APN Asian REIT Fund: What could possibly go wrong?

Everything has been going swimmingly well at APN's Asian REIT Fund. Inflows have been steady and I'm pleased with the 21.81%[1] return over the last 12 months. In fact, it may well be that the returns explain the steady inflows. Such is the life of a fund manager.

We do, however, know that trees don't grow to the sky. Risks, some of which manifest at shareholders expense, are an inevitable consequence of investing. Unfortunately, most investors consider them only when it's too late.

We're not going to make that mistake. Having enjoyed impressively high returns over the past year it's time to consider what might go wrong with APN's Asian REIT Fund.

The most recent REIT rally was fuelled by lower bond yields, not just in Asia but across the globe. The US Federal Reserve under Janet Yellen had pursued a policy of "normalization" over almost a decade. The Fed's ambition was to move away from record low interest rates as the US economy recovered from the global financial crisis, a policy position pursued by her successor Jerome Powell.

After the market wobbles from October last year to January, Powell has reversed that position, halting any further plans to raise interest rates. So-called bond yield proxies like infrastructure stocks and REITs rallied as a consequence. This wasn't a surprise. Seen as safe yield havens, REITs often behave like an interest rate sensitive sector, if only over the short term.

The risk lies in the reason behind the Fed's move. The pause in rate increases is a response to weaker economic conditions and slowing growth. This inevitably points to a series of potential impacts, from lower corporate profitability, leading to decreasing investment and potentially increasing unemployment, to slowing retail sales growth and downward pressure on rents. Under such conditions retailers will be quicker to close underperforming stores.

What has been good for REITs in the short term - the assurance of no further interest rate increases - could well be a symptom of trouble ahead.

What defence do investors in the APN Asian REIT Fund have against this possibility? Well, the lease structure offers a cushion against a slowing economy. Companies need to decide how long the weak economic conditions will last and whether they are able to 'tough it out' without making too many drastic changes, like relocating staff or closing stores or offices.

It's much the same for individuals who rent their homes. If, for example, I lose my source of income but have six months remaining on my rental lease, I don't immediately move back in with mum and dad and stop paying rent.

The lease is still my obligation that needs to be fulfilled, no matter where I live. So it is for tenants of commercial property. In this sense the risk to investors of a slowly economy is real but cushioned by the rent collecting nature of real estate investment trusts.

Another risk to consider in this 'back to lower' interest rate environment is that asset values continue to be pushed up because borrowing costs are so low.

REITs hell bent on getting bigger may take advantage of their lower cost of equity to raise capital to buy assets. The problem is that borrowing costs have been low for quite some time. It is, therefore, an especially risky time if the weak economic conditions that led us to this pause in rate increases continues to worsen. Just think about it; a year ago the world was in a synchronised global expansion. It remains synchronised but is now moving in the opposite direction.

There is no way one can map out all the risks, but as the father of modern investing, Benjamin Graham, once said, "successful investing is about managing risk, not avoiding it".

In managing the APN Asian REIT Fund, I am always wary of the downside, especially so when things are going swimmingly. Our fund owns high quality assets in diversified geographic and commercial property markets. That should give investors a high degree of confidence in the income stream that these assets produce.

So should the fact that dividends from Asian REITs were left unscathed during the global financial crisis. A lot would have to go wrong before the income collected and paid by the REITs in which we invest was impacted.

This should help our investors sleep well, especially after such an impressive return over the past year. Risk cannot be eliminated but we can prepare for it. Consider the APN Asian REIT Fund prepared.

1 Performance to 31 March 2019. Returns shown are net of fees and expenses and are annualised for periods greater than one year. Assumes distributions are reinvested. Investors' tax rates are not taken into account when calculating returns. Past performance is not an indicator of future performance.

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Established in 1996, APN's listed on the ASX and manages $2.8 billion (as at 31 December 2018) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

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