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Get Real: Billions Set to Pour into Real-Estate Investments

Mutual funds are about to get much more real. A big change is coming in how stock indexes measure the market, one that's likely to push tens of billions of dollars into real-estate investments, according to estimates. All that cash could drive further gains for a group of stocks that's already done quite well since the financial crisis. Critics say it could also make an area of the market that they call overvalued even more so. The deluge of cash is the result of a re-think by index providers about how they see the market's construction. The Standard & Poor's 500 and other indexes have long split the market into 10 main sectors, such as technology companies or utilities or industrials. After the market closes on Aug. 31, S&P Dow Jones Indices and MSCI will carve out real estate to become the 11th sector. For investors who own only broad index funds, the change won't mean much. Real-estate investment trusts, which own apartments, office buildings and shopping malls, will still make up about 3 percent of the S&P 500, and they'll make up the same percentage of S&P 500 index funds. The change is much more than housekeeping for actively managed mutual funds, which still control more dollars than their index-fund rivals. It's a stock picker's job to be different from the index. That's why they charge more in expenses than S&P 500 funds, for the opportunity to do better than the index. Even so, active managers pay close attention to how indexes are constructed. If their portfolios are very different, they'll need to explain why to their investors. Many mutual funds have nothing at all invested in real estate. Nearly 40 percent of large-cap core fund managers have zilch, according to a review by Goldman Sachs strategists. But that's not obvious from a quick glance at funds' marketing materials, which generally show how much is invested in each of the 10 big sectors. REITs are currently categorized as part of the financial sector. So an actively managed fund could have 16 percent of its investments in financial stocks, the same as the S&P 500, but with no real estate. At first glance, such a fund could look like it's built similarly to the S&P 500 index. But come September, that same fund would suddenly appear as if it's optimistic about banks, insurers and other financial companies — and pessimistic about real estate — because it will hold more financials and less REITs than the index. Estimates vary widely on how much REIT buying the index changes will drive, but most are big. They range from about $10 billion to 10 times that."It's a tsunami," says Mike Underhill, portfolio manager at the RidgeWorth Capital Innovations Global Resources and Infrastructure fund, which owns several REITs. And he says the buying has already started. He's recently noticed prices doing better than he'd typically expect for REITs that operate in areas where renters are falling behind on rents. He attributes that to mutual funds buying REITs in advance of the index shift. The expected jump in demand could help keep REIT prices high, even after their strong performance both this year and since the stock market bottomed in March 2009. An index of REITs by MSCI has returned a cumulative 434 percent since March 9, 2009, versus 265 percent for the S&P 500. Investors have been buying REITs in part because they offer relatively big dividends. Bond yields are low, so investors have gone searching elsewhere for yield. And REITs can avoid taxes if they pass on 90 percent of their profit to shareholders as dividends. That's drawn investors to REITs like Simon Property Group, which owns shopping malls around the country, or Public Storage, which runs self-storage units. The jump for REITs mean they make up about 3 percent of the S&P 500 index now, up from 0.1 percent in 2003, according to Goldman Sachs. When it becomes the 11th sector, real estate will be roughly the same size as the utilities, raw materials and telecom services sectors. The largest component in the S&P 500 is technology, which makes up 21 percent of the index. All the demand for

REITs in recent years, though, means their prices have climbed not only on an absolute level but also relative to how much cash their businesses are producing. The jumps have been big enough that some investors call REITs overly expensive, while others say they’re fairly valued. Most fund managers agree that REITs are no longer cheap. The index changes could have particularly big impacts on investors with funds that focus on just financial stocks, which control a total of about $39 billion in assets. The largest such exchange-traded fund, the Financial Select Sector SPDR fund, has already laid out its plans. It will pay out a special dividend to investors in September, one made up entirely of shares of an ETF created in October that focuses exclusively on REITs. But the index shifts will likely reverberate across the market. S&P Dow Jones Indices and MSCI say they’re upgrading real estate to stand-alone “sector” status because they want to acknowledge its importance to the global economy. That may push lay investors to give the sector a closer look. **(Denver Post)**

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Denver Laundromat Transforms into Co-Working Space for Lawyers

It might have been less expensive for law partners Siddhartha Rathod and Qusair Mohamedbhai to gut a portion of the industrial warehouse they purchased on Lawrence Street in Denver's River North neighborhood and start from scratch. Instead, they hired crews to painstakingly remove soot from the wooden ceiling damaged in a fire years ago and strip away the floor panels to get to the textured concrete surface.“The building has character. It has great bones,” Rathod said. The partners in Denver law firm Rathod Mohamedbhai LLC bought the building at 2701 Lawrence St. in December 2014. The previous owner already had renovated two-thirds of the 21,200-square-foot-building and there were 23 businesses renting there, including Angie's List, Colorado Vodka, and Apex Engineers Inc. But the law partners had an idea for a co-working space for lawyers. And they spent the last year updating 7,000 square feet of the the building but keeping its industrial personality. The building was originally the City Elite laundromat and was a hodgepodge of seven buildings, Rathod said. A client told them that her mother once worked at the laundromat at a time when it was one of the few places in the city that hired minority women. So, the partners call their building The Laundry on Lawrence to pay homage to the original owners, Rathod said. The floors are textured concrete, the walls are brick, and the pipes and ceiling are exposed. The new décor, including glass garage doors to separate the conference rooms, update the industrial lookl. But underneath, the building is completely modern with 1 gigabyte of fiber optic Internet. “We’ve been wanting to do a collaborative legal space,” Rathod said. “It was the right opportunity at the right time.” **(Denver Post)**

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Negative Interest Rates the Greatest Threat

As yield-deprived bond investors swamp the asset class, real estate managers need to adjust their performance expectations. “You need a fixed income view to be a real estate player, now more than ever,” declared Sabina Kalyan at this week’s PERE’s annual Europe

Summit in London. Kalyan is global chief economist and head of European research at real estate investment management giant CBRE Global Investors (GI). She made the remark midway through a keynote presentation in which she was listing reasons for European real estate investment managers and investors to be concerned about their future prospects. She analyzed oil prices, China's economic challenges, banking headwinds and a myriad of threats deriving from "populism" in society today. But it was negative interest rate policy, "NIRP" as she termed it, that she said has her most worried. Making apples to apples comparisons when you're dealing with a fruit bowl of problems is, by definition, impossible. But when considering which threats have the most direct impact on real estate pricing, then interest rates stands alone. Not only do they dictate lending conditions, but when they're as low they are today, they lead to asset price inflation, which in turn drives yield-deprived fixed income capital into the real estate asset class. Few can deny that this is happening at the moment, particularly in prime property markets. As Kalyan reminded the PERE audience, we're now seeing government bond rates in the sub-2 percent range. The margin between these bonds and prime property remains acceptable and yet yields are compressing to record levels. Showing delegates a chart depicting 10-year sovereign bond yields, including certain countries whose bond yields have now turned negative, Kalyan declared: "This chart is setting prices in our market", rather than real estate fundamentals. And given the heights that these have now reached, how many real estate managers today would be investing at the pace they currently are, were it not for the current spreads between cap and lending rates? That's a questions real estate investment managers and their investors should consider carefully. It may be hard to imagine any near-term scenario in which interest rates would rise meaningfully, but when a turning point does happen, how much of the real estate acquired today will become distressed? Bubbles can last for years, time enough for managers and their investors to benefit, sometimes multiple times. We are eight years on from the crash of Lehman Brothers, and yet, as Kalyan pointed out at PERE's conference, most of the world's most important economies are still feeding off state stimulus. But this cannot continue indefinitely and so both managers and capital providers should prepare for lower yielding investments at some stage. Bill Tresham, president at Canadian institutional investor Ivanhoe Cambridge, agreed as much when he shared with PERE's audience in an onstage interview the importance of convincing his firm's parent, the public, private and insurance fund manager Caisse de depot et Placement du Quebec, that the 11 percent to 13 percent annual returns they enjoyed in recent years are not sustainable. By his reckoning, even with all of his firm's manager selection and asset picking skills, 7 percent should be acceptable going forward. The opening speech at the conference was by renowned 'undercover economist' Tim Harford who, discussing effective forecasting techniques, extolled the virtues of changing your thinking when the facts change. Listening delegates might well agree that a fixed-income view will not always be so critical when central banks change tack. **(PERE)**

	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED TARGET RATE	.50	.50	.25
3 MONTH LIBOR	.66	.63	.29
PRIME RATE	3.50	3.50	3.25
10 YEAR TREASURY	1.64	1.73	2.37
30 YEAR TREASURY	2.44	2.58	3.08