YFYS regulation prompts funds to question property strategies

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The constrained nature of the new Your Future, Your Super (YFYS) property performance benchmark is challenging superannuation funds to consider how they invest in the sector.

"We're at the crossroads with regard to real estate," Jennifer Johnstone-Kaiser, Principal Consultant, Frontier said, given the pandemic had also challenged traditionally popular sub-sectors such as office and retail.

The new YFYS benchmark aims to force out underperforming funds, but Johnstone-Kaiser said the property benchmark has several shortcomings, including a lack of diversification and inability to invest in it directly.

"If you choose to pursue a benchmark return – and if you're constrained and can't invest offshore – then most likely Australian core diversified funds are a clear option for you. But you can also pursue offshore needs-based sectors through low cost, passive GREIT strategies.

"We think you can go down a path of pursuing excess returns, primarily in the unlisted sector, because the returns spreads between tradition and niche sectors are still attractive. But to get exposure to these specialist niche sectors you have to go offshore to get scale."

YFYS and other major unlisted benchmark at 30 June 2021

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)
Australian YFYS benchmark	**8.3**	**4.2**	**7.2**	**8.4**	**8.5**
US Core benchmark	6.9	4.5	5.6	7.4	8.6
European Core benchmark	5.0	4.4	5.3	5.7	4.4

Source: MSCI *local currency, after fees

Domestic property markets offer little access to these potentially higher-returning niche sectors such as healthcare, residential and logistics.

Macquarie Group Division Director, Rod Cornish, said demographic and structural shifts are changing demand for housing (Millennials wanting apartments, an aging population), industrial (e-commerce growth), data centres (the rise of cloud computing and online demand), and offices (work from home).

While global office pricing remained tight, it is still attractive compared to local 10-year bonds.

"The difference between cap rates and 10-year bonds across different markets do remain elevated – they have come in a bit – but they're still about 250 to 300 basis points. This is one of the reasons why real estate is still compelling for many investors."

Melinda McLaughlin, Senior Vice President Global Head of Research, Prologis, said logistics real estate has outperformed due to structural trends such as e-commerce. Meanwhile, barriers such as a lack of land supply are also driving up costs.

"Replacement costs have risen more than 15% in 2021 alone," she said "That's put more upward pressure on rents and values than before. But as we look forward, the supply rates remain low: roughly 70% of the pipeline in the US is already pre-leased."

Strong US and Europe rent growth is being driven by key markets where demand exceeds supply and companies are seeking to protect supply chains or last mile delivery.

"At today's historically low vacancy rates, if customers want more space to be able to grow, they're going to have to pay those rents."

Core life sciences is another strongly growing offshore area, with. Lab rent compound annual growth rates have been approximately 9% since 2014, according to sector specialist Breakthrough Properties.

The sector's growth is being driven by the convergence of technology and biological sciences that is underpinning new medical advances such as cell and gene therapies.

Breakthrough Properties Chief Executive Officer and Co-Founder, Dan Belldegrun, said there has been a major compression of cap rates but there are still development and redevelopment opportunities.

"You can get a return on costs in the 7% range in the same markets where you're seeing low 4% cap rates and that spread is really where were seeing the capacity for opportunistic returns, whether it's ground-up development or repositioning product in the life sciences space to take advantage of the mark to market."

He said the US is the most advanced life sciences market with opportunities in Boston, San Francisco, San Diego, Los Angeles and Philadelphia, although Europe is also attractive.

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