Chapter 3
The Return Performance of Real Estate Investment Trusts (REITs) and Portfolio Diversification Benefits: Evidence From the European Market

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ABSTRACT
This study describes the emergence and the structure of Real Estate Investment Trusts (REITs) and investigates whether European REITs provide higher risk-adjusted returns and portfolio diversification benefits relative to the market portfolio. The top public listed companies of five (5) established (Belgium, France, Germany, Netherlands, UK), three (3) emerging (Italy, Spain, Ireland) and one (1) nascent (Greece) European REIT markets, are considered over period 2007 – 2018. The empirical findings denote poor performance of most European REITs over the Global Financial Crisis period but strong risk adjusted returns, overall, outperforming the equivalent European stock market indices and bonds over the first years of post-GFC period. In the recent period (2015 – 2018), most European REITs continued to deliver positive but modest risk adjusted returns relative to the previous period. The analysis provides evidence of poor portfolio diversification benefits and weak cross country diversification benefits among the European REITs.

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INTRODUCTION

Real estate assets due to their tangible nature are considered to be secure and value-appreciating investments. An investor benefits, in the long-run, from the capital appreciation gains of the real estate asset and, in the short-run, from the monthly fixed income that the property produces through rent. However, real estate markets are considered highly decentralized and illiquid. Property investments necessitate the disposal of large amounts of capital, on the part of the investor, restraining access to small-scale investors. Also, the requirement of sizeable investments and large capital injections makes it difficult for the private investors to diversify their portfolios, remaining prone against asset specific risk. Portfolio diversification is a process of capital allocation on different asset classes. The significance of portfolio diversification is that it reduces the exposure on one particular asset and hence against the overall investment risk, by spreading capital across different asset classes, provided the risks of these assets are not directly related (Markowitz, 1952).

The above-mentioned drawbacks were first concerned by the US congress with the establishment of the Real Estate Investment Trusts (hereinafter called REIT(s)) regime in the 1960s (Cigar Exercise Tax Extension). REITs are mainly close-ended funds (public listed) traded on the major stock exchanges, which invest in income-producing real estate assets and distribute that income as dividends to the shareholders. The potential benefits of the REIT regime are summarized in three main sources. First, the REIT regime allows investors to immediate access (even) large scale property investments. Second, (public listed) REITs are tradable in the Stock Exchange, thusly benchmarked against an index and easily liquidated at par value. Third, the REITs investments provide portfolio diversification benefits and low correlation with other stocks and bonds.

The high growth of the US REITs, took place in the 1980s, especially after the Tax Reform Act of 1986. Today, roughly 60 years after the US REITs establishment the sector, in US only, is estimated at more than one (1) trillion $ market capitalization, occupying approximately 65% of the FTSE EPRA/NAREIT global real estate index (ERPA, 2018). In Europe, REITs were first introduced in Netherlands (1969), followed by France (2003), UK and Germany (2007). According to the European Public Real Association (ERPA) research (2018), the total listed real estate sector in Europe is valued at 490 bn $, with Germany being the dominant player (107 bn $), followed by the UK (100 bn $) and France (94 bn $). Today, the REIT regime exists in nearly forty (40) countries, and according to each country’s stage of (REIT regime) maturity, are grouped into four different classes: nascent, emerging, established and mature (Ernest & Young, 2018).

To this end, this study investigates the return performance of real estate investment trusts (REITs) and portfolio diversification benefits. The study concentrates in the
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