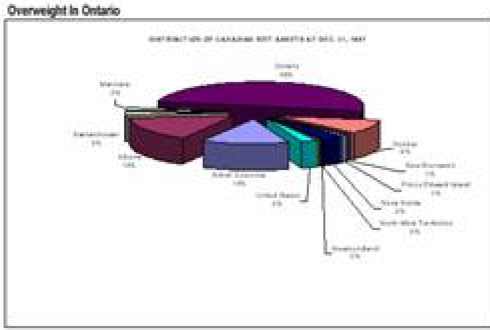
click for full sized graph



To see complete Canadian REITS data for the Year Ending 31 st December 1997.

click for full sized graph

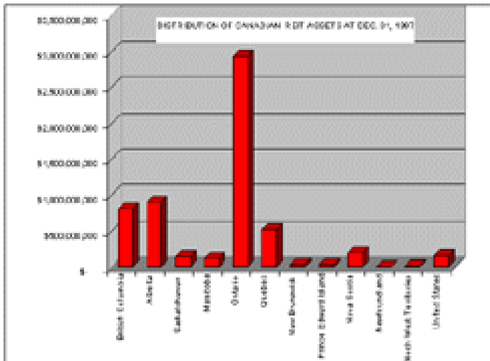
TURNER DRAKE & PARTNERS LTD.



The pie chart shows the distribution of Reit assets at 31st December 1997, but also includes Cominar Reit which officially did not commence operations until 31st March 1998. The investment policy of the Reits, taken as a whole reflects the usual ethnocentric bias of the head offices, most of which are located in Ontario. They are not well poised yet to benefit from the oil and gas activities in Atlantic Canada though many Reits notably Avista, H & R, CAP, CPL and Royal Host turned their attention to the region in 1998. (RioCan, CREIT, Summit, Avista, Realfund, Royal Host, CHIP, already had some investments here).

Nonetheless Reit investments in Ontario dwarf those elsewhere: almost $3 billion had been invested there by 31st December 1997:

click for full sized graph



Source: Turner Drake & Partners Ltd. Field Survey, September 1998.

It’s the Right Reit Time in the Maritimes

The 1990 property collapse coincided with overbuilt markets and soured many pension funds on the region. The recession took its toll too on the property companies and they too retreated or collapsed under the weight of their debt. The resultant void presents enormous buying opportunities, the like of which we have not witnessed during the past thirty years. The Maritimes are now stitched together with a new highway network which, when it is completed next year, coalesces the three provinces into a single market most of which can be easily reached by automobile in a morning. Moncton, N.B. is now just 2½ hours drive from Halifax; Charlottetown, P.E.I., 3 hours (thanks to the Confederation Bridge opening, last year). Fredericton, N.B. to Halifax, N.S. travel time will be less than 4 hours when the highway twinning is completed next year. Five years ago those centres would have been the best part of a day’s driving time apart. For those nurtured on the Internet, distance is measured in terms of

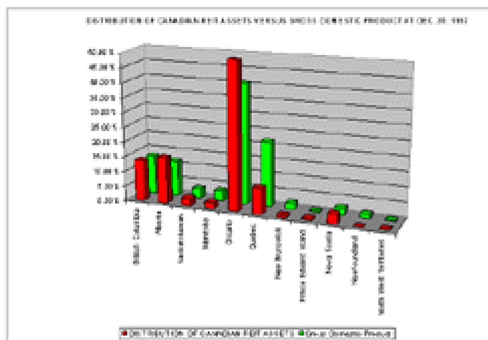
accessibility; time not kilometres is the defining medium ... today only old people (those over the age of thirty) place any significance on provincial boundaries. Young Halifax consumers now think nothing of jumping in a car for an afternoon at the Magic Mountain water park in Moncton, or Cavendish Beach, P.E.I. ... and vice versa. Property investment companies and pension funds have been slow to recognise this new reality, most after all are run by ... well, people past the age of thirty ... some by people well past thirty! The Reits however have started to move into this vacuum. CREIT, which has been here longer than most in its former life as MD Realty, records its 1997 return on book values as follows:

Region	Return on Book Value
Quebec	9.1%
British Columbia	9.4%
Alberta & Prairies	10.1%
Ontario	10.5%
Maritimes	11.7%

Source: CREIT 1997 Annual Report.

Given that the Maritimes should start to reap the benefit of the offshore oil and gas industry over the next two years, including the onshore impact of Sable gas, whilst producing superior returns, one would expect increased interest by property investors here. Certainly the Reits still have some way to go:

click for full sized graph



Reits versus Real Estate

TURNER DRAKE & PARTNERS LTD.

As the Hamilton Heinkel study discovered, the value of Reit shares are quite highly correlated with stocks (Newsletter Vol. 2 No. 61), rather than changes in the value of the underlying real estate asset base each Reit owns ... a unhappy circumstance amply demonstrated by recent events. Since the stock market rises and falls with U.S. President Clinton's er ... libido, Reits do not afford investors the same opportunity for diversifying away non-systematic risk as real estate in the raw. However for those long term investors who like the thought of participating in the real estate recovery, but place a premium on liquidity, Reits do provide one vehicle for doing so. On the other hand investors, or groups of investors, who prefer to trade off liquidity for higher returns should consider the more direct route. It is again possible to obtain mortgage financing for 65% of the property value without including your first born as collateral. If you are able to raise the remainder, there are opportunities available still in Atlantic Canada, to acquire property at prices which will yield upwards of 12% in the first year, on your equity investment. A tempting prospect in these days of increasing economic uncertainty. Most of those opportunities are located in Nova Scotia's capital city ... and so, by happy coincidence, are we. If you would like to explore them, please give Mark Offman or Verna Turner a call at 1-800-567-3033.

TURNER DRAKE
& PARTNERS LTD.