review insights from real estate experts

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Visible performance and hidden risks

In investing, as in other areas of life, there is the visible and the hidden. Something tangible, like an object or a number, is easily seen, and more memorable because of it. The hidden - a risk or a threat, for example - travels below the radar, until it materialises.

So it is right now with the performance of APN's AREIT Fund. Since inception in January 2009, it has returned an annual income of 8.34%[1] and a total return of 13.97%[2] a year, comfortably beating the ASX 300 AREIT index. These numbers reflect APN's "property for income" style, with the majority of the returns driven by income rather than growth.

The figures are clear and visible, impressive even. Right now, though, relative performance (compared to the index returns) are not quite as impressive. In the year to June 30, the ASX 300 AREIT Index rose 19.4% while the AREIT Fund returned 10.2%[2]. This is a significant difference which for those investors who may not be fully aware of APN's investment approach, naturally raises questions. We'd like to provide some context, starting with an explanation for this underperformance.

The best performing AREITs over the year to 30 June 2019 were Charter Hall (ASX:CHC), up 72.4% and Goodman Group (ASX:GMG), up 59.9%. Goodman's outstanding performance now makes it the largest AREIT by market capitalisation, bigger even than Scentre Group (ASX:SCG), owner of Westfield shopping centres across Australia and New Zealand.

In June 2018, CHC and GMG accounted for 15.8% of the AREIT 300 index. A year later this figure has risen to 22.5%. This growth is a function of the unsustainable returns of these two stocks which have provided over half the AREIT indexes FY19 total return.

And yet the AREIT Fund's portfolio weighting to Goodman is just 5.82% with no exposure to Charter Hall. In market parlance, the Fund has been substantially 'underweight' the two best performing stocks in the index.

This is the reason behind the fund's significantly lower than index return, a figure that is up in lights for all to see. What is less visible, are the risks taken by investors to achieve index returns.

Goodman's latest results revealed that just 34% of earnings came from rents whilst Charter Hall's proportion was just 39%. The majority derived from development and funds management activities, both significantly more volatile sources of revenue than rent.

With low payout ratios and dividend yields of 1.9% and 2.7% respectively, investors are apparently happy to pay hefty amounts for non-REIT type returns based around modest income and uncertain growth. The approach is more like a growth-orientated equity investment that property for income.

APN is not. AREITs can't provide returns of the magnitude delivered by Goodman and Charter Hall on a sustainable basis. In fact, such is the nature of these two companies, there's a powerful argument that they shouldn't be considered AREITs at all. In other global developed markets these stocks would be considered real estate operating companies rather than property trusts.

The difference is significant, especially for those focused on future rather than past returns. During the global financial crisis, many property developers and fund managers wrestled with bankruptcy, some unsuccessfully.

The industrial property sector in which Goodman operates fell over 80% during the crisis and in just two years, AREIT profits from property development and funds management evaporated. Many investors, excited by the recent increase in share prices, and perhaps reassured by the AREIT label, are ignoring this history. We're not.

We could not stay true to the AREIT Fund's mission of stable and secure income over the long term and chase the kinds of returns posted by Goodman and Charter Hall in the last 12 months. In our view, being underweight two of the top performing stocks in the AREIT index is staying true to our investment style (and mandate), managing our investors' money responsibly and cautiously.

Many investors see the performance of the index but fail to see the risks. Investors in the APN AREIT Fund, many of whom rely on us for their monthly income, pay us to think about these risks and manage them accordingly.

That's why the APN AREIT Fund's portfolio is full of investments that deliver monthly income from quality tenants on long term leases run by professional property managers. We are not prepared to put the stable, secure income these assets deliver, and on which our investors rely, at risk.

This approach entails having minimal exposure to Goodman and Charter Hall. The short term cost of remaining cautious is a performance penalty. The long term gain is a consistent, relatively high level of income which in today's low interest rate environment is hard to come by.

In AREITs, you can have a high quality, reliable income stream sourced from rent or you can chase growth from low yielding entities focused on development and funds management earnings which are far riskier and far less predictable. Unfortunately, you can't have both.

Some may pay a hefty price to learn this lesson. We doubt investors in APN's AREIT Fund will be among them.

1. As at 30 June 2019. Past performance is not an indicator of future performance.
2. As at 30 June 2019. 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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APN Property Group
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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