



Vanguard INVESTMENTS™

A new way to diversify – International property

Investment in international listed property securities is inevitable.

The underlying property portfolios of Australian listed property trust investors are well diversified, however there are two trends emerging within the property sector. There is a concentration of management within the sector, with Westfield Group comprising 35% of the sector and the five largest property trusts comprising 65%.

The other trend is increasing control by institutions of a large proportion of the existing supply of listed property in Australia. We

estimate that Australian institutional investors now hold over 75% of Australian LPTs. This 'crowding out' effect by institutional investors and the increasing concentration of LPT management is forcing Australian investors to look offshore for alternative property investment opportunities.



“With international property, there’s safety in diversity – something you can’t afford to ignore.”

The weight of money

The supply of capital available to invest in the Australian equities market, and in particular into the property sector, is one of the driving forces behind the move by Australian investors to look offshore.

The growth in Australian compulsory superannuation assets is projected to rise from A\$650 billion in 2005 to reach A\$1.6 trillion by 2015! With growth in demand for property of around 7-8% p.a. forecast to outstrip supply – which is estimated to be 2.5-3.5% p.a.² – diversifying into international property appears inevitable given the demand/supply imbalance in the domestic property sector. Super funds currently allocate around 10% of funds to the property sector. Concentration in the sector means that many funds already hold over 3% of total assets in one LPT.³

The anticipated movement by investors into international property is a similar situation to what happened in the 80s with investors looking offshore to diversify into international equities. Fixed interest investors in the 90s were also faced with limited domes-

-ERIC SMITH, CHIEF INVESTMENT OFFICER

tic supply due to the weight of money going into fixed interest (from superannuation) and were forced to move offshore into international fixed interest. Investors in property are facing similar challenges to seek wider investment opportunities as a result of this domestic demand/supply imbalance.²

The growth of international property

Australia and the US are leaders in the listed property market. However, other countries in Europe and Asia are experiencing rapid change and growth, offering many diverse investment opportunities. In the Australian market there are about 30 LPTs, compared to 150 real estate investment trusts (REITs) in the National Association of Real Estate Investment Trusts (NAREIT) Index in the US. The UBS Global Real Estate Investors Index, which excludes the more volatile, lower-yielding real estate development companies, comprises approximately 250 REITs and real estate management companies outside Australia.

It's all about diversification

The 1980s saw the first significant moves, by Australian investors, into international equities as they took the opportunity – post the floating of the Australian dollar – to diversify their equity portfolios. The arguments then are still valid today – global markets are not perfectly correlated, their long-term

returns should be similar (at least within developed markets) and hence a mix of Australian and international equities should have lower risk for a similar long-term return. And the arguments are even more powerful for listed property.

To characterise the diversification benefits of an international property allocation, we have looked at the volatilities of key markets – Australia, North America, Europe ex-UK, the UK, Japan and Hong Kong – and the correlations between them for both property and equities. Charts 1 and 2 allow a comparison of currency-hedged return characteristics for equity market pairs and property market pairs, using returns from the five years to 31 December 2004. Charts 3 and 4 allow a similar comparison for unhedged return characteristics.

There are a number of key findings:

- Equity volatility was higher than listed property volatility in all major markets except the UK.
- Higher listed property volatility in the relatively small Hong Kong market was offset by very low correlation with most markets and in particular Australia.
- Property market to property market correlations were significantly lower than same pair equity market correlations – for all market pairs except Japan v North America and Japan v Europe ex-UK on an unhedged basis.

Chart 1: Equity v equity markets using hedged AUD returns*

	Australia	North America	Europe ex-UK	UK	Japan	Hong Kong
Australia	11.1%					
North America	0.63	16.4%				
Europe ex-UK	0.63	0.83	19.6%			
UK	0.54	0.86	0.86	15.0%		
Japan	0.51	0.48	0.47	0.41	15.3%	
Hong Kong	0.42	0.61	0.57	0.52	0.44	21.8%

Chart 2: Property v property markets using hedged AUD returns*

	Australia	North America	Europe ex-UK	UK	Japan	Hong Kong
Australia	8.1%					
North America	0.35	14.0%				
Europe ex-UK	0.23	0.40	10.9%			
UK	0.19	0.36	0.75	16.6%		
Japan	0.33	0.30	0.34	0.09	11.8%	
Hong Kong	0.00	0.19	0.44	0.46	0.06	29.0%

Chart 3: Equity v equity markets using unhedged AUD returns*

	Australia	North America	Europe ex-UK	UK	Japan	Hong Kong
Australia	11.1%					
North America	0.46	14.7%				
Europe ex-UK	0.48	0.70	16.5%			
UK	0.28	0.78	0.76	13.0%		
Japan	0.26	0.37	0.16	0.22	17.3%	
Hong Kong	0.29	0.47	0.46	0.42	0.22	18.8%

Chart 4: Property v property markets using unhedged AUD returns*

	Australia	North America	Europe ex-UK	UK	Japan	Hong Kong
Australia	8.1%					
North America	0.20	14.9%				
Europe ex-UK	0.36	0.33	10.8%			
UK	0.21	0.34	0.62	15.0%		
Japan	0.21	0.46	0.39	0.11	15.5%	
Hong Kong	-0.07	0.14	0.25	0.39	0.02	27.8%

*Source: Vanguard, using market data.

- The average correlation of Australian equities with other markets was around 0.55 on a hedged basis and 0.35 on an unhedged basis. In contrast, the comparable Australian property correlations were 0.22 and 0.18 respectively.

As a consequence, the risk reduction benefit (per dollar) of allocating from Australian to international property was more significant than from Australian to international shares – despite the greater dominance of the US for international property (66%), compared with international shares (47%).

All results are for the five years to 31 December 2004. Percentage figures on the diagonals are total annualised volatility and off-diagonal terms are market-to-market correlations.

Persistence of risk characteristics

As well as the five years shown above, we also analysed the previous five years. There was no property market data for Japan. However, the pattern of generally lower volatility and lower correlation for property markets versus equity markets was consistent with the subsequent five year period.

We have also used Barra's Global Equity Model to estimate risk characteristics for the immediate future, and again the results are consistent with the observations for the five years to 31 December 2004.

Currency management

As with any investment in non-\$A assets, international property investment brings with it currency exposure that should be assessed at the total portfolio level. Depending on the weighting to non-\$A assets within the portfolio (equities, bonds and property), it may be appropriate to include an allocation to either hedged or unhedged international property assets within the portfolio.

However, for typical diversified fund strategic asset allocations, substituting international property securities for a proportion of an Australian LPT allocation is expected to be diversifying. This is the case with or without hedging of the incremental currency exposure.

The inevitability of allocation to international

Diversification and the resulting lowering of portfolio risk, is already a key benefit of incorporating international listed property into a diversified portfolio. With the continued evolution of the international listed property sector – the market capacity for growth in the sector is significantly greater offshore than the already mature domestic market – it should become an important component of a diversified portfolio's overall property allocation.

Not every investor will make an allocation, but as with bonds, the sheer weight of money will force a significant allocation to international property. Larger investors, with the scale to keep the costs under control, are the obvious 'first movers'.

Index or active management?

The key objective of an allocation to international listed property should be to capture its 'property-like' characteristics rather than just 'equity-like' characteristics – in particular the higher yields derived from rental income and the expected inflation hedge associated with property investment. In our view, there are a number of factors that support making a first allocation on an index basis.

- There are few managers of international property anywhere with a significant track record.
- Our analysis suggests that the higher-performing managers, with a long domestic history, have outperformed relevant benchmarks by investing outside the universe of 'property investor' REITs and companies and are more correlated with equities in general.
- The costs of investing in the sector are significantly higher than for equities in general due to liquidity issues and the need to access specialist brokers.
- Management fees in the sector are generally higher than for equities, yet the level of outperformance of even the better managers is relatively limited.

Indexing captures the risk characteristics without compromising capture of the risk characteristics – and does so with low implementation costs and at low fees.

Vanguard capability

Vanguard is a significant player in listed property securities, able to draw on both Australian and US expertise. Vanguard Investments Australia Ltd is Australia's second largest manager of listed property securities, managing in

excess of A\$3.1 billion in specialist property mandates. Since its inception in March 1998, the Vanguard Property Securities Index Fund has attracted A\$1.6 billion in funds under management. Vanguard also manages more than A\$340 million invested in global property securities, of which over A\$80 million is in the international property securities index funds as at 30 September 2005.

Vanguard has launched two new funds:

1. Vanguard International Property Securities Index Fund; and
2. Vanguard International Property Securities Index Fund (Hedged)

Offering both hedged and unhedged versions, Vanguard's new international property securities index funds bring the benefits of diversification and reduced portfolio risk to Australian wholesale investors. The funds invest in approximately 250 property securities listed on the exchanges of 20 of the world's major economies.

Our funds aim to deliver:

- yield derived from rental income;
- a mix of defensive as well as growth characteristics;
- low ongoing fees of 0.40% p.a. - around half the industry average; and
- diversification benefits at the total portfolio level.

The funds are designed for wholesale investors wishing to invest A\$500,000* or more in international listed property securities for the medium to long term.

* A lesser amount may be accepted by Vanguard at its discretion. Access to the Fund with less than the minimum initial amount may also be available through selected master trusts and wrap accounts.

1 ASFA-Access Economics 2004

2 *The Case for Global Property*, Russell Investment Group, 2004

3 *Global Property – is it right for you?*, Mercer Investment Consulting

Contacting Vanguard

For more information or a copy of our Product Disclosure Statement, please contact our Institutional Sales team on (03) 8888 3876 or visit our website at vanguard.com.au

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