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## REITS IN A MULTI-ASSET CLASS PORTFOLIO

Many investors have remained underexposed to Real estate investment trusts (REITs) as an asset class despite their low correlation and commendable track record of performance relative to other assets over the long term.

*This article argues why many investors should consider maintaining a higher exposure to REITs, particularly in multi-asset-class portfolios with longer-term strategic objectives. In addition, we will provide an analytical perspective on some common misperceptions about REITs.*

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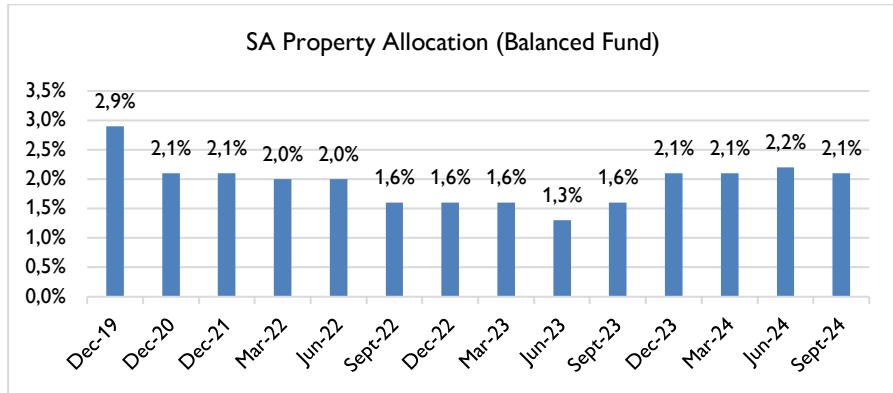
The SA-listed property sector has grown considerably in size and prominence since the advent of the modern property era in the early- 2000s. Today, REITs are well represented, making up:

- **4.9%** of the JSE All Share Index (ALSI)
- **10.2%** of the JSE Mid Cap Index
- **26.0%** of the JSE Small Cap Index

Despite the proliferation of REITs in major equity market indices, many investors may be underexposed to this asset class. RMB Morgan Stanley (see exhibit 1) estimates that domestic property accounted for 2.1% of an average balanced fund at the end of the third quarter of 2024.

The increase in offshore limits, as per Regulation 28, has seen significant assets reallocated to foreign bonds and equities.

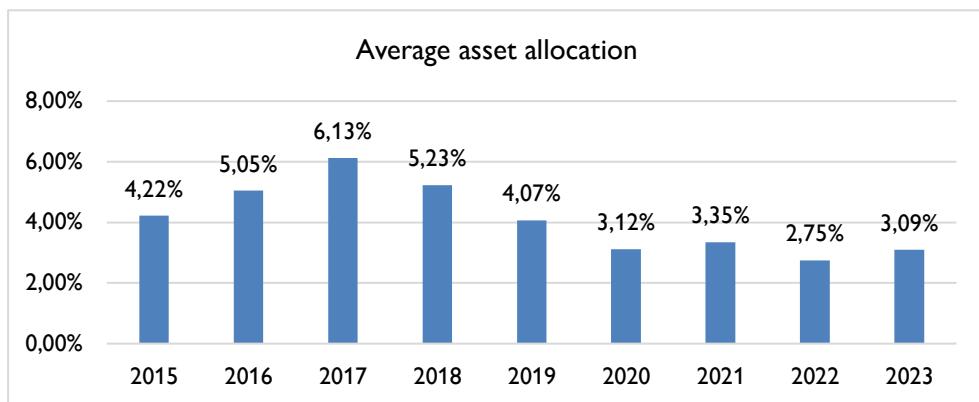
### Exhibit 1 – SA property allocation



*Source: RMB Morgan Stanley*

Meanwhile, the Alexforbes Manager Watch (exhibit 2) survey shows an average allocation of 4.1% since 2018 and 3.1% at the end of 2023 for a global balanced fund.

#### **Exhibit 2 – Alexforbes Manager Watch**



*Source: Alexforbes Manager Watch*

Combining assets that exhibit low-performance correlation can play an important role in reducing portfolio risk without sacrificing return potential and reflects the central focus of portfolio optimisation.

One asset class that has consistently provided diversification benefits is REITs. Since 1976, global REITs have exhibited a relatively low correlation with both the broader equity market (0.42) and bonds (0.37), which are generally considered core components of a diversified portfolio. (For reference, a correlation of -1 indicates perfect negative correlation, 0 represents no correlation, and +1 signifies perfect positive correlation.)

We note that the correlation to local bonds has increased to 0.49 over the past 10 years.

### Exhibit 3: Correlations since 1976

	Local bonds	Local equity	Local property	Foreign cash	Foreign bonds	Foreign equity
Local bonds	1					
Local equity	0.29	1				
Local property	0.37	0.42	1			
Foreign cash	-0.34	-0.09	-0.25	1		
Foreign bonds	-0.21	-0.07	-0.19	0.88	1	
Foreign equity	-0.1	0.38	0.09	0.55	0.59	1

*Source: Bloomberg*

To demonstrate the potential diversification benefits of incorporating REITs into a strategic portfolio over the long term, we enlisted an independent research analyst from Anchor Stockbrokers to conduct a mean-variance optimisation (MVO) analysis. The analysis utilised a dataset from 1976 to 2023, which included local cash, local bonds, local equity, local property, foreign cash, foreign bonds and foreign equity.

Mean-variance optimisation, introduced by Harry Markowitz in 1952 and foundational to modern portfolio theory, helps investors identify the optimal asset mix that maximises returns for a given level of risk. This approach takes into account the risk (volatility) and expected return of each asset, as well as how the assets interact or co-move with each other, which is quantified through covariance and correlation.

Based on their analysis (Exhibit 4), the optimal strategic allocation to listed property in a Regulation 28-compliant fund is 12.1%.

### Exhibit 4: Findings of MVO analysis

Return	Risk	Sharpe ratio	Local Bonds	Local Equity	Local Property	Foreign Cash ZAR	Foreign Bonds ZAR	Foreign Equity ZAR
12.0%	6.1%	0.33	60.5%	2.2%	5.9%	31.4%	0.0%	0.0%
13.8%	7.1%	0.54	48.0%	6.4%	8.4%	5.2%	14.2%	17.7%
14.6%	8.2%	0.57	39.2%	9.3%	10.4%	0.0%	14.2%	26.9%
<b>15.2%</b>	<b>9.1%</b>	<b>0.58</b>	<b>31.6%</b>	<b>11.8%</b>	<b>12.1%</b>	<b>0.0%</b>	<b>10.5%</b>	<b>34.0%</b>
15.8%	10.2%	0.57	25.0%	15.8%	14.2%	0.0%	4.4%	40.6%
16.3%	11.2%	0.57	19.0%	19.9%	16.1%	0.0%	0.0%	45.0%
16.7%	12.3%	0.56	10.0%	26.2%	18.8%	0.0%	0.0%	45.0%
17.1%	13.3%	0.54	1.6%	32.0%	21.3%	0.0%	0.0%	45.0%
17.5%	14.3%	0.53	0.0%	44.6%	10.4%	0.0%	0.0%	45.0%
17.7%	15.3%	0.51	0.0%	55.0%	0.0%	0.0%	0.0%	45.0%

*Source: Anchor Stockbrokers*

In an earlier academic paper, Bradfield et al. 2015 found that the historical optimal allocation to property in a mean-variance in SA was 33%. Using a non-parametric framework with a CPI+5% benchmark, they found the optimal allocation to be 23%.

A 2024 analysis by Morningstar Associates found that the optimal allocation to US REITs ranges from 4.2% to 20.0% depending on the investor's life stage. For investors with a time horizon of 45 to 25 years, the optimal allocation to REITs is 20.0%. This optimal allocation gradually decreases over time, with 11.0% for those at retirement and 4.2% for investors 15 years into retirement. This analysis was based on data from US REITs, equities, bonds and emerging markets from a US investor's perspective.

In addition, numerous academic studies in international literature consistently advocate for a significantly higher allocation to property, often around 20%.

Indeed, investors face practical problems, particularly around the liquidity of the sector. The property sector sits in the bottom third of liquid stocks on the JSE, which suggests that there are material liquidity risks and frictional costs to holding a large weight in listed property.

Nevertheless, Anchor Stockbrokers concluded that "the findings present a compelling case to, at the very least, reassess the long-term strategic weight of listed property."

As mentioned earlier, the strong impact of REITs on portfolio diversification largely stems from their imperfect correlation with both equities and bonds. The following characteristics of REITs contribute to their unique performance, setting them apart from other asset classes:

- REITs are required to distribute at least 75% of their taxable income in the form of dividends. This dividend income has constituted 80% of REITs' total returns and has helped dampen volatility during equity market stress periods.
- The contractual nature of real estate leases and the predictability of rental income and expenses give REITs a defensive quality, allowing analysts to more accurately forecast earnings, which helps reduce share price volatility.
- Asset values and rental rates tend to rise during periods of increasing inflation; therefore REIT dividends tend to be protected from the detrimental effect of rising prices, unlike many bonds.

By incorporating REITs into a diversified portfolio, investors can potentially enhance risk-adjusted returns, hedge against inflation and gain exposure to the commercial real estate asset class.

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