Real Estate Investment Trusts and Japanese Institutional Investors' Approach to Asset Management

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Although Japanese real estate investment trusts (J-REITs) have seen their market capitalization grow steadily as a result of their high distribution yield since they were first launched in September 2001 following the reforms of the previous year, they urgently need to broaden and diversify their investor base. At the same time, Japanese pension funds, which have been expected to lead other institutional investors, have steered clear of property investment for a number of years—partly because of regulatory requirements and partly because they are still sitting on losses from earlier direct investments in property. Even now, there is still a lack of understanding of securitized property products in general, in spite of the deregulation that has since occurred. This report takes a fresh look at the role of property investment and real estate investment trusts in Japanese institutional investors' approach to asset management, taking into account the changes securitization has brought about in Japan and US institutional experience of investing in such trusts.

1. Pension Fund Management and Investment in Property and Property-Related Securities

1) Pension funds and property investment

In terms of market size, property is the largest class of assets after traditional securities. Moreover, its low liquidity and its cyclicality make property particularly suitable as a long-term investment. Russell L. Olson, for many years a pension fund manager at Eastman Kodak, has said that "real estate is one of the biggest asset classes in the world, and it's a fine diversifier for a portfolio of stocks and bonds" and "of all private, illiquid investments, real estate funds are the asset class most widely used."[1]

It is common in Europe and the United States for property to be the third-largest asset class (after equities and bonds) in pension fund portfolios, even though it may account for only a few percent of total assets. For example, the California Public

1 See Russell L. Olson, "The Independent Fiduciary."

Employees' Retirement Scheme (CalPERS) has target allocation ratios of 64% for equities (including private equities), 28% for bonds and 8% for property, while, as of end-April 2002, its property portfolio was worth $13.3 billion.[2] Similarly, the BT Pension Scheme, the biggest occupational pension scheme in Europe, had target allocation ratios of 79% for equities (including private equities), 11% for bonds (including index-linked bonds) and 10% for property as of end-2000, while its property portfolio was worth £2.75 billion.[3] Likewise, an analysis of the average asset allocations of the top 200 US pension funds (in terms of assets) shows that between 3.5% and 5% of their assets are invested in property (see Figure 1).

Figure 1 Breakdown of Assets under Management of Top 200 Defined-Benefit Pension Funds in the United States

	1990	1992	1994	1996	1998	2000	2001
Equities	43.4	48.3	53.7	56.2	57.7	61.5	56.6
Bonds	40.4	40.1	35.9	32.9	32.7	28.0	31.4
Cash and deposits	7.4	4.2	3.5	2.8	2.2	1.8	1.9
Property	4.9	4.0	3.5	3.8	3.4	3.1	4.2
Mortgages	1.5	1.3	0.8	0.9	0.6	0.8	0.9
Other	2.4	2.1	2.6	3.4	3.4	4.8	5.0

Source: NRI, from survey by Pensions & Investments.

In practice, there are several different ways in which a pension fund can invest in property. First, it can invest directly. Second, it can invest through a limited partnership. If so, it can either exercise considerable control over the choice of investment (similar to a joint equity stake) or it can leave most of the investment decisions to a general partner. In either case, however, it will act as a limited partner.[4] Third, it can invest in a property investment company or property-backed securities by buying traded ordinary shares or other securities. In such a case, it will normally invest in equity securities such as a real estate investment trust (in the United States) or a listed property trust (in Australia) as investing in a conduit (a tax-exempt investment scheme) generates a higher current yield.[5]

2 Its target allocation ratio for property was raised from 6% to 8% in May 2000.

3 Annual Report, BT Pension Scheme.

4 The former case would appear to be denoted by the term "limited partnership" used in Figure 2 while the latter case would appear to be denoted by the term "commingled fund." However, in the absence of clear definitions, it is difficult to distinguish between the two terms. It also appears that the latter case is sometimes denoted by the term "blind pool fund."

5 Conduit status also confers exemption from tax in the Netherlands, where there are property investment schemes (Bleggininstelligen) similar to real estate investment trusts in that the equities are listed. For more on property investment schemes outside Japan, see Yuta Seki, "Fudosan Toshi Shintaku no Tojo to Eikyo" [The Emergence and Impact of Real Estate Investment Trusts], Shihon Shijo Kuwotari [Capital Market Quarterly], special edition No. 6.

Figure 2 Property Investments and Investment Methods of US Public Pension Funds with the 10 Largest Property Investments

	($ mil)			(%)		(Investment method)			
	NAV of property investments		Total assets	Actual allocation	Target allocation	Direct investment	Commingled fund	Shares in REITs	Limited partnership
	End-2000	End-2001	End-99						
1 Calpers	9876	13358	151800	8.8%	8.0%	O	O	O	O
2 State Teachers Retirement System of Ohio	6,300	5,900	50,800	11.6%	12.0%	O		O	O
3 NY State Common Retirement Fund	5,340	5,240	112,535	4.7%	4.0%	O	O	O	O
4 California State Teachers Retirement System	4,549	5,222	100,797	5.2%	6.0%	O	O		
5 Ohio Public Emloyees' Retirement System	5,400	5,209	55,870	9.3%	9.0%	O		O	
6 State of Michigan Retirement System	4,340	4,027	47,220	8.5%	8.5%		O	O	O
7 Washington State Board	3,382	3,959	41,235	9.6%	21.0%	O	O		O
8 Florida State Board of Administration	4,200	3,840	96,000	4.0%	4.0%	O		O	O
9 NY State Teachers Retirement Fund	4,616	3,674	78,180	4.7%	6.0%	O	O	O	O
10 LA County Employees Retirement System	3,116	3,384	27,300	12.4%	10.0%	O	O		

Note: Data as of end-2001
Source: Real Estate Alert

In the United States, institutional investors also divide their property portfolios into core and noncore (or venture) holdings. According to Russell L. Olson (see above), core property holdings are long-term investments in high-quality commercial property in the investor's home country. They are likely to include offices, shopping centers and rented housing, with the prospect of a return consisting of an annual net income and long-term capital appreciation. However, the expected rate of return is unlikely to be particularly high. Noncore property holdings are also likely to comprise a range of investments, but the investor will probably expect to add considerable value to the property by extending, refurbishing, leasing or recapitalizing it. Once the investor has added some value to the property, it would normally try to sell it to an investor that wanted it as a core holding. Because noncore property holdings are generally expected to generate high returns, much also tends to depend on the skill of the fund manager. In the case of CalPERS, for example, it appears that roughly 70% of the assets allocated to property are invested in core holdings, with a 30% cap on noncore holdings.

2) The position of pension funds in the US property market

As a result of their history as long-term property investors, US pension funds now rank alongside real estate investment trusts as one of the two biggest investors in US commercial property (see Figure 3). Real estate investment trusts are the biggest source of real estate equity in the United States, and their combined equity market value is now over $140 billion. However, most of their growth took place between 1992 and 1997: until 1990 their combined equity market value was only about $10 billion. Most investors in real estate investment trusts are either individuals or mutual funds, although no official statistics on this exist.

Figure 3 Pension Funds and Investment in US Commercial Property

	($ bil)							
	1998	1999	2000	2001	1998	1999	2000	2001
Total value of US commercial property	3,700.0	4,010.0	4,300.0	4,600.0				
Noninstitutional investors	2,130.0	2,220.0	2,370.0	2,530.0				
Institutional investors	1,570.0	1,790.0	1,930.0	2,050.0				
Equity	349.5	360.9	378.7	372.7	100%	100%	100%	100%
REITs	144.8	136.0	141.6	146.6	41.4%	37.7%	37.4%	39.3%
Non-US investors	36.6	46.2	52.5	39.2	10.5%	12.8%	13.9%	10.5%
Pension funds	121.4	139.3	141.9	144.0	34.7%	38.6%	37.5%	38.6%
Life insurers	42.6	36.0	39.7	39.9	12.2%	10.0%	10.5%	10.7%
Commercial banks	2.7	2.1	1.8	1.9	0.8%	0.6%	0.5%	0.5%
Savings & loan institutions	1.4	1.3	1.2	1.1	0.4%	0.4%	0.3%	0.3%
Debt	1,228.0	1,430.0	1,551.9	1,676.0	100%	100%	100%	100%
Commercial banks	489.2	552.1	610.0	704.0	39.8%	38.6%	39.3%	42.0%
Life insurers	184.3	182.2	212.9	218.7	15.0%	12.7%	13.7%	13.0%
CMBS issuers	172.6	241.7	213.7	247.8	14.1%	16.9%	13.8%	14.8%
Non-US investors	127.6	183.0	215.1	177.7	10.4%	12.8%	13.9%	10.6%
Savings & loan institutions	122.6	134.5	139.8	156.5	10.0%	9.4%	9.0%	9.3%
Federal mortgage agencies	40.7	52.8	61.0	69.3	3.3%	3.7%	3.9%	4.1%
Other	40.3	39.0	52.7	55.8	3.3%	2.7%	3.4%	3.3%
Pension funds	33.4	31.2	36.4	37.6	2.7%	2.2%	2.3%	2.2%
REITs	17.3	13.5	10.3	8.6	1.4%	0.9%	0.7%	0.5%
	1,577.5	1,790.9	1,930.6	2,048.7				

Source: Lend Lease Real Estate Investments, "Emerging Trends in Real Estate."

3) Pension fund management and investment in property and property-related securities in Japan

The history of pension fund management in Japan is rather different from that in Europe and the United States (see above).

Japanese pension funds have never been prohibited from investing in property. However, the so-called "5:3:3:2 Rule" placed a 20% limit on the percentage of their assets they could invest in property.[6] Also, the fact that only trust banks and life insurance companies were allowed to act as pension fund trustees meant that most property investment by pension funds was done either directly or via life insurance companies' general accounts. Unlike their counterparts in Europe and the United States, Japanese pension funds made little use of property funds. Nor was there any institutional framework for securitization. As a result, when Japanese pension funds invested in property during the late 1980s, they did so either directly or via trust accounts. However, in the early 1990s Japanese property prices began to tumble, and the property market became increasingly illiquid. With Japanese pension funds either forced to discontinue property investment or faced with considerable difficulty in trying to recoup their investment capital, the property market became virtually off-limits to them for the rest of the 1990s (see Figure 4).

6 This rule used to govern the maximum proportion of a fund that could be invested in each of the four eligible classes of asset.

Figure 4 Extract from Pension Fund Association's "Investment Guidelines"

II. Permitted Investments

1. Core investments

Members' core holdings should consist of marketable, liquid assets in the traditional classes of (Japanese and non-Japanese) equities, bonds and money-market instruments.

In view of factors such as the contraction in the market in convertible bonds brought about by factors such as large-scale redemptions, members may hold convertible bonds as alternatives to equities or bonds but not as assets in their own right.

2. Life insurers' general accounts

In view of factors such as the constraints imposed by life insurers' policies, members should be cautious about making any additional investments of this type. Furthermore, in view of the fact that such investments account for only a very small proportion of members' holdings, members should regard them as noncore holdings.

3. Property investments

Property investment is problematical because of the need to assess the value of each property and the poor liquidity of property compared with marketable securities. Furthermore, in view of the fact that such investments account for only a very small proportion of members' holdings, members should regard them as noncore holdings.

4. Nontraditional investments

Members should only invest in nontraditional assets such as venture capital trusts and property derivatives (i.e., noncore holdings) after (1) carefully considering their risk-return characteristics, their liquidity and the various methods of valuing them to see whether they are suitable for future investment and (2) drawing up guidelines for investing in them.

If members do decide to invest in such assets, they should ensure that they form only a small proportion of their holdings as members so as not to have a major effect on their holdings as a whole

Note: The extract is taken from the April 2002 revision to the original Guidelines of May 1996.

Source: Pension Fund Association's Web site (http://www.pfa.or.jp/).

However, the changes brought about by securitization have not been without effect on the attitude of Japanese pension funds to property investment. First of all, investment returns on commercial property have improved considerably, as indicated by the current yield generated by rental income. Property pricing is returning to normal, and investors can expect to acquire property at a price that will earn them an annual net return of 5%-10%. This is also consistent with the 6%-plus average net operating income yield (net operating income/purchase price) currently being achieved by Japanese real estate investment trusts with a portfolio of 20-30 rental offices. In any case, it would hardly be surprising if pension funds were to seriously consider investing in property, given the current level of interest rates and the situation on the country's securities markets.

Nevertheless, they might well be deterred by their past experience of property investment or by factors such as the market's diversity and poor liquidity, and decide that there were major disadvantages to investing in property directly. However, the fact that deregulation in recent years has widened the range of options available to property investors could overcome these concerns. Following (1) the enactment of the Law on the Special Collective Real Estate Business in 1995 and several rounds of deregulation, (2) the enactment of the Special-Purpose Company Law in 1998 and its amendment in 2000, and (3) two series of amendments to the Investment Trust Law in 1998 and 2000, Japanese institutional investors can now invest in property securities, listed real estate investment trusts and private property funds. In terms of investment vehicles and securities, property securities are likely to be marketed in the form of trust beneficiary rights or special-purpose company bonds (debt) and preferential participation certificates (equity). Listed real estate investment trusts, on the other hand, are likely to be marketed in the form of investment company (company-type investment trust) equity (investment securities) or investment company bonds, while private property funds are likely to be marketed in the form of silent partnerships (collective real estate business partnerships), special-purpose company equity or private investment trusts. Property securities and listed real estate investment trusts are treated as securities under the Securities and Exchange Law, and pension funds are allowed to manage them in house.[7] Japanese pension funds can therefore now invest in property via the same range of options as their counterparts in Europe and the United States.

2. US Institutional Investors and Real Estate Investment Trusts: Current Situation and Recent Developments

It is a well-known fact that US pension funds traditionally tended to invest in property directly via limited partnerships rather than by buying shares in real estate investment trusts. However, the surge in the market value of real estate investment trust shares and in the number of such investment trusts as well as advances in the techniques for valuing them have meant that in recent years the attitude of US pension funds has begun to change.

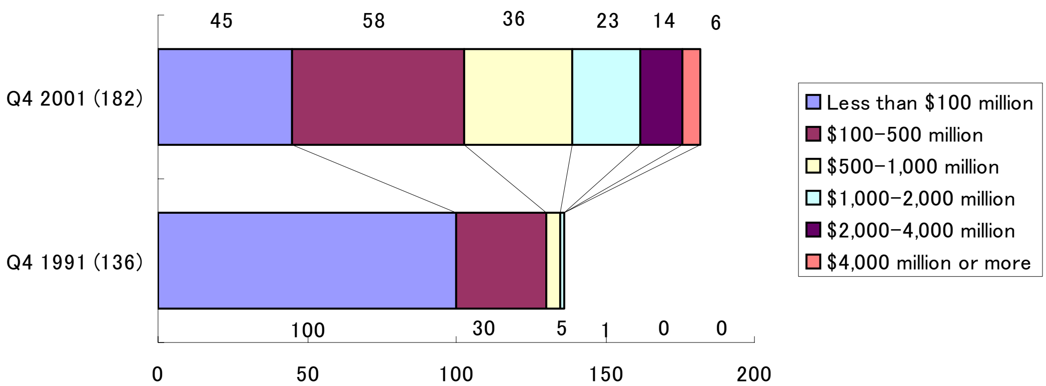
One of the main reasons why US institutional investors tended to steer clear of real estate investment trusts was a tax provision (the "Five-or-Fewer Rule") which limited the percentage of the shares in a publicly traded real estate investment trust which the five main shareholders could own to 50%. Since the rule was amended in 1993, however, pension plans have been regarded as a conduit for pension beneficiaries rather than as a single investor, and this has apparently led them to take a greater interest in real estate investment trusts.

7 Since the issue of Directive No. 727 of the (former) Ministry of Health and Welfare's Pension Bureau ("Amendments to the Directives Relating to the Special-Purpose Company Law Following the Enactment of the Amended Special-Purpose Company Law") on 30 November 2000, pension funds have also been allowed to manage in house (1) beneficiary certificates issued by investment trusts that invest mainly in property and (2) bonds issued by special-purpose companies, provided their (i.e., the pension funds') administration and fund management meet the required standard.

The reason many US pension funds invested in real estate investment trusts in the early 1990s was that they converted their existing holdings in partnerships to real estate investment trusts via umbrella partnership real estate investment trusts (UPREITs).[8] One well-known example of this is the fact that General Motors' pension fund, which had a collective investment in a shopping center owned by Taubman Centers Inc.(one of the first real estate investment trusts), received shares in the trust when Taubman Centers Inc. went public.

Another reason why US institutional investors tended to steer clear of real estate investment trusts was that the market used to be quite small. As real estate investment trusts have increased their capital and as mergers and acquisitions have become commonplace, institutional investors have gradually gained confidence in the market and now tend to invest in large-cap trusts (see Figure 5).

Figure 5 US Real Estate Investment Trust Market: Number of Companies in Each Market Value Band



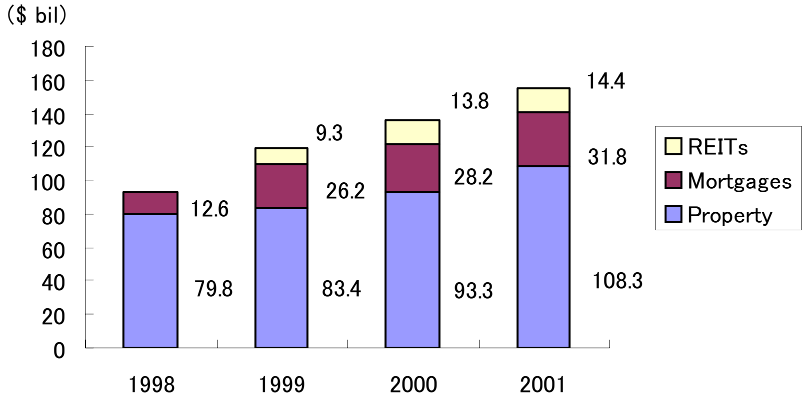
Source: Green Street Advisors, from NAREIT data.

As a result, a number of major pension funds, including the State of Michigan Retirement System, the Ohio Public Employees' Retirement System and Philip Morris's pension fund, began to invest in real estate investment trusts in 1994 as part of their property investment strategies, and investment in real estate investment trusts, especially by the largest US pension funds, has continued to increase ever since (see Figure 6).[9]

8 In these schemes the real estate investment trust acts as the general partner (i.e., parent company) while the actual property is owned by an operating partnership (i.e., subsidiaries). The previous owner of the property becomes a limited partner. The emergence of these schemes was one of the factors that led to the boom in initial public offerings of real estate investment trusts.

9 See Steve Bergsman, "REITs' Rise", Plan Sponsor, April 1996.

Figure 6 Net Asset Value of Property Investments of Top 200 Defined-Benefit Pension Funds in the United States



Note: The survey does not give any data for real estate investment trusts in 1998.
Source: NRI, from survey by Pensions & Investments.

The National Association of Real Estate Investment Trusts (NAREIT) recently published the results of a study it commissioned on the correlation between the returns on shares in real estate investment trusts, ordinary shares and long-term bonds since 1972. The study, which was carried out by Ibbotson Associates, a company well known for its quantitative analyses of securities prices, showed that the correlation had declined significantly during the past 10 years (see Figure 7). The Association has used the study's findings to promote its members among US institutional investors by claiming that adding shares in real estate investment trusts to a portfolio of securities will considerably increase the diversification effect.[10] There have also been a number of other studies that claim that the distinctive features of direct property investment and real estate investment trusts should enable pension funds to achieve enhanced returns by adding both of them to their portfolios.[11]

10 However, the study itself did not analyze the correlation between the return on real estate investment trusts and that on actual property.

11 See Timothy Craft, "The Role of Private and Public Real Estate in Pension Plan Portfolio Allocation Choices," Journal of Real Estate Portfolio Management, Vol.7, No.1, 2001.

Figure 7 Correlation of Returns on NAREIT Equity Index and Other Security Indices

	Period of observation	
	Jan 1972-Mar 2002	Jan 1992-Mar 2002
Wilshire 5000	0.58	0.29
S&P 500	0.54	0.26
Russell 2000	0.63	0.42
Merrill Lynch Bond Index	0.20	0.09
Merrill Lynch Mortgage Index	0.16	0.06

Note: The NAREIT Equity Index comprises all public equity real estate investment trusts in the United States.
Source: NRI, from NAREIT data (based on study by Ibbotson Associates).

In 2001, the Dallas Employees' Retirement Fund (with total assets of $1.8 billion) announced that it would no longer be investing in property directly and would instead invest its asset allocation (of 10%) in real estate investment trusts.[12] Many smaller pension funds that have allocated a percentage of their assets to property investment actually find it difficult to create a diversified property portfolio within that asset class. The decision of the Dallas Employees' Retirement Fund reflects the view that it is easier to create such a portfolio by using real estate investment trusts, and it would not be surprising if other pension funds of the same size were to follow suit.

It has been pointed out that not only pension funds but also mutual funds have played an important role in the development of the market in real estate investment trusts in the United States. As well as Fidelity, which launched its Fidelity Real Estate Investment Portfolio (with net assets of $1.78 billion as of July 2002) in 1986, Cohen & Steers, which launched its Cohen & Steers Realty Shares (with net assets of $1.51 billion as of July 2002) in 1991, there are a number of mutual fund groups, including, the Russell and Vanguard groups, with funds that invest in real estate investment trusts. Also, there are apparently a large number of major mutual funds (marketed as "income funds" or "value funds") that invest 4%-5% of their assets in shares in real estate investment trusts.[13] Although the boom in real estate investment trusts in the 1990s is often attributed to demand from retail investors, the existence of attractive products and specialist managers may also have contributed—something that Japanese real estate investment trusts eager to expand their investor base could perhaps learn from.

[12] Wall Street Journal, 17 April 2002.
[13] From comments to the author and Nomura Financial Research Center by Jon Forsheim, founder of the real estate investment trust research company Green Street Advisors.

Figure 8 Overview of Japanese Real Estate Investment Trusts

Investment company (code)	Office Building Fund of Japan, Inc.(8951)	Japan Real Estate Investment Corporation (8952)	Japan Retail Fund Investment Corporation (8953)	ORIX JREIT Inc. (8954)	Japan Prime Realty Investment (8955)
Date of listing	10-Sep-01	10-Sep-01	12-Mar-02	12-Jun-02	14-Jun-02
Management company	Office Building Fund Management Japan	Japan Real Estate Asset Management	Mitsubishi Corp.-UBS Realty Inc.	Orix Asset Management	Tokyo Realty Investment Management
Date of approval of management	07-Mar-01	07-Mar-01	05-Apr-01	20-Jun-01	20-Jun-01
Main backers	Mitsui Fudosan, Sumitomo Life	Mitsubishi Estate, Tokio Marine & Fire, Dai-ichi Mutual, Mitsui & Co	Mitsubishi Corp, UBS	Orix	Tokyo Tatemono, Taisei Construction, Asahi Mutual, Yasuda Mutual
Investments	Office blocks	Office blocks	Commercial establishments	Offices, houses, hotels, etc.	Office blocks, commercial establishments
% of which in Tokyo area	86%	66%	40%	98%	58%
Number of properties	26	24	4	40	23
Main properties	NKK BUILDING, Shiba NBF Tower (formerly Tokyo Life Shiba Building), GSK Building (formerly Fujita Building)	Mitsubishi Research Institute Building, Shibuya Cross Tower (formerly Toho Seimei Building), Nagoya Hirokoji Building	Sendai Nakayama Shopping Center, ESPA Kawasaki, JRF Osaka Shinsaibashi Building, JUSCO Chigasaki Shopping Center	Cross Gate, Landic Akasaka, Carrot Tower, Toyo MK	Kanematsu Bldg., Tanashi ASTA, Yasuda-Life Osaka Bldg., Arca East

Note: Data as of end-June 2002.
Source: NRI, from various sources.

Figure 9 Main Japanese Property Stocks and Real Estate Investment Trusts

		Shares issued	Share price				Market value (¥ bil)			
	(code)	(1,000)	Dec-01	Mar-02	Jun-02	Jul-02	Dec-01	Mar-02	Jun-02	Jul-02
Mitsui Fudosan	8801	812,560	1,000	1,043	1,060	937	812.6	847.5	861.3	761.4
Mitsubishi Estate	8802	1,299,185	959	932	980	955	1,245.9	1,210.8	1,273.2	1,240.7
Heiwa Real Estate	8803	112,589	236	267	263	260	26.6	30.1	29.6	29.3
Tokyo Tatemono	8804	228,142	177	208	218	208	40.4	47.5	49.7	47.5
Daibiru	8806	116,851	689	656	643	600	80.5	76.7	75.1	70.1
Sankei Building	8809	55,324	345	365	355	342	19.1	20.2	19.6	18.9
Tokyu Land	8815	457,256	148	182	193	183	67.7	83.2	88.3	83.7
Sumitomo Realty & Development	8830	407,086	600	669	727	744	244.3	272.3	296.0	302.9
TOPIX Real Estate Index			577.50	581.55	594.98	566.93	3,006.0	3,100.9	3,197.0	3,047.4
TOPIX (TSE 1st Section)			1,032.14	1,060.19	1,024.89	965.00	290,670	299,620	292,960	275,910
REITs		Units issued								
Office Building Fund of Japan	8951	280,700	495,000	543,000	554,000	540,000	138.9	152.4	155.5	151.6
Japan Real Estate Investment	8952	225,400	515,000	530,000	517,000	528,000	82.6	85.0	116.5	119.0
Japan Retail Fund Investment	8953	52,400	—	468,000	467,000	477,000	-	24.5	24.5	25.0
ORIX JREIT	8954	123,372	—	—	507,000	501,000	—	—	62.5	61.8
Japan Prime Realty Investment	8955	289,600	—	—	200,000	203,000	—	—	57.9	58.8
Subtotal							221.6	262.0	417.0	416.2

Notes: 1) Share prices and market value are end-month data.
2) Japan Real Estate issued 65,000 units with payment on 7 May 2002.
Source: NRI.

3. Real Estate Investment Trusts in Japan and Their Significance for Japanese Institutional Investors

1) Low level of investor awareness

In Japan, trading on the market in real estate investment trusts began on 10 September 2001 following the reforms of the previous year and a number of regulatory changes earlier the same year. To begin with, there were two funds (Office Building Fund of Japan, Inc. and Japan Real Estate Investment Corporation), but the number had risen to five by July 2002. True to their declared growth strategy, the funds subsequently acquired more properties, and Japan Real Estate Investment Corporation also raised more capital by issuing more shares. Moreover, the funds' distributions, paid twice a year, have so far apparently exceeded their own expectations. Japan's market in real estate investment trusts, the value of which has risen to more than ¥400 billion in less than 12 months, has therefore made a good start with no major problems.

An analysis of data on the two investment trusts' share prices and distributions for the period from their listing to the end of June 2002 reveals three main risk-return characteristics: falling share prices, a high distribution yield and a low correlation with the TOPIX (see Figure 10). Although the two investment trusts' unit prices underwent a sharp correction, with their market value at one stage falling below that of their book (i.e., initial) value,[14] it should not be forgotten that it is still early days and that shortly after the trusts were listed a series of events occurred (including the terrorist attacks of 11 September in the United States and Mycal's petition to file under the Reorganization Law on 14 September in Japan) that made investors sensitive to credit risk. Moreover, the fact that the two investment trusts' share prices have been stable for most of the time since they were listed and that their return on equity has been high (5%-7%) should suffice to counter the criticism at the time of their listing that their share prices would be volatile and that they had acquired the properties in their portfolios at the top of the market. However, the sluggish performance of their shares *has* led to the listing of other real estate investment trusts and the issue of more shares being postponed or cancelled.

Two of the reasons why the share prices of Japanese real estate investment trusts have failed to pick up, leaving them on a distribution yield of 5%-plus, are probably the fact that investors are still relatively unaware of these products and the fact that only a relatively small cross-section of investors participate in this market. This is evident, for example, from the breakdown Office Building Fund of Japan, Inc. gave of

[14] The value of Office Building Fund of Japan, Inc. at listing was ¥148,889 million and that of Japan Real Estate Investment Corporation ¥81,260 million (¥112,152 million after the issue of additional units).

its shareholder structure (in terms of numbers of units held) when it published its results for the year to December 2001: individuals, etc. (14.9%), city and regional banks (12.4%), trust banks (7.9%), life and casualty insurers (12.6%), shinkin banks, etc. (2.4%), nonfinancial corporations, etc. (26.2%), non-Japanese investors (17.9%) and securities companies (5.7%). Compared with US real estate investment trusts, roughly half of whose shareholders are said to be individuals, the proportion of individual shareholders is small. Similarly, the majority of securities investment trusts are inhibited from investing in them by restrictions in their trust agreements, while pension funds and other institutional investors have yet to invest in them via trust banks and investment advisory companies. There would therefore appear to be an urgent need for Japanese real estate investment trusts to attract a wider range of investors, both retail and institutional.

Figure 10 Performance of First Two Real Estate Investment Trusts Listed in Japan to End-July 2002

		Office Building Fund of Japan, Inc.	Japan Real Estate Investment Corporation	(Compare) TOPIX (same period)
Issue price	A	625,000	525,000	
Closing price on first day of trading (10 Sept 2001)	B	616,000	545,000	1,055.98
Price at end-July 2002	C	540,000	528,000	965.00
First accounting period		Dec-01	Mar-02	
Actual period of investment		223 days	203 days	
Distribution per unit		19,026	14,983	
Distribution yield (at end-July 2002)		5.77%	5.10%	
ROE (annualized)		6.9%	5.2%	
Investment return	A→C	-13.6%	0.6%	
(Adjusted for distribution)		-10.6%	3.4%	
	B→C	-12.3%	-3.1%	-8.6%
(Adjusted for distribution)		-9.2%	-0.4%	
Average daily return since listing		-0.05%	-0.01%	-0.03%
Standard deviation of daily return		1.56%	1.26%	1.51%
Correlation coefficient with TOPIX		0.260	0.292	

Notes: 1) The distribution yield is adjusted for actual business days and annualized.
2) The daily return was calculated using closing prices (excluding day of listing, i.e., for 11 Sept 2001-31 July 2002).
Source: NRI.

2) The pros and cons of real estate investment trusts from the point of view of institutional investors

(1) Pros and cons

The fact that real estate investment trusts are publicly offered and listed securities means that their liquidity gives them a big advantage—even over other types of property securities such as trust beneficiary rights and special-purpose company bonds. Similarly, the fact that their conduit status as investment companies (company-type investment trusts) exempts them from corporate income tax and they distribute their income gains from letting property means that investors can expect to receive a current yield. Moreover, the fact that the gross price of commercial property in Japan tends to be very high and that it is therefore difficult for any single institutional investor to have a diversified property portfolio means that real estate investment trusts offer Japanese institutional investors exposure to "core property holdings" in the same way as their counterparts in the United States.

On the other hand, the fact that many Japanese institutional investors are still hesitant about investing in real estate investment trusts probably reflects the fact that low investor awareness of them in Japan and the absence of long-term trading data is likely to make investors uncertain and skeptical about their characteristics and suitability as securities.

(2) Real estate investment trusts as equity

In spite of the fact that they are investment trusts and listed on the Tokyo Stock Exchange, real estate investment trusts are not components of the TOPIX. However, inasmuch as they are (1) diversified investments in real assets, (2) able to raise debt, (3) expected to add management value by, for example, cutting costs and acquiring property, and (4) comparable in terms of their market value and trading volume with some listed Japanese property companies, they might well be expected to be considered a type of equity asset (see Figure 9).

In this regard, the decision by Standard & Poor's in the autumn of 2001 to include real estate investment trusts in the S&P 500 (the main benchmark for US equities) marked a watershed in their establishment of a position for themselves as equity assets. In a news release dated 3 October 2001, the rating agency explained that it had decided on careful consideration to regard real estate investment trusts as operating companies rather than as merely passive investment vehicles for the same economic and financial reasons as other listed companies and would be including them in its S&P 500, S&P MidCap 400 and S&P SmallCap 600 indices.[15] On 9 October of that year Equity Office Properties Trust was included in the S&P 500 and has since been joined by the following real estate investment trusts: Equity Residential Properties Trust on 30 November 2001, Plum Creek Timber, specializing in forest resources, on 16 January 2002, and Simon Property Group, specializing in shopping centers, on 25 June 2002.

As it is only relatively recently that the first real estate investment trusts were listed in Japan, it is too soon to reach any definitive quantitative conclusions about their price performance and risk-return characteristics. However, their trading data so far

[15] However, Standard & Poor's decided to use net profits rather than funds from operation (the figure used by most real estate investment trust analysts) to calculate the earnings per share of its indices.

suggest that their returns have a relatively low correlation with those of listed real estate companies, so it may prove to be the case that including them in the market (i.e., Tokyo Stock Exchange) portfolio improves its risk-return characteristics.[16]

(3) Investment policy and information disclosure

Since the first Japanese real estate investment trusts were listed, their management companies have been assiduous in disclosing information, for example, on their investment policies, in an effort to woo investors and as befits institutions keen to observe their accountability to beneficiaries.

Each investment company's "investment policy" is set out in its trust agreement, and investors can usually find it in the company's prospectus. Extracts such as "the Company will normally invest only in property that is currently in use and will not invest in development projects" and "the Company will only borrow from qualified institutional investors—up to a limit of ¥1 trillion" indicate that these real estate investment trusts' cashflow comes from a stable source of rental income and that they do not rely on either a high degree of leverage or development profits. Although the companies do not disclose in their annual reports any details of any new investment opportunities that may arise in the course of the fiscal year, this is simply because they cannot have any idea at the start of the fiscal year whether any such opportunities will arise or on what scale. However, they do normally indicate at analyst briefings what their investment limits are and, if they do decide to invest, they do make timely disclosure of the information and inform analysts and credit rating agencies.

Real estate investment trust unitholders have virtually the same rights and status as shareholders of normal companies (e.g., the right to vote at general meetings, call a general meeting, file a suit against the company on behalf of other unitholders, and to inspect the company's accounts). If there is a vote, they have the right to terminate the contract with the existing management company and to hire another one. The criticisms that are sometimes levied against management companies (e.g., that they might act irresponsibly or do not provide sufficient disclosure) would therefore seem wide of the mark.

4. Issues Outstanding

As we have seen, Japanese institutional investors have made a number of criticisms of real estate investment trusts, ranging from the claim that the market is too thin to

[16] However, the fact that these real estate investment trusts have only been trading for about a year means that any conclusions can be affected considerably by share price movements lasting only a few weeks. Also, differences in market capitalization make it difficult to reach any meaningful conclusions from a comparison with stock indices.

claims that their track record is rather short and that the existence of a management company reduces the ability of the trustees to exercise control. It appears to us, however, that there may be a perception gap here and that these problems may come to be seen as less serious as investors become more aware of real estate investment trusts and as institutions come to attach greater importance to diversifying into a wider range of assets.

However, more concrete action may be called for if more investors are to have a more accurate perception of real estate investment trusts and to regard them as an attractive investment product. For example, including real estate investment trusts in the TOPIX would probably generate more interest in trading in such issues on the Tokyo Stock Exchange and increase investor awareness of them as equity products. Another possibility would be to allow pension funds and investment trusts to retain their conduit status for tax purposes even if they increase their holdings in real estate investment trusts beyond currently permitted limits (as US institutions were allowed to do once the Five-or-Fewer Rule was relaxed).[17]

Yet another possibility would be to allow real estate investment trusts to be formed by means of investments in kind. The original aim of activating the real estate investment trust market in Japan was supposed to be to free up the property market and encourage the process of securitization so that the corporate sector would be able to make more efficient use of its assets and raise productivity. If, as the market in real estate investment trusts expands, (1) some of the distortions that exist because of current property holdings are corrected, (2) the market is opened up to a broader range of investors and (3) a recovery in the corporate sector also promises to boost returns, Japanese institutions that invest in the broader stock market will have a strong incentive to invest in real estate investment trusts. So far, however, insufficient use has been made of real estate investment trusts to restructure the assets of the corporate sector. One of the reasons for this is probably the requirement in Section 5.3 of the Investment Trust Law that investment trusts be in the form of money trusts. If a financial institution or nonfinancial corporation seeking to dispose of a number of idle properties were to transfer them all together to a real estate investment trust, it would find itself liable to capital gains tax on each individual property. Provided adequate protection was provided for investors, allowing real estate investment trusts to be formed by means of investments in kind—in the same way as financial institutions have been allowed to dispose of their equity holdings by transferring shares to

[17] Under current Japanese tax law, real estate investment trusts are regarded as family businesses and lose their tax-exempt conduit status if the top three unitholders own more than 50% of their units. Similarly, the Tokyo Stock Exchange's listing rules do not permit the top 10 unitholders in a real estate investment trust to own 75% or more of the listed units. For more on the regulations governing real estate investment trusts in Japan, see Masahiro Kimura, " Handbook of Japanese Real Estate Investment Trusts“, Nomura Financial Research Center Japanese Equity Investment Report No. 01-173.

exchange-traded tracker funds[18]—would help nonfinancial corporations to restructure their property holdings as well as help to expand the market in real estate investment trusts and attract a broader range of investors.

As was suggested at the beginning of this report, real estate investment trusts are both a property investment and a new type of marketable security for many of the pension funds and trustees that manage clients' money according to investment guidelines. Therefore, unless investors become more aware of and experienced in property investment and alternative investments in general, and unless this is reflected in the Pension Fund Association's Basic Investment Management Policy, investment in real estate investment trusts will be held back. Although it has been said that this fiscal year is a bad time to think about new investment vehicles because employers are considering repaying the non-index-linked part of the state earnings-related pension which they administer on behalf of the state and investment management companies are revising their investment policies, it is also the time when all those involved (i.e., institutional investors, fund management companies and those who create the investment products) must do their utmost to contribute to the debate in as specific a way as possible in order to determine how best to create the conditions in which the institutional reforms of recent years can bear fruit.

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[18] Government and Cabinet ordinances permitting in-kind exchange-traded funds as exceptions to the requirement that investment trusts must normally be in the form of money trusts (Section 5.3 of the Investment Trust Law) were enacted in June 2001. See Sadakazu Osaki, "The Development of Exchange-Traded Funds (ETFs) in Japan", Capital Research Journal, Autumn 2001.