TOP STORY FOR THE WEEK 21 June - 25 June 2021

AREITs earnings yield update – May 2021

Melbourne, Australia 29 June 2021.

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Australian real estate investment trusts (AREITs), as represented by the S&P/ASX 200 AREIT Index, returned +1.7% in the month ending 31 May 2021. The AREIT index underperformed the S&P/ASX 200 return of +2.3% over the month.

Over the 12 months to May 2021, AREITs posted a total return of +24.4%, underperforming the S&P/ASX 200 return of +28.2%. Recovery from the depths of falls prompted by the pandemic is reflected in this performance.

Sector Performance

Table 1 below shows the performance of AREITs for various periods ending 31 May 2021.

Table 2 – S&P/ASX 200 AREIT Accumulation Index Performance: Income Returns (31 May 2021)

	1 Month (%)	3 Months (%)	6 Months (%)	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)
Income Return	0.0	0.1	2.0	3.6	4.3	4.5
Volatility				2.1	2.1	2.1

Source: S&P/ASX 200 AREIT Accumulation Index (2021)

Over the 3 years and 5 years to the end of May, the sector produced total returns of 6.6% and 5.4% per annum respectively.

Returns were strong across all sectors. Sector returns in May were led by Industrial and Office AREITs which each producing a return of +2.8%, followed by Diversified AREITs with +1.2% and Retail AREITs with +0.3%.

Table 2 below shows the income performance of AREITs for various periods ending 31 May2021.

Table 1 – S&P/ASX 200 AREIT Accumulation Index Performance: Total Returns (31 May 2021)

	1 Month (%)	3 Months (%)	6 Months (%)	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)
Total Return	1.7	11.5	4.6	24.4	6.6	5.4
Volatility				19.6	27.8	22.5

Source: S&P/ASX 200 AREIT Accumulation Index (2021)

The income component of the total return was 3.6% for the 12-month period to May 2021. Annual volatility of income returns was 2.1%, which is low when compared with other asset classes. AREITs were trading at an earnings yield of approximately 5.9%, significantly higher than yields of both cash and Commonwealth Government bonds. The spread of the earnings yield over the 10-year government bond yield remained at 4.3%.

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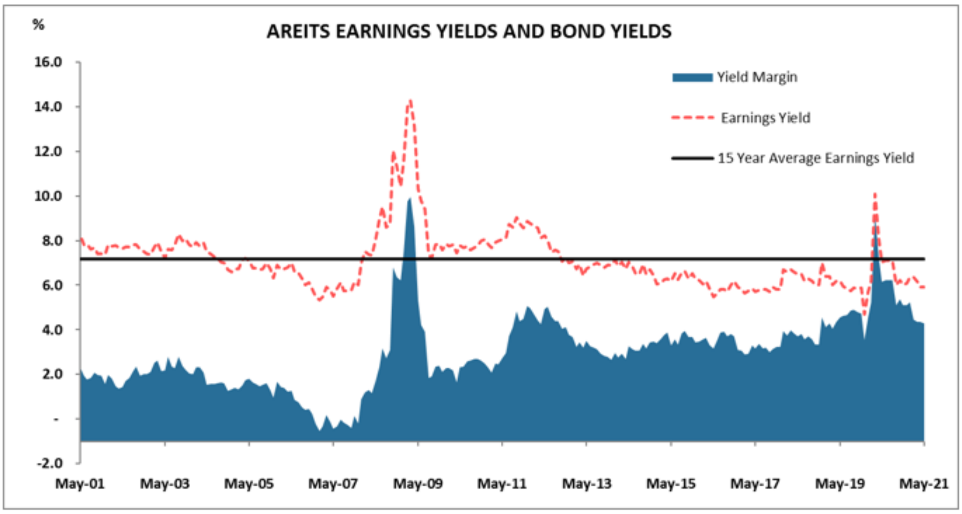
Changes over time of the spread between the earnings yield of AREITs and the 10-year government bond yield are shown in Chart 1.

Chart 1– AREITS Earnings Yields Compared to Bond Yields



Source: RBA, UBS (2021)

MARKET REVIEW

Property as an Inflation Hedge

Wharton professor Jeremy Siegel said inflation could spike to 20% in the next 2-3 years due to unprecedented fiscal and monetary stimulus. Consequences of inflation, including the impact of inflation on asset class returns and valuations, is a principal financial concern of investors. In managing inflation risk, various assets and/or combinations of assets can be included in a portfolio to protect investors against inflation. Such assets are called inflation hedges, with return patterns exhibiting a positive correlation with inflation.

Property investment is an inflation hedge. Inflation elicits varying responses in the range of property sectors through differing impacts on the income and capital value components of total return. Inflation is embedded in lease agreements as owners seek to keep rent levels rising in real terms. How quickly inflation affects net rents depends on the structure of leases, which in turn varies with property types. Current office rent reflects the inflation experience of one to several years of past inflation. In major property sectors, standard lease terms contain such clauses.

Inflation impacts the levels of both current rents and expenses. In the retail sector, current inflation raises net rents as the impact on rents and percentage rents based on turnover more than offsets the impact on the expenses which are not passed through.

Inflation impacts the capital value return in three ways. Inflation impacts net rents which feeds through to capital value via the capitalisation rate (“cap rate”). This particularly applies to retail assets. Inflation also affects the cap rate directly through expectations of growth in net rents and therefore demand for property investment. Finally, changes in inflation have an impact on the nominal level of interest rates which in turn will impact on the cap rate applied in property valuations.

AREITs which are focused on the ownership of property assets for rent, will provide the greater inflation hedge. GPT and Dexus provide a significant level of inflation hedging through office property. Despite the turmoil of the pandemic, retail property through AREITs, such as Scentre Group, provide real income growth.

For investors with expectations of maintaining retirement income in real dollars, the inflation hedging role of property is material. Listed property, through lease structures, provide a hedge against rising inflation.

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