INVESTMENT INSIGHTS

Global Evolution a Game Changer for Real Estate

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What to tell your clients:

Real estate is not solely a vehicle for producing income. It could also be a source of wealth creation.

- Rising interest rates are not always directionally bad for real estate. If tied to an improving economy, they are a constructive backdrop for real estate equities.
- The asset class is evolving, with more countries and even individual industries opening up to real estate investors.
- New real estate opportunities across the globe provide access to some of the fastest growing economies in the world.
- Invest globally to get access to markets where interest rates may move in different directions.

As investors consider rising rates and the impact on yield-based assets, it is time to address a couple of common misperceptions about real estate. Patrick Brophy, Portfolio Manager of the Janus Global Real Estate Fund, explains why rising rates are not directionally bad for real estate equities. He also explains why real estate can be more than just a source of income for portfolios. Yield is important to total return, but a myopic focus on yield overlooks the potential of real estate as a source of wealth creation, particularly as the asset class expands and garners increasing attention in equity markets across the globe.

Rates may rise, but that's not always bad for real estate

With U.S. interest rates likely to rise from historical lows, we think it is high time to take a closer look at what rising rates *really* mean for real estate equities. A common misperception about real estate equities is that, similar to other yield-bearing investments, rising rates are always directionally bad for the asset class.

While rising rates do translate into higher borrowing costs and often higher capitalization rates, which can lead to lower asset values, the notion that rising rates are categorically bad for real estate equities is somewhat overstated, and often incorrect. Rising rates tied to an improving economy, which is what we are seeing today in the U.S., can actually provide a constructive backdrop for the asset class. An improving economy typically means landlords benefit from better operating fundamentals – lower vacancy rates, higher lease rates and better acquisition/development yields.

There are numerous past periods when rates rose on the back of an improving economy and real estate performed well. In fact, during the five periods of rate increases since 2000, the MSCI U.S. REIT Index averaged a 1.2% return over the three months following the initial rate increase and a 14.7% return over the ensuing 12 months (outpacing the S&P 500 Index by more than 200 basis points).

The misperception that rising rates are always bad for real estate stems in part from the fact that most investors focus purely on the yield characteristics of the asset class. This narrow focus overlooks one of our main tenets of real estate investing – that real estate is not only a good vehicle for current income, but has the potential to be a source of wealth creation.

Real estate is evolving to provide more growth opportunities around the globe

We believe the real estate sector is at an important point in its evolution, as more countries open their real estate markets to investors. This has important implications for diversification, and also for accessing new growth opportunities around the globe.

Real estate is a cyclical industry, meaning its cycles are different around the world, just as interest rates move in opposite directions in different markets. This is especially true today, and is a key reason for our global focus. We remain convinced the sector lends itself to an opportunistic approach to deploying capital in far-ranging geographies.

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About the Manager:

Patrick Brophy joined Janus in 2005, and has been Portfolio Manager of the Janus Global Real Estate Fund and related portfolios since that time.

Janus Global Real Estate Fund: Portfolio Snapshot

- Takes a global approach to real estate equities.
- Seeks good businesses with prime holdings in strategic locations.
- Looks for quality, committed management teams with a strong track record of value creation.
- Emphasizes total return through a combination of capital appreciation and current income.

While yield remains an important component of real estate investing, we believe the growth potential of the asset class should not be overlooked, particularly in today's rapidly evolving and increasingly global investment market. As an example, the strongest economic growth we're seeing is typically in emerging markets. In many of these markets, the listed real estate sector provides a means of gaining exposure to those higher growth rates. A focus solely on investments that produce the highest yield would likely miss out on many of these opportunities.

In Mexico, for example, the FIBRA, which is essentially the Mexican version of a REIT structure, was introduced in 2011. Tax incentives associated with the FIBRA should encourage significant consolidation within what is currently a very fragmented commercial real estate market. The FIBRA is also providing a way to take advantage of new manufacturing moving to Mexico as the North American economy recovers. In India, the new government has hinted at the creation of a REIT structure, and has made it clear that they view it as a constructive means of both encouraging economic growth and supporting the country's vast commercial property market. Meanwhile, in Brazil, we've been impressed by the real estate expertise of the management teams that continue to take advantage of what remains in several key sectors an underpenetrated commercial property market.

Even in more established real estate markets, the asset class is evolving in ways we think will provide considerable potential for capital appreciation, not just yield. In Europe, new companies have been formed to buy real estate assets, which are being shed by European banks as they deleverage to meet new regulatory requirements. In the U.S., some companies with hard assets and long-term, transparent cash flows in nontraditional real estate industries are converting into REITs. Most recently, we've seen companies owning cell towers and billboards successfully make the conversion.

Think of real estate for both yield, *and* capital appreciation

As the asset class evolves, we believe investors should evolve in their thinking about real estate. The asset class can fare well in a rising rate environment, largely because it does more than just provide yield. It can also provide capital appreciation.

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Mutual fund investing involves market risk. Investing involves risk, including the possible loss of principal and fluctuation of value.

Past performance is no guarantee of future results.

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Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Investments in Real Estate Investment Trusts (REITs) may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographic region. REITs may be subject to risks including, but not limited to: legal, political, liquidity, interest rate risks, a decline in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrowers.

The Fund will normally invest at least 80% of its net assets, measured at the time of purchase, in the type of securities described by its name.

Basis point (bp) is a unit equal to 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%.

MSCI US REIT Index is a free float- adjusted market capitalization weighted index that is comprised of equity REITs that are included in the MSCI US Investable Market 2500 Index, with the exception of specialty equity REITs that do not generate a majority of their revenue and income from real estate rental and leasing operations. The index represents approximately 85% of the US REIT universe.

S&P 500® Index is a commonly recognized, market capitalization weighted index of 500 widely held equity securities, designed to measure broad U.S. equity performance.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility and differing financial and information reporting standards, all of which are magnified in emerging markets. Sovereign debt securities are subject to the additional risk that, under some political, diplomatic, social or economic circumstances, some developing countries that issue lower quality debt securities may be unable or unwilling to make principal or interest payments as they come due.

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