J-REIT Market Trends—Implications of the Growth of Index Funds

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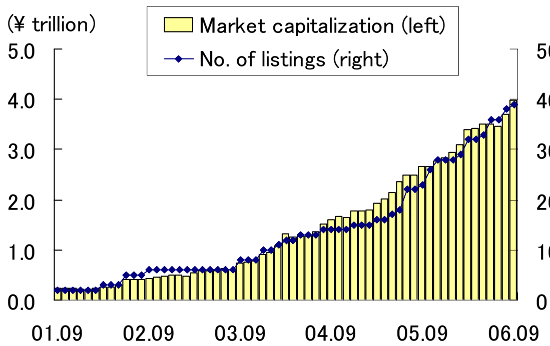
Propelled by attractive dividend yields and the real estate market recovery, the five-year-old J-REIT market has grown impressively in terms of market capitalization and number of listings. Meanwhile, J-REIT index funds have gained prominence as major investors. Generally, when index funds attain an excessive market share, adverse effects can arise in the form of abnormal returns and inefficiency. We confirmed the existence of abnormal returns and observed possible signs of reduced efficiency in the J-REIT market.

1. J-REIT Market Growth

Launched on the Tokyo Stock Exchange in September 2001, the J-REIT market started with two listings and a market capitalization of ¥200 billion. As of the end of September 2006, the market boasts 39 listings and a 16-fold increase in market capitalization to ¥4 trillion (Exhibit 1).

In addition, the acquisition value of managed properties has grown to ¥5 trillion, while the scope of properties has expanded from the initial focus on office properties to commercial, rental housing, hotel, and logistics properties. Property locations—at first concentrated in Tokyo, particularly the central 5-ku area—have also fanned out to other cities (Exhibit 2). This trend reflects not only the emergence of local J-REITs in the Kyushu and Kansai areas, but the pursuit of higher returns outside of central Tokyo, where competition among funds is fierce and property prices are rising. Moreover, a large number of listings are planned ahead, indicating good prospects for further market growth.[1] As J-REITs grow, so too will their role in integrating the real estate and financial markets.

Exhibit 1 J-REIT Growth—Market Cap and No. of Listings



Source: NLI Research Institute

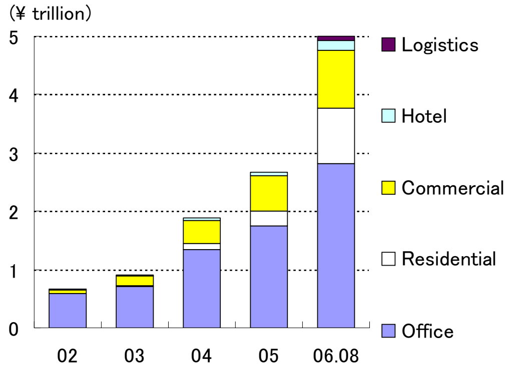
This paper first reviews the five-year history of the J-REIT market and identifies market growth factors and participation trends. We then analyze whether the growth of index funds has produced adverse effects on the J-REIT market.

2. Growth Factors

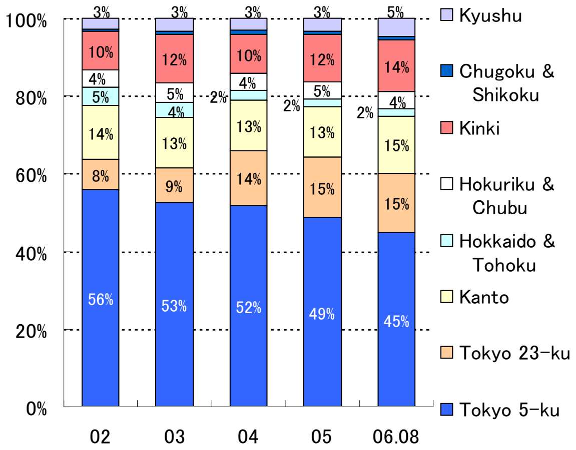
J-REITs have attracted investors with their high dividend yield, stable semiannual dividend payout, conduit status (providing corporate tax relief), and high transparency of disclosure. In addition, growth has been boosted by the real estate market recovery as well as market improvements that encourage investment,

Exhibit 2　Composition of J-REIT Properties

Property type



Location



Source: NLI Research Institute

including the Japanese Bankers Association's notification to report J-REIT gains in net business profits, and the launch of the TSE REIT index in April 2003.

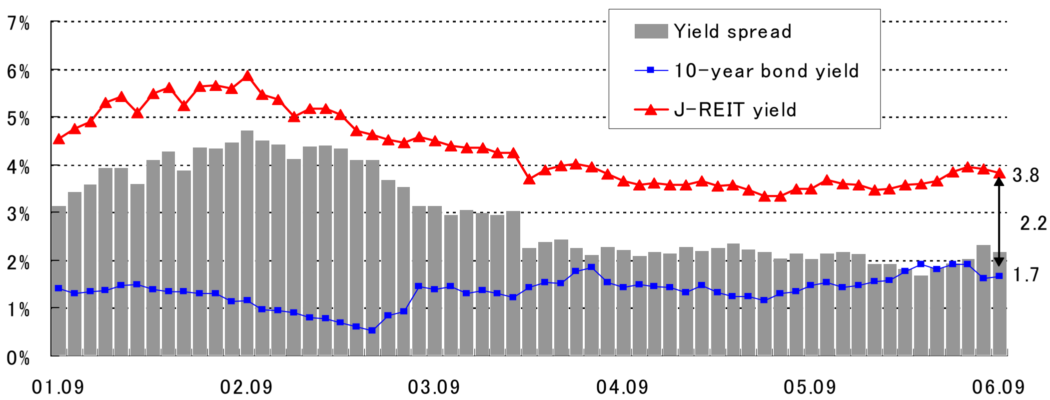
(1)　High Dividend Yield

High dividend yield is arguably the most attractive feature of J-REITs. This is achieved with the stable and long-term income stream from income-producing properties, and from the requirement that J-REITs pay out at least 90% of taxable income each year as dividends. At the end of September 2006, the yield spread (J-REIT risk premium) with the benchmark 10-year government bond was 2.2% (Exhibit 3).

Moreover, at the time of listing and at each financial statement release, J-REITs must announce forecasts for the next dividend payout six months ahead. Remarkably, in all past 118 periods, J-REITS have never disappointed expectations.[2] The positive divergence from guidance numbers varies widely from 0.2% to 46.9%, and averages 8.7%.

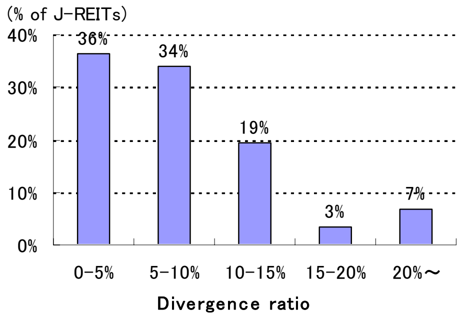
The six-month dividend guidance is relatively easy to prepare for several reasons. First, lease agreements are usually renewed for a period of at least two years. Second, tenants must give a six-month advance notice for lease termination. Third, REITs prefer to use a fixed-period lease with a clear termination date. In addition, they can increase distributions through new acquisitions (external growth), and by improving occupancy rates and cost efficiency of existing properties (internal growth). Because of their impressive performance, J-REITS have earned the confidence of investors, helping to reduce the

Exhibit 3　Yield Spread Between J-REITs and the 10-Year Bond



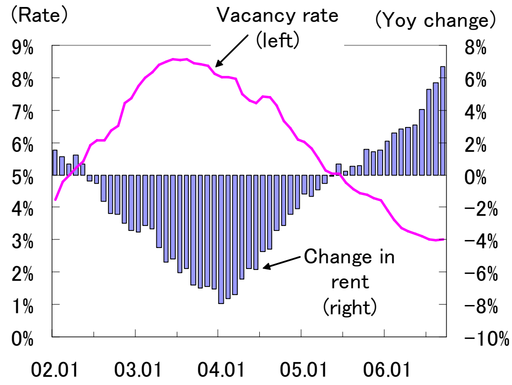
Sources: Association for Real Estate Securitization, Japan Securities Dealers Association yield spread with the benchmark 10-year government bond from a high in the upper 4% range to around 2% since April 2004.

Exhibit 4 Divergence Between Predicted and Actual Dividend



Source: Disclosures

Exhibit 5 Vacancy Rate and Change in Office Rent in Tokyo's Business District



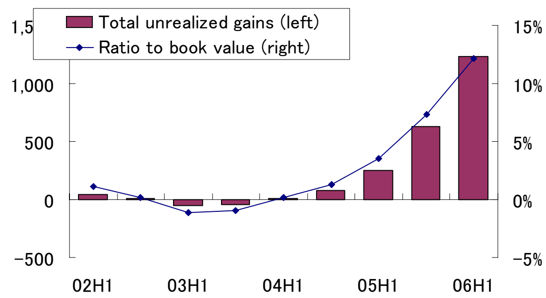
Source: Miki Shoji Co.

(2) Real Estate Market Recovery

The economic recovery has been a boon for the real estate market, driving down office vacancy rates in major cities and accelerating the rise of office rents in some markets such as Tokyo and Nagoya. In the Tokyo business district (the 5-ku area of Chiyoda, Chuo, Minato, Shinjuku and Shibuya), the year-on-year rent increase turned positive in June 2005 (Exhibit 5).

As a result, in the past two years, surging property valuations have generated a significant amount of unrealized gains (appraisal value minus book value) for many J-REITs.[3] Back in the second half of 2003, Nippon Building Fund Inc. (NBF) and Japan Real Estate Investment Corporation (JRE)—the two oldest listings, both of which specialize in office buildings—were saddled with unrealized losses. Recently, however, the combined unrealized gains of the two funds topped ¥100 billion, for a premium of more than 10% over book value (Exhibit 6). Keeping in mind that appraisal values have a subjective element, the large unrealized gains nonetheless make J-REITs more stable as investments by buffering against the risk of decreasing rental income and impairment losses of property values.

Exhibit 6 Unrealized Gains of NBF and JRE



Source: Disclosures

Exhibit 7 Market Improvements

Date	Event	Effect
02.12	JBA notification on reporting J-REIT gains	More money flows to regional banks
03.01·04	Lower transfer & dividend tax rate (10%)	Tax relief for individual investors
03.04	Launch of TSE REIT index	Better market environment & transparency
03.05	2 J-REITs included in MSCI index	More money flows from foreign investors
03.07	Fund of funds (FOF) allowed to invest in J-REITs	More money flows from investment funds
06.10	Revised listing standards, stricter rules for disclosure and conflict of interest	Better market environment & transparency
07 summer (planned)	Listing of J-REIT index futures; reporting of major fund holdings	Better market environment & transparency

Source: NLI Research Institute

(3) Improved Market Environment

Improvements to the market environment, by encouraging investment, are drawing in more investors and driving the market's growth (Exhibit 7). The JBA notification of December 2002 allows gains from REITs to be recorded in the net operating profit of the core business, investment grew primarily from regional banks. Then in July 2003, the Investment Trusts Association of Japan revised its rules to allow funds of funds (FOFs) to invest in REITs, opening the way for investment trusts to invest in REITs. [4] In addition, two new developments will further enhance liquidity and transparency in 2007—launch of REIT index futures trading on the TSE, and the requirement to report large fund holdings.

3. Growth of Index Funds

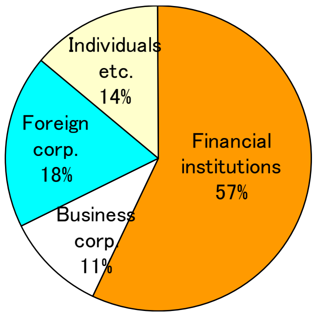
The largest J-REIT investors are financial institutions, with a 57% share. This share is far larger than their 33% share in domestic stock exchanges (Exhibit 8).

The shift in awareness from saving to investment has heightened the market presence of investment trusts. At NBF, whose market cap is the largest among J-REITs, trust banks (including investment trusts) have increased their share at a rapid clip and are now the largest investors (Exhibit 9).

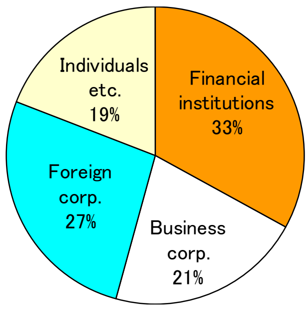
As of the end of September 2006, 40 major funds invest in J-REITs, with a total asset value of over ¥700 billion. [5] Growth has come not only from funds that specialize in J-REITs, but from domestic and foreign funds with diversified holdings in stocks and bonds. Moreover, in the past year, index funds that track the TSE REIT index have gained a 10% market share, surpassing the share of active funds (Exhibit 10).[2]

Exhibit 8 Composition of Investors

J-REIT



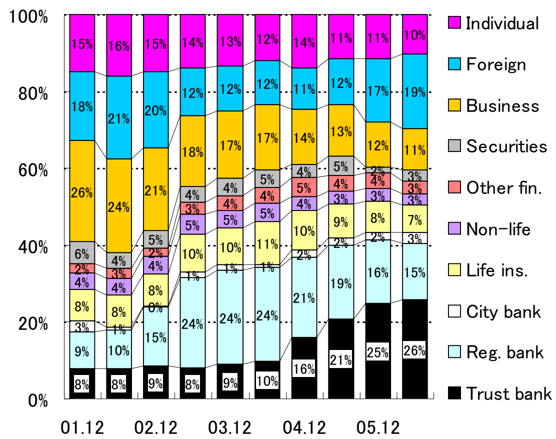
Domestic stock exchange



Notes: J-REIT composition is based on investment unit data as of 2006.08.
Sources: Disclosures; TSE web site

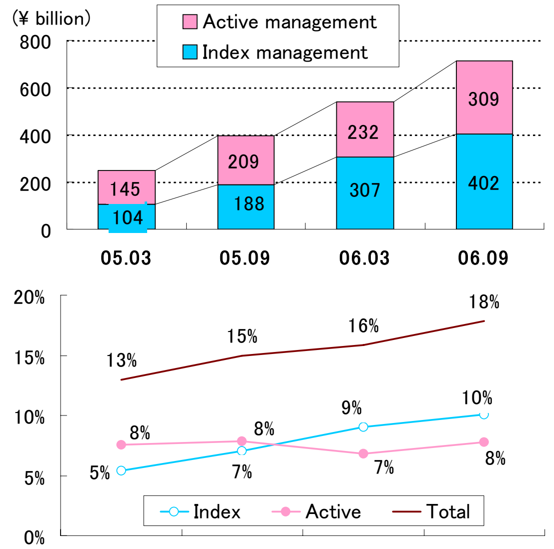
Considering that domestic stock index funds (TOPIX-tied) comprise a 4% share of the stock market, the influence of index funds in the J-REIT market appears to be growing steadily. [7]

Exhibit 9 Composition of NBF Investors



Source: Disclosures

Exhibit 10　J-REIT Investment by Investment Trusts



Sources: Real Estate Economic Institute Co., *Real Estate Fund Review*, prospectuses of investment trusts.

4. Market Impact of Index Funds

Generally, index management can impact the market by generating abnormal returns and reducing market efficiency.

(1) Abnormal Returns

Abnormal returns refer to the return spread that arises when index components are added to or removed from an index. Since index funds alter their portfolios accordingly, a return spread arises between the corresponding components and the index. For example, whenever a listing moves up from the TSE second section to the first section, abnormal returns are observed before and after inclusion in the TOPIX. The same phenomenon occurs in the J-REIT market when a new listing or secondary public offering is made.

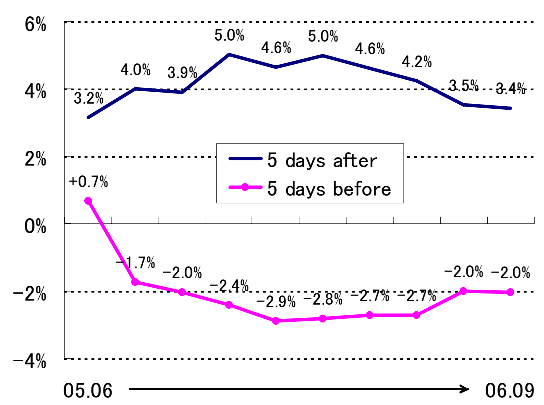
Since June 2005, the TSE REIT index has been adjusted at the end of the month following the listing, the same way as for the TOPIX. From June 2005 to September 2006, 22 new listings appeared. Their price movements around the inclusion date show an excess return of +3.4% on average in the five-day period leading up to the eve of change, and -2.0% in the five-day period after the change (Exhibit 11). For the 16 listings that made a secondary public stock offering during the same period, the average excess return is +2.0% on the eve , and -2.3% on the day of change.

Theoretically, price movements can be attributed to block purchases by index funds on the eve of change (at near the closing price), and to trading by other investors in anticipation of the event. But as the market learned to recognize abnormal returns, index fund managers adopted new methods, while other investors began closing positions more quickly. As a result, trading has become less concentrated at the end of the month, reducing the magnitude of excess returns from peak levels (Exhibit 11).

Exhibit 11　Excess Return of New Listings

Cumulative return		Excess return
5-day period before		+3.4%
	(T−5)〜(T−2)	+2.0%
	T−1	+1.4%
	T	−1.0%
	(T+1)〜(T+4)	−1.0%
5-day period after		−2.0%

Average cumulative return



Sources: Real Estate Economic Institute Co., *Real Estate Fund Review*, prospectuses of investment trusts.

(2) Reduced Market Efficiency

Unlike active funds, index funds do not research and analyze the market to select outperformers, but instead maintain an overall position in the market by simply mimicking the composition and weights of the index. Index funds are thus criticized as being free riders, in the sense that prices are driven more by active-fund trading. Moreover, if index funds gain an excessive market share, investment money flows can tilt toward inferior investments, distorting prices and impairing market efficiency. On the other hand, if index funds actually reduce market efficiency, active fund managers should be able to capture excess returns by taking advantage of such inefficiencies.

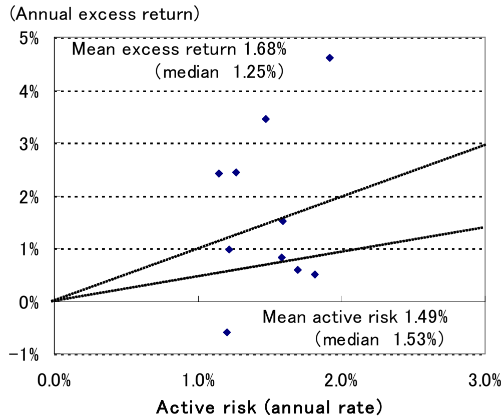
We examined the performance of active funds in the J-REIT market for the period from the end of March 2004 through September 2006. Using quarterly data of ten active funds with at least six quarters of performance data, we calculated the annualized excess return with respect to the TSE REIT index (with dividend) and the active risk (standard deviation of excess return). The excess return is shown both before and after deducting management fees (Exhibit 12).

Nine out of the ten funds show a positive excess return before fees, ranging widely from -0.6% to 4.6%, and averaging +1.68%. By comparison, the active risk is tightly concentrated from 1.1% to 1.9%, with an average value of 1.49%. In addition, the information ratio—a measure of the fund manager's performance against risk and return relative to the benchmark (excess return / active risk)—is superior (0.5 or better) for seven out of ten funds, and exceptional (1.0 or better) for four of these funds.

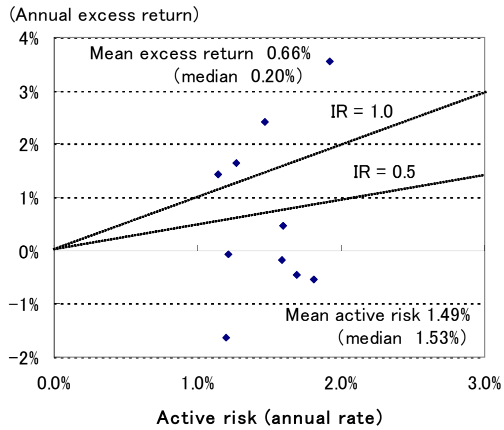
By comparison, the excess return after deducting fees is negative for five of the ten funds. However, considering that index funds consistently underperform the index by -0.5% after deducting the management fee, two of the five active funds with a negative excess return still beat the index fund return, while another two funds match it.

Exhibit 12 Risk-Return Performance of Active Funds

Before deducting fees



After deducting fees



Sources: Bloomberg; prospectuses of investment trusts.

Only one active fund significantly underperforms both the index and index funds.

These results show that many active funds are efficiently earning an excess return in today's J-REIT market. Moreover, active funds also appear to consistently beat the index fund return after deducting fees.

Given the short history and limited number of investment trusts in the J-REIT market, the available data allows us at best only to suggest the possibility of reduced market efficiency. However, looking ahead, it is certain that the efficiency of the J-REIT market will rest heavily on trends among major investors—investment trusts, and particularly index funds.

5. Conclusion

Since real estate markets are unique to each country, direct comparisons are not always meaningful. Nonetheless, we close by noting that the U.S. REIT market has grown into a ¥40 trillion market over its 40-year history. Considering that Japan's income-producing properties are currently valued at ¥70 to ¥80 trillion, today's ¥4-trillion J-REIT market appears to have enormous growth potential ahead.

On the other hand, entering 2006, the impressive growth of the J-REIT market has been marred by revelations of compliance failures by J-REITs and asset management companies. Setbacks to investor confidence include penalties imposed by authorities for fabricating board meetings and failing to examine property specifications.

To enter the next stage of growth, J-REITS must gain broader investor acceptance among pension funds and others. Being publicly offered financial products, J-REITs need to recognize anew the paramount interest of investors. Indeed, all market participants must strive to build investor confidence by addressing such key issues as governance and compliance, reliability of appraisal values, and prevention conflicts of interest.

Notes

1 Over 20 listings are planned in the next two to three years (including Mori Hills REIT, listed on November 30, 2006), with total assets under management exceeding ¥1 trillion.

2 Data period covers from December 2001 financial results of Nippon Building Fund, Inc., to August 2006 financial results of New City Residence Investment Corp.

3 According to financial statements available at the end of August 2006, total unrealized gains exceed ¥300 billion (for the 30 J-REITs that released financial statements).

4 A fund of funds invests in other investment funds instead of investing directly in stocks or bonds. According to ITAJ, the total asset value of FOFs topped ¥10 trillion in September 2006.

5 See Real Estate Economic Institute Co., *Real Estate Fund Review*, October 25, 2006.

6 Investment management styles can be broadly classified into index management, which seeks to match a benchmark return such as the TOPIX index, and active management, which seeks to beat market returns.

7 The total asset value of TOPIX index funds index include passive domestic stock funds of the Government Pension Investment Fund, investment trusts so classified by the Investment Trusts Association (including ETFs), and commingled pension funds of trust banks reported in *Newsletter on Pensions & Investment* (Rating and Investment Information, Inc.). Data is current as of the end of March 2006.