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Rise of passive investment causes headaches for REITs

Experts suggest changing shareholder mix is influencing share prices, particularly in wake of Brexit vote

BY GUY MONTAGUE-JONES

The ownership of listed property companies is undergoing a transformation that is having a potentially distorting effect on share prices and forcing REITs to seek out new investors.

In recent years, tracker funds and exchange traded funds (ETFs) have grown in prominence while actively managed funds specialising in listed property companies now own significantly less stock than they once did.

Some now argue that this shift in the make-up of shareholder registers is starting to affect the share prices of different companies in ways that do not necessarily reflect their underlying performance. This has been brought into focus by the fallout from the EU referendum result, which caused some companies, particularly those with significant London development exposure, to suffer sharp falls in share prices.

Passive investment has gained in popularity across the listed sector because of an investor backlash against the high fees charged by active managers and the lack of evidence of outperformance to justify them. The extent of the shift is underlined in BlackRock's latest results, which show net inflows totalling $64.5bn (£49.9bn) into its iShares ETFs in the first quarter of 2017 alone, while its active institutional funds suffered net outflows of $1bn.

Success story: ETF growth is driving buying activity and influencing share prices

WATCHARAKUN/SHUTTERSTOCK

Complex algorithms

In the UK listed property sector, the same trends apply. Over the past five years, active property fund ownership of the biggest UK REITs as a proportion of total fund ownership has fallen from 33.3% to 25.2%, while generalist index fund ownership has more or less doubled to 15.4% and property specific index fund ownership has grown from 8.2% to 10.8%, according to capital advisory firm Radnor Capital Partners (see graph overleaf).

ETFs typically track an index, such as the FTSE 100. However, a plethora of more sophisticated smart-beta ETFs have emerged that use complex algorithms to pursue more specific investment strategies. A common type is a dividend-focused ETF that screens companies for dividend growth and, in the wake of the Brexit vote, a popular trade was to invest long in companies that earn the bulk of their revenues overseas and short more UK-focused companies.

The largest UK REITs are believed to have been caught up by this trade. Their poor share price performance in the wake of the EU referendum could have "amplified the feedback loop" for these Brexit algorithms and driven more shorting, according to one REIT insider, who questions whether they have caused share prices to overreact.

This touches on a wider point about ETFs. So far, they have performed as well, if not better, than active funds, and part of the reason for this could be that they are benefiting from their own success. In other words, their growth is driving buying activity that is significant enough to influence share prices.

Analysts at Green Street Advisors in the US » made that point earlier this year in an investor note called 'The Indexing Headwind' and went a step further, arguing that the changing ownership of US REITs was a cause of the recent underperformance of actively managed funds, which have traditionally performed better than such funds in other sectors.

They also argue that the rise of passive funds and decline of actively managed funds is negatively affecting the share price performance of the most highly-regarded US REITs. Although the paper's focus was on the US market, a board member at one of the top UK REITs says the same issues apply in the UK.

Green Street's analysts say actively managed funds dedicated to investment in REITs suffered large outflows in recent years and that their forced selling has had a disproportionately negative effect on the companies such funds prefer, which typically offer lower-than-average dividend yields.

"As redemptions have occurred, selling pressure on the shares of those companies has been far more pronounced than has been the case at other REITs," they argue. "The mismatch in fund flows need only have had a small impact at the margin on a regular basis to have caused a sizeable impact on share prices."

At the same time, they say the growth of passive funds is benefiting more income-focused REITs. "The passive investors are bidding for shares of those companies unloved by the dedicated investors, putting upward pressure on those share prices," they say.

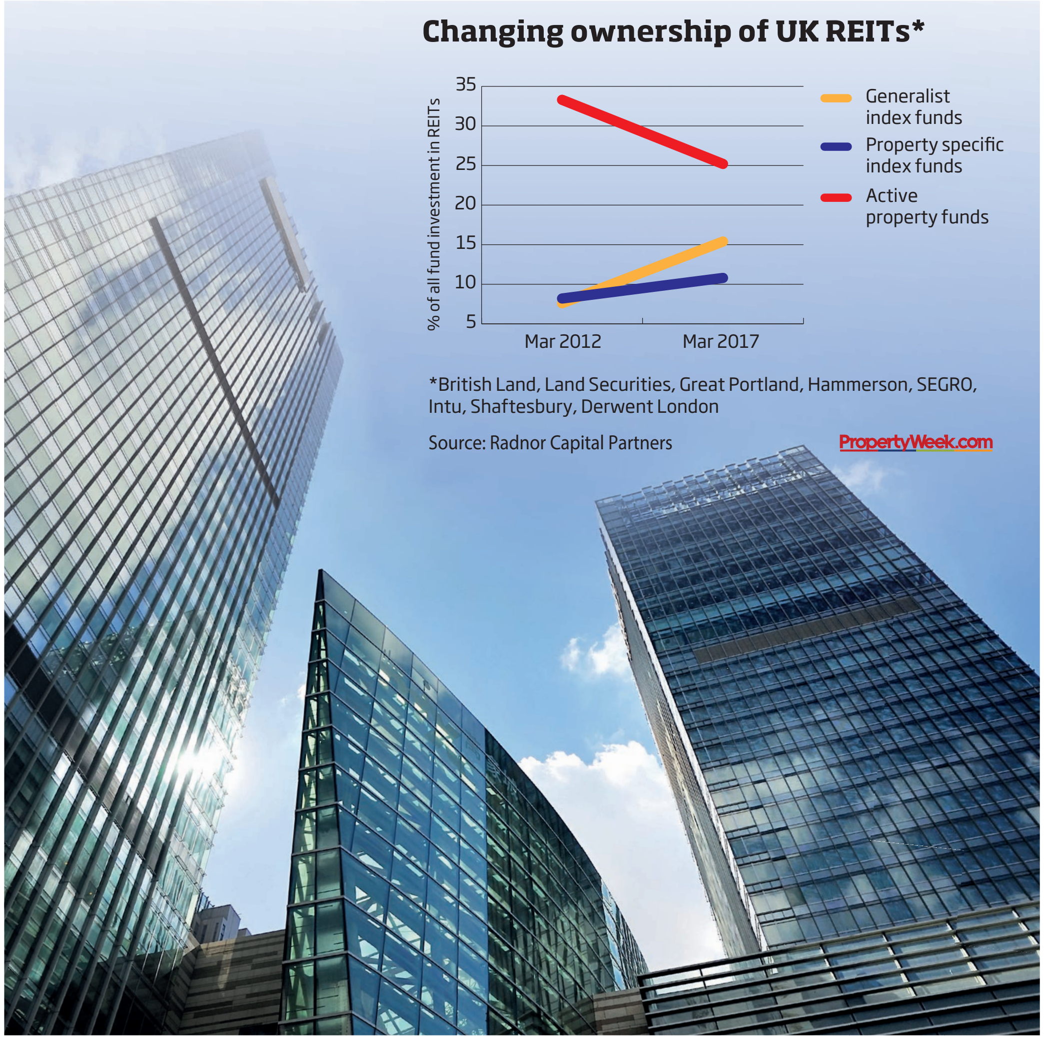
Another factor contributing to the recent underperformance of specialist investors could be the low interest rate environment, which has helped companies that invest in long-income property and deliver higher than average dividends.

In the UK, the best-performing companies in 2016, including Secure Income REIT, MedicX Fund and Target Healthcare, fit this profile. The REIT board member says this would have put extra pressure on specialist investors in REITs and that their selling activity may have exacerbated the poor share price performance of some major UK companies since the Brexit vote.

Mixed evidence

The evidence for this is mixed. While the ownership of UK REITs by UK-based actively managed property funds fell sharply after the vote, their US counterparts, whose ownership of UK REITs is larger, invested heavily in July and August, capitalising on share price falls and the weakness of the pound, according to Radnor.

However, there is no doubting the longer-term shift in ownership, which some UK REITs are taking steps to address. To counteract the fall in demand from specialist investors in REITs, they are increasingly seeking out new long-term investors from emerging economies in Asia and Africa. This is understood to be one of the reasons for the growing popularity among listed property companies of secondary listings on the Johannesburg Stock Exchange.



The hedge fund that went against the grain

Undeterred by the negativity surrounding UK property following the EU referendum, one of the world's largest hedge funds, Lansdowne Partners, made a significant investment in British Land in July.

Lansdowne's stake in British Land increased to 5.3% of the company's shares on 18 July, according to a regulatory filing.

Around the same time, the firm said in a note to investors that it felt share prices in some UK listed companies were "meaningfully over-discounting" the impact of the Brexit vote and that it was adding to its exposures.

It is unclear whether the investment has worked out for Lansdowne. British Land's share price has recovered from 628p when the hedge fund made the investment to 668.5p as of Tuesday this week.

However, Lansdowne's stake fell below 5% in February this year when the shares were trading at only 595p. Perhaps the hedge fund giant gave up too soon.

Listed companies are also putting additional resources into the production of all their written materials including financial reports and presentations. In a world where more passive styles of investment are becoming increasingly dominant, these materials are more important than ever.

The wording used can even influence investment decisions as some ETFs have been built to screen company reports for certain key words such as 'strong' and 'challenging' and factor them into their algorithms.

"The old school was about personal relationships, but now in the digital age so much is digested from online and printed materials, you have to ensure these stand alone," says one investor relations head.

With the rise of ETFs and trackers showing no sign of slowing, it pays for companies to think carefully about what it means for their investor relationships and share price performance. ■