Real estate ETFs – A new investment product to gain real estate exposure?

Follow this weekly blog to broaden your knowledge on real estate ETFs.

The following series of six essays/notes will discuss structures, risks and investment quality of property ETFs and assess their suitability to gain real estate exposure from an investor's point of view.

Week 1:	**Introduction**
Week 2:	**Understanding the differences in real estate fund vs real estate ETF structures**
Week 3:	**Understanding the risks of ETF Structures vs real estate REIT funds**
Week 4:	**The investment universe (AUM, specialisation & fees)**
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Week 1: Introduction

Over several decades now it has been one of the primary goals of the real estate investment industry to find new ways to make real estate investments more liquid. Efforts started with increasing market transparency for the physical asset and fund investing directly in the physical assets by

- Introducing performance/benchmarking measurement
- Making transaction data more available through databanks
- Making portfolio data including valuations available in fund prospectus and fund audit reports

Multiple ongoing discussions have also been held on finding the optimal fund structure.

- Closed-end property funds
- Open-ended property funds (i.e. Property Unit Trusts)
- Fund of funds
- Investment trusts, Real estate investment trusts (property companies, investment companies)

There are two main types of fund structures: open-ended or closed-ended. Closed-ended funds include investment trusts, real-estate investment trusts (REITs) and property funds traded.

The closed-ended structure makes life simpler for fund managers, as they do not have to deal with inflows and redemptions (avoiding forced selling in a falling market). Closed-ended funds also allow higher gearing levels (debt-equity ratio) to boost returns, although gearing exacerbates losses in a falling market, as seen during the last crisis 2007/08.

The major downside of the closed-ended structure is that a fund's shares can trade at a discount or a premium to their true net asset values (NAVs), and there is typically hardly any secondary market to trade these shares.

Open-ended funds include property unit trust or OEIC (open-ended investment companies). The fund manager creates or cancels units that investors buy or sell. The pricing of units typically happens ones per day and directly reflects the value of the underlying assets.

Fund-of-Funds are fund managers who invest in other closed-ended funds. They can offer superior diversification, but are more passive as they don’t directly manage the underlying assets. They also belong into the category of closed-ended funds.

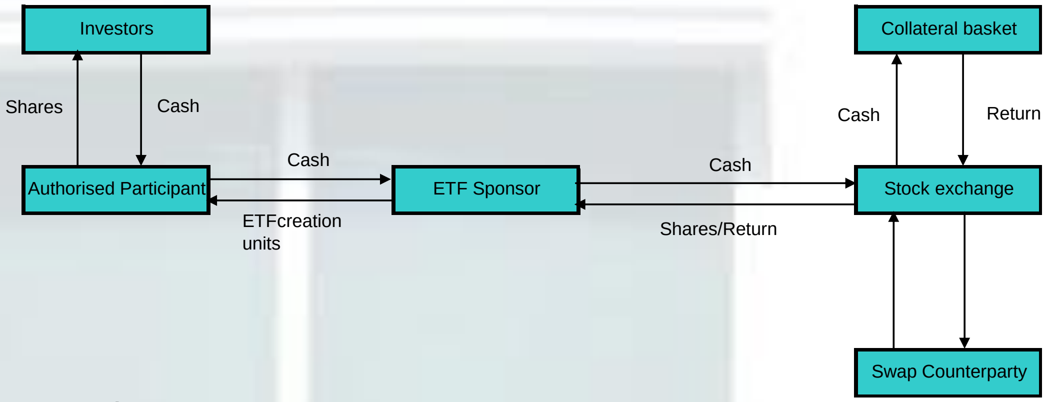
Both closed-ended as well as open-ended fund structures have been criticised at different points in the property cycle. Closed-ended funds have been found too illiquid and inflexible as it is difficult for investors to exit from them. Open-ended funds, which are supposed to be more liquid also had their problems managing redemptions, and some were found to close due to large money outflows in a down-market.

However, from 2000 onwards it wasn't just about different fund structures but totally new products have also emerged in the European market:

- commercial mortgage backed securities
- property derivatives
- property notes
- property ETFs

Like unit trusts and OEICs, ETFs are open ended investment companies, meaning that you can buy or sell their shares, however the shares are much more liquid as they are being traded throughout the day. Hence, the difference to a property securities fund or PUT is that their trading price differs from the underlying NAV. The price of an ETF share on a stock exchange is influenced by the forces of supply and demand.

Figure 1: Basic ETF structure



Source: Nicole Lux, 2013

The market of ETFs has especially grown in other sectors such as commodities, equities, fixed income, currencies. They are used by retail and institutional investors alike.

Next: Understanding the different structures of ETFs and how to mark-to market