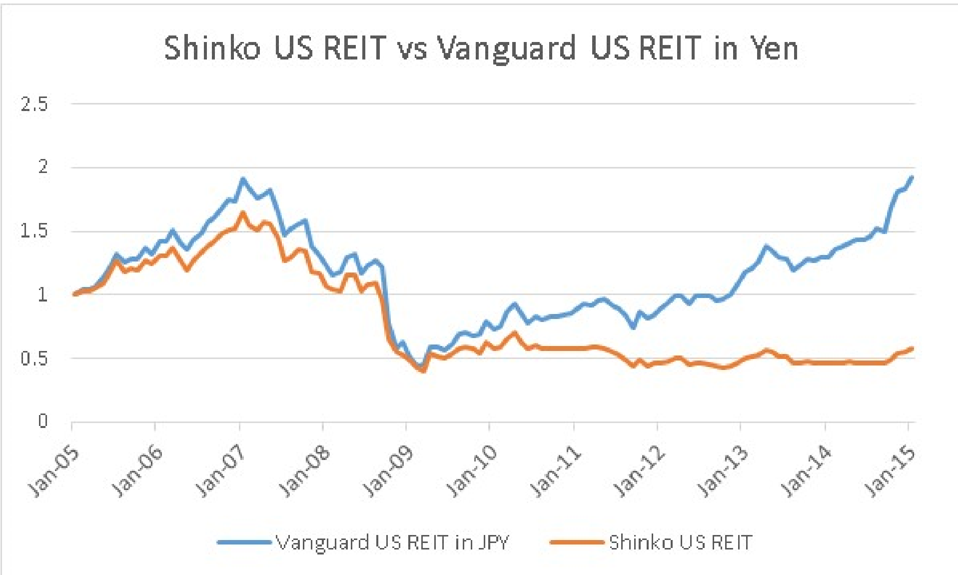
JAPANESE US REIT FUNDS AND THE BUY CASE FOR YEN

Written in conjunction with Shannon McConaghy

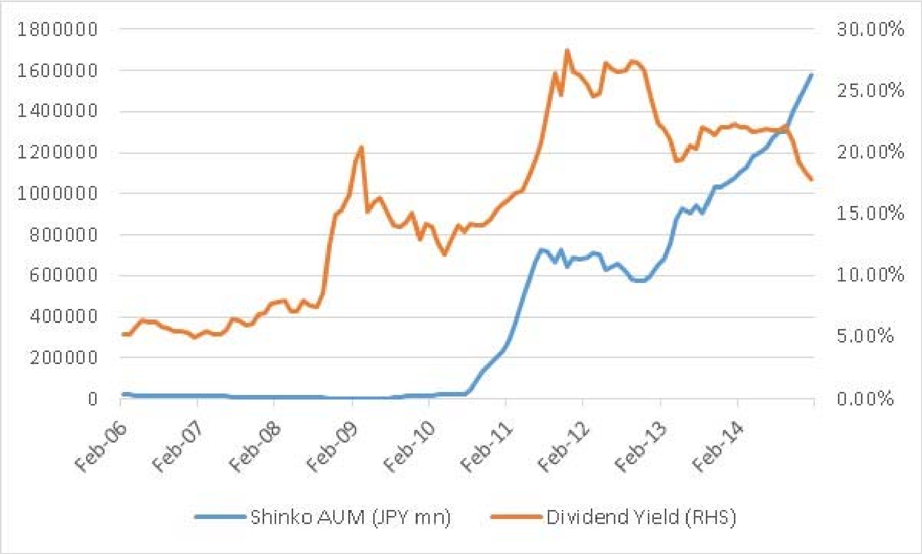
The last few years in Japan have seen the emergence of and selling of some innovative high yield funds. These asset management products are designed to pay out very high yields, while sadly almost guaranteeing the destruction of capital. There are numerous examples of this but this note shall deal with only US REIT Funds sold in Japan.

According to Goldman Sachs, the largest 20 Japanese US REIT funds have 50bn USD under management. The single largest is the Shinko US REIT fund (Bloomberg Ticker: 06311049 JP), which has an AUM of around 14bn USD. For comparison the Vanguard US REIT Index fund has 26bn USD of assets, total US REIT market capitalization is 720bn USD.

Japanese US REIT funds tend to offer a dividend yield in the high teens. The Shinko fund has a yield of 17% currently. For reference the US based Vanguard REIT Fund has a yield of 3.4%. The extra yield of 13.6% does not come from leverage. In fact the assets owned by the funds are very similar. Rather Japanese funds will sell down assets to ensure that a higher yield is paid out.



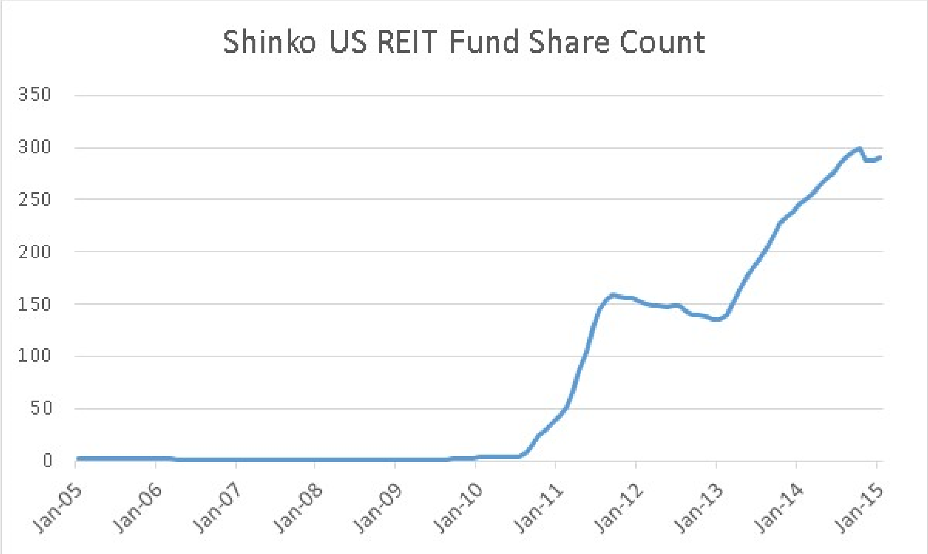
From 2005 to 2010, the Shinko fund and Vanguard fund had very similar performance, after 2010 a huge divergence opened up. In my view, Shinko noticed that assets under management at their fund grew aggressively when funds offered a high dividend yield. Talks with participants in Japanese financial markets indicate Japanese investors prefer funds that offer at least a 1% monthly dividend yield.



As can be seen from above, Shinko AUM exploded higher once it began to offer a yield in excess of 12%, and it continues to rise. The other major funds that I have looked at all offer similar yields and are presumably managed in a similar way.

With such high dividends, assets under management can fall as the fund needs to sell assets to pay dividends. To get an idea of when this can happen we can use the change in the share count of the fund multiplied by the fund price and then subtract the dividend payout to calculate net cashflow movements in the fund. We can see that there have been two times when assets raised have fallen below the cash needed to pay out.

This has a very clear effect on the shares outstanding for the Shinko fund, which fell in 2012, and again in recent months.



I suspect this new fund structure will have a big effect on the Yen. Typically, the flow of investment funds relative to currency movements is unknown. The reason for this is that sometimes investors will see the currency depreciation as a chance to buy an asset cheaper. Certainly US listed Japan equity funds tend to see rising share count (i.e. raising assets) when the yen is weakening. In other cases, weak currencies tend to correlate to weak returns and investors selling assets. The latter is what we have seen more recently with emerging markets funds

What I find most intriguing is that at constant values, ie US REITS remain constant, and the Yen exchange rate does not change, and Shinko does not raise any more assets, then this fund will be forced to sell 14% of its holdings in the US to repatriate to Japan to pay dividends each year. What is true for Shinko would be true for the industry as a whole.

The implications of this are intriguing for me. Firstly, assets in these funds are very unstable, as the high yields destroy assets under management very quickly. Secondly, if there was a shock that caused yen to appreciate or US REITS to fall in value, funds like Shinko would be forced to liquidate their assets very quickly to meet redemptions and dividend payments. Their liquidation could cause yen to appreciate further and possibly REIT to fall in value locking them into a vicious cycle. Even more disturbing, that this is only one of seemingly many assets classes that have this feature.

For investors nervous about the state of global markets, a long yen position seems to offer a good hedge in my view.

INFORMATION

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