First State Investments

Global Property Securities

Quarterly Review and Outlook

As at March 2016

Key Highlights

- US REITS performed well and European markets were also buoyant over the quarter.
- Material risks to global economic growth rates remain. Central banks continue to implement unprecedented policy measures.
- The strategy continues to remain well diversified, both by geography and sector.

Market Insights

Global property securities fared well in the March quarter, supported by positive returns from US REITs which account for more than half of the Index.

US REITs performed well following comments from Federal Reserve Board members that suggested the pace of monetary policy tightening in the US will be slower than previously anticipated. Treasury yields declined against this background, improving sentiment towards income-generating investments such as REITs.

European markets were also buoyant. The announcement of extended Quantitative Easing measures in Continental Europe and the release of the Budget in the UK dominated attention from an economic perspective.

Strategy Performance

The strategy registered a positive return in the March quarter, although returns were behind the benchmark index.

During the period the investment in Hong Kong Land acted as a drag on performance, affected by Chinese economic growth-related concerns.

Exposure to US-based Brookdale Senior Living also detracted from performance as the stock underperformed. We have grown increasingly concerned about the near-term outlook for senior housing, non-investment grade credit spreads and management's poor execution. These concerns prompted us to sell the strategy's holding in the stock during February.

Concerns around the UK's possible exit from the European Union affected the entire UK equity market, and the strategy's investments in Derwent London, Great Portland Estates, Land Securities and Hammerson, in particular.

In fact 'Brexit' concerns have pushed UK REIT valuations down to very appealing levels, prompting us to increase exposure to the UK during the March quarter. Vacancy rates remain low and market rental growth continues in London office, malls and industrial warehousing. Exposure to the UK is primarily held through stocks exposed to these areas of the market.

Strategy Activity

In the US, Apartment Investment and Management was added to the portfolio. The company has one of the most diversified portfolios of apartments by geography and asset quality, provides relatively stable cash flows and was trading on a 10%+ discount to NAV.

Another new position was established in Tanger Factory Outlet Centers, whose valuation had become appealing following a long period of underperformance. The company has relatively low financial leverage and consistently high occupancy levels, making it one of the more defensive exposures in the US retail sector.

In Australia, GPT Group was re-introduced to the portfolio. The company has a high quality asset portfolio and the new management team is expected to make operational improvements that should be beneficial for shareholders over time.

Market Outlook and Strategy Positioning

Material risks to global economic growth rates remain. Central banks continue to implement unprecedented policy measures of historically low interest rates and direct intervention in credit markets. With risk-free rates remaining very low, yield-producing investments are likely to remain popular with investors – this augurs well for global property securities in the remainder of 2016, even though solid gains have already been made in the year to date.

The outlook for Chinese economic growth remains uncertain and there is the potential for a tightening in global credit markets. In this environment, we are firmly focused on companies with balance sheet strength, access to capital, high quality assets and which have relatively stable cash flows.

The strategy remains well diversified, both by geography and sector.

Following their recent rally, US REITs have become less attractive on valuation grounds. The sector now trades at a 4% weighted average premium to NAV.

The strategy's US exposure is predominantly held in companies with proven management teams and investment grade balance sheets. Many holdings trade at discounts to NAV and have attractive total return expectations. Current sector biases include Class A retail malls, data centres and selected office REITs. These sectors are generally attractively valued relative to private market values and have superior earnings growth outlooks, in our view.

In Europe, retail sales have increased and consumer confidence levels have risen. Office market fundamentals remain weak, however, with most cities experiencing subdued new tenant demand and minimal market rental growth. The strategy maintains selective exposure to European REITs whose net operating income growth rates are running ahead of nominal GDP growth.

In Asia, we maintain our positive view on Hong Kong landlord names which have healthy balance sheets, investment grade portfolios, stable medium-term earnings growth outlooks are which are trading on attractive valuations.