Finding security in a time of volatility - Part II

If a week is a long time in football, in financial markets a fiscal quarter can feel like an eternity.

In the first part of this series, we noted the high volatility in the final quarter of 2018 and how some investors might feel the best place for their portfolios was a biscuit tin buried in the backyard.

The last few months might have caused them to reach for a shovel. The local equity market is up 10.9%[1] (S&P/ASX 200 Accumulation Index) for the first quarter of the year while the APN AREIT Fund has returned a satisfying 9.8%[2] over the period. Volatility, meanwhile, is down by 33.8%[1] (S&P/ASX 200 VIX Index).

The trigger was a reset in central bank rhetoric - the RBA included - and the prospects of domestic fiscal stimulus. Equities markets are again on the up-and-up.

Needless to say, the original causes of the volatility late last year have not gone away. The prospect of a US/China trade war hasn't receded and may well have increased in recent days. Brexit, meanwhile rumbles on, ever more chaotic. Domestically, residential house prices continue to fall and there is still no sign of wages growth.

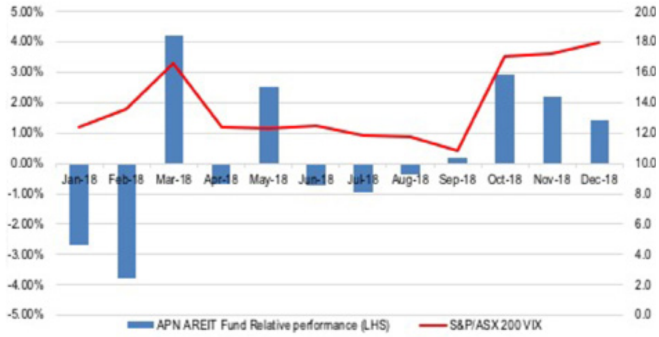
For investors after high income certainty with lower relative risk, who aren't prepared to bury their portfolios – and their heads - in the ground, thoughts naturally turn to security.

Regular readers of our research will know that AREITs tend to outperform in periods where market expectations of volatility are high. The strength of this relationship appears to have increased in recent years, suggesting the defensive characteristics of AREITs have been in demand.

In Part 1 we suggested that the AREIT sector total return appears to exceed that of the equities market during periods where market expectations of volatility is relatively high.

Below we have replaced the index benchmark (S&P/ASX 200 AREIT Accumulation Index) with the APN AREIT Fund. The chart below shows the Fund has also outperformed relative to the S&P/ASX 200 Accumulation Index through periods of elevated share price volatility in 2018.

1 year APN AREIT Fund relative performance and volatility*

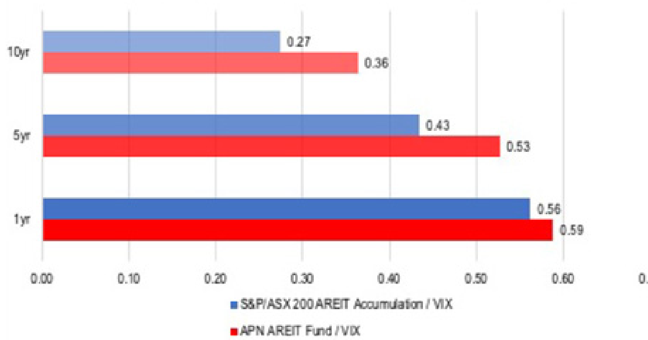


Source: IRESS, APN FM

*AREITs relative performance is the S&P/ASX 200 AREIT Accumulation Index less the S&P/ASX Accumulation Index. Market volatility is the S&P/ASX 200 VIX Index, used by investors, financial media, researchers and economists for insights into investor sentiment and expected levels of market volatility

One can't learn too much, however, from a solitary year. How did AREITs perform relative to equities through periods of elevated volatility over a 1-year, 5-year and 10-year time horizon? Correlation analysis helps us answer this question:

Correlation: APN AREIT Fund Relative Performance & Market Volatility*



Source: IRESS, APN FM

*AREITs relative performance is the S&P/ASX 200 AREIT Accumulation Index or APN AREIT Fund Total Return less the S&P/ASX 200 Accumulation Index. Market volatility is the S&P/ASX 200 VIX Index

Here, the blue bars, which show volatility, tell us what we already know; that AREITs outperform during periods where market expectations of volatility are high.

The new finding is shown by the red bars. This reaffirms the relative success of our flagship APN AREIT Fund by delivering a stronger positive correlation to market outperformance than the benchmark through periods of elevated market expectations of volatility. In layman's terms, when the market expects volatility, the AREIT Fund is more likely to outperform.

It's also worth appreciating the increase in correlation over the last 10 years, when AREITs have been increasingly sought after against a backdrop of expected market volatility.

As income investors focused on minimising risk, we are laser-like in our implementation of three components to our underlying investment process. We believe these three factors have helped to deliver relatively low volatility in our investment returns over the 10 years since the Fund's inception:

1. Passive income focus

Concentrating our investments in AREITs that derive most of their earnings from contracted rental receipts, as opposed to riskier sources like property development, funds management and transaction performance fees;

2. Asset quality

Directing our Fund's exposure to the highest quality assets located in the deepest and most active markets. We believe that, over the long term, these assets will be best positioned to deliver rental growth;

3. Appropriate capital structure

We prefer AREITs with a suitably conservative balance sheet and a healthy level of fixed debt coverage and a long maturity profile across diversified sources of finance.

All of this suggests that in times of market turbulence investors might be well served by the APN AREIT Fund, especially for investors after high income-based returns with lower relative risk in an environment where expectations of volatility might be just around the corner.

1. IRESS, 31 March 2019.
2. Returns after all fees and expenses. 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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A specialist real estate investment manager

We actively invest in, develop and manage real estate and real estate securities on behalf of institutional and retail investors. APN's approach to real estate investment is based on a 'property for income' philosophy.

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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