Real Estate Mutual Fund- Broadening India's Capital Market

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Abstract: - **Today, the Indian economy is growing at a scorching pace and the real estate sector is growing even faster. Eventually, more and more money is chasing a limited quantity of high-quality property. This makes real estate potentially one of the best investment opportunities out there. However high prices and transactions costs make it a difficult investment for an average investor to take bets on this fast-growing sector. Fortunately, a new investment product called real estate mutual fund is being developed which will make it easier for the average investor to invest his or her hard-earned money in real estate. According to survey, real estate mutual funds "tend to focus their investment strategy on real estate investment trusts (REITS) and real estate companies." real estate investment trusts are companies that buy and manage real estate with funds collected from investors. This study provides an overview of the concept REMF, its working process and certain conditions of investment in REMF.**

Keywords: Investment, REIT, REMF, Indian Economy, Profit.

I. INTRODUCTION

One sector that has assumed growing importance in the liberalized Indian economy is that of real estate. Growth in real estate has been fuelled by expanding economy, rising urbanization and improved transparency. According to survey, real estate mutual funds "tend to focus their investment strategy on real estate investment trusts (REITS) and real estate companies." Real estate investment trusts are companies that buy and manage real estate with funds collected from investors.

Real estate mutual funds provide investors with one of the easiest ways to get started in this market. These specialized funds oftentimes allow investors to participate with as little as Rs.1,000. Real estate funds also offer the investor the advantages of a mutual fund, which includes a portfolio with lower overall risk, as well as professional management of the investments.

II. OBJECTIVE OF THE STUDY

- To study the concept of REMF, its working process and certain conditions of investment in REMF.
- To study about Real Estate Investment Trusts and how it differs from REMF.

III. LITERATURE REVIEW

Mark Gordon (2008), in his book, "The Complete Guide to Investing in REITs, Real Estate Investment Trusts: How to Earn High Rates of Return Safely", mentioned publicly and privately held REITs, Net Asset Value (NAV), Adjusted Funds From Operations (AFFO), Cash Available for Distribution (CAD), the benefits associated with REITS, dividend reinvestment programs (DRiPs), capitalization rate, equitization, leverage, positive spread investing, securitization, and straight-lining. He also stated that a REIT stock becomes like any other stock that represents the holder s ownership in a business. However, REITs have two distinct features: REITs manage groups of income-producing properties and must distribute 90 percent of profits as dividends. The Complete Guide to Investing in REITs will teach you everything you need to know about REITs and how you can earn high rates of return.

Carolyn Janik (2005), in her book, "Making Money in Real Estate: How to Start Out on the Road to Financial Independence with Residential and Commercial Property", explained that investing in real estate can be a good way to build wealth, diversify their investment portfolios, and create financial security. Yet real estate investing isn't a surefire strategy, and it isn't for everyone. She provides checkpoints (including financial tips and contract safeguards) to ensure that every investment is a good one. It covers key intuitive skills that real estate investing requires such as negotiating effectively and recognizing a good deal. In their love affair with real estate, Americans need guidance to make commonsense decisions, minimize risk, and maximize their profits.

IV. THREE WAYS TO INVEST IN REAL ESTATE

With that introduction, let's step back for a moment to briefly review the three ways everyone can invest in real estate:

- *Owning Properties*: This strategy involves the investor selecting, and purchasing, individual real estate properties. There are many experts that can help investors to get started in this area. This particular strategy is beyond the scope of this publication, other than an introduction to the topic of flipping homes.

- *Real Estate Investment Trusts*: companies established as trusts that invest in real estate, mortgages, or a combination of each. Real estate investment trusts are often referred to as REITs.
- *Mutual Funds:* includes funds composed of real estate companies, businesses supplying services to the real estate market, as well as real estate investment trusts.

V. REAL ESTATE INVESTMENT TRUSTS

Real Estate Investment Trusts, or REITs, typically own and operate real estate properties. These may include multifamily dwellings, shopping centers and malls, commercial office space, and even hotels. Real estate investment trusts are run by a board of directors, which make the investment decisions on behalf of the trust.

REITs offer the investor several advantages such as diversification, liquidity, and professional property management services. The earnings growth for these trusts can come from several sources. For example, an increase in occupancy rates for hotels or commercial office space. The trust can grow earnings by investing in additional properties, or by running existing properties more efficiently. They can also invest additional capital into existing properties to improve their appearance and marketability.

Federal Income Taxes

The structure of a REIT was originally designed to provide individuals interested in investing in real estate with the same benefits that mutual funds provide to those interested in stocks. REITs can be both publicly or privately held companies. Non-private (public) REITs can be listed on stock exchanges just like shares of common stock.

REITs themselves usually pay little or no federal income tax. But they are subject to a number of requirements set forth by the Internal Revenue Service. In particular, there is a requirement to annually distribute at least 90% of the REIT's taxable income in the form of dividends to its shareholders.

Many REITs distribute all of their current earnings; under certain conditions, they may even distribute more than current earnings. If a REIT distributes more than its taxable income, the excess distribution is considered "return of capital." This kind of distribution is taxed as a capital gain rather than regular income. The requirement to distribute earnings can have a negative effect on individuals seeking to maximize the growth on their investment. However, improvements in the underlying holdings such as leases, properties, or changes in interest rates continue to fuel the market's demand for real estate.

Mutual Fund Returns

According to Morningstar's rating system, the mutual funds in this specialty area enjoyed tremendous growth in the past ten years, with an average annual return of over 9.0% as of September 2013. This is quite remarkable, given the downturn that occurred in 2007 through 2009. In fact, most analysts agree that real estate mutual funds play an important role in a long-term investment portfolio.

Typically, the managers of these funds tend to focus their investing strategy on real estate investment trusts and real estate companies. This latter category would include large builders of properties. The returns of these mutual funds will usually be influenced by economic factors such as the matching of supply and demand for commercial office space as well as interest rates.

In the same way that interest rates affect the local real estate market, rising interest rates usually result in decreased demand for real estate and flat or declining housing prices. This is true because an increase in interest rates means home buyers will qualify for smaller mortgages. On a larger scale, rising interest rates can have a dramatically negative effect on new home sales.

Top Performing Real Estate Mutual Funds in 2013

All of these funds performed very well, but reward does not come without risk. Each of these funds beat their category average in the last three and five years:

- *Fidelity Advisor Real Estate Fund Class T (FRIFX*): a mid-blend real estate mutual fund, this no-load fund requires an initial investment of only $2,500. Top holdings include Banc America Large Ln 2010, MFA Financial, Inc., and USD. The fund has about $3.9 billion in assets, and the average return over the last five years is 9.57%.
- *Managers Real Estate Securities (MRESX):* a mid-blend real estate mutual fund, this no-load fund requires an initial investment of only $2,000. Top holdings include Simon Property Group Inc., Prologis Inc., and AvalonBay Communities Inc. The fund has about $1.3 billion in assets, and the average return over the last five years is 4.76%.
- *Fidelity Advisor Real Estate Income A (FRINX):* a mid-blend real estate mutual fund, this carries a 4.0% load and requires an initial investment of only $2,500. Top holdings include Banc America Large Ln 2010, MFA Financial, Inc., and Equity Lifestyle Properties, Inc. The

fund has about $3.9 billion in assets, and the average return over the last three years is 4.45%.

VI. REMF

A real-estate fund (REMF) functions like any other mutual fund. Instead of investing in stock or bonds, an MEMF invests directly in property or indirectly in the equity of real estate companies. There can be two ways of Real Estate Mutual Funds:

- Mutual Funds that invest directly in real estate – currently not allowed in India.
- Mutual Funds that invest in equity of real estate companies, viz., development companies, operating companies and REITs.

Working of REMF

Since the product is at a very basic stage in India, it makes sense to look at international markets where a similar product -- the real estate investment trust (REIT) -- is quite popular. In the US alone there are hundreds of publicly traded REITs (just like we trade in shares or mutual fund units) with several hundred billion dollars in assets. An REIT by its very nature will buy, develop and maintain property both for sale and rent and share profits with those who invest in such funds. Like our regular mutual funds, real estate funds will also charge various fees for administrative and management expenses. There are different business models for REITs. Some of them may focus on buying and selling property thus making money on increases in value. Others may focus on renting or leasing commercial property. Yet others may finance mortgages and earn income through interest payments on property-related loans (just like your HDFC Bank, ICICI Bank or LIC Housing Finance does).

As with mutual funds we can choose different products based on the business model we prefer.

REMF Vs REIT

REITs are also investment vehicles dealing in real estate. Like REMFs, they too are close ended schemes and listed on stock exchanges. But there are big technical differences between the two.

First, a REIT is mandated to distribute at least 90 per cent of the gains it makes in a year to its unit holders.

Second, a REIT can invest only in finished projects and not in the ones that are under construction.

Hence, it earns its major chunk from renal income. While REITs help you earn only o regular income, REMFs give you capital appreciation too.

Spreading of Risk

Real estate mutual funds, as being developed in India, are along similar lines. They will offer the same general advantages that mutual funds offer for investors: namely diversification and lower transactions costs. For example suppose you want to invest in real estate in Navi Mumbai, perhaps with the expectation of rising prices as the area develops and as the nearby special economic zone, SEZ, gets going. It's not a bad investment idea but the problems are immediately obvious. For one thing even a relatively inexpensive flat might cost upward of Rs 10 lakhs, which is obviously beyond the means of an average investor. Even if we could obtain that kind of money, buying property involves all sorts of transactions costs. Finding the flat in the first place will take a fair amount of legwork and research. Then there is the issue of negotiating the sale, obtaining proper title and dealing with potential legal disputes. Then again even after taking ownership we will have to invest in maintaining our property. As an investment, a single flat is obviously not adequately diversified and may not appreciate as much as we expect. Perhaps the area starts to suffer from chronic electricity or water problems dampening the value of our property. Perhaps the SEZ runs aground because of political controversies. Clearly having all our eggs in one basket is not a good investment strategy.

This is where a real-estate mutual fund comes in. The fund will invest in a large number of properties in different places thus providing much greater diversification than an individual is capable of. It will also take care of the costs of buying and managing property.

While real estate mutual funds, REMFs, are an exciting investment opportunity, retail investors will have wait for some time before they hit the market.

An idea whose time has come?

Currently, the Securities and Exchange Board of India (SEBI), the market regulator that approves of such schemes in India, is in the process of examining the product and is especially concerned about developing sound valuation norms for the funds.

There are real-estate funds, which have been approved, but these are venture capital funds, which are targetted at high net-worth individuals or institutions. For example the HDFC Property Fund has a minimum investment of Rs 5 crore. However it's only a matter of time before real estate mutual funds are opened to retail investors. This will not only provide a promising new investment vehicle but will also help develop the nation by channeling savings into much needed housing and commercial projects.

VII. INVESTMENT IN REMF SCHEMES

Securities and Exchange Board of India has recently notified SEBI (Mutual Funds) (Amendment)

Regulations, 2008 for Real Estate Mutual Funds (REMFs) to invest directly or indirectly in real estate assets or other permissible assets.

The regulations defines "real estate" to mean immovable property, which is (i) located in India in cities specified by the Board or in Special Economic Zones(ii) constructed and usable (iii) evidenced by valid title documents (iv) legally transferable (v) free from encumbrances (vi) not subject matter of any litigation, but excludes (I) project under construction, or (II) vacant land, or (III) deserted property, or (IV) land specified for agricultural use, or (V) a property which is reserved or attached by any Government or other authority or pursuant to order of court of law or the acquisition of which is otherwise prohibited under any law in force.

Real Estate Mutual Fund Schemes may be launched by an existing mutual fund having adequate number of key personnel and directors having adequate experience in real estate or new entrants carrying on business in real estate for at least 5 years. They will also have to fulfill all other criteria applicable to a mutual fund.

Such schemes will be subject to the conditions that (1) it is close ended and its units shall be listed on a recognized stock exchange (2) the units issued shall not confer any right on the unit holders to use the real estate assets held for the scheme and any provision to the contrary in trust deed or in the terms of issue shall be void (3) the title deeds pertaining to real estate assets held by scheme shall be kept in safe custody with the custodian of the fund (4) shall not undertake lending or housing finance activities (5) all financial transactions of the scheme shall be routed through banking channels and they shall not be cash or unaccounted transactions

The Real Estate Mutual Fund has to follow the prescribed permissible pattern of investments, which is

- The fund has to invest at least 35% of the net assets of the scheme directly in real estate assets and balance in mortgage backed securities (but not directly in mortgages), equity shares or debentures of companies engaged in dealing in real estate or in undertaking real estate development projects (whether listed on a recognized stock exchange in India or not), and in other securities. Taken together, investment in real estate assets and real estate related securities shall not be less than 75% of the net assets of the scheme;
- No fund shall, under all its mutual fund investment schemes, invest more than 30% of its net assets in a single city;
- No fund shall, under all its mutual fund investment schemes, invest more than 15% of its net assets in the real estate assets of any single real estate project. "Single real estate project" means a project by a builder in a single location within city;
- No fund shall, under all its mutual fund investment schemes, invest more than 25% of the total issued capital of any unlimited company
- No fund shall invest more than 15% of the net assets of any if its mutual fund schemes in the equity shares or debentures of any unlisted company;
- No fund scheme shall invest in:

  - any unlisted security of the sponsor or its associate or group company;
  - any listed security issued by way of preferential allotment by the sponsor or its associate or group company;
  - any listed security of the sponsor or its associate or group company, in excess of 25% of the net assets of the scheme.

- No fund shall transfer real estate assets among its scheme;
- No funds shall invest in any real estate assets which were owned by the sponsor or the asset management company or any of its associates during the period of last 5 years or in which the sponsor or the asset management company or any of its associates hold tenancy or lease rights.

Disadvantages

- When we **own** real estate mutual funds, we have no role in deciding what companies are invested in or how they are run. Unlike directly owning stock in a company, we do not have voting privileges on issues having to do with the fund. Our role is diminished compared to most other types of real estate investment. We do not receive tax benefits like depreciation, although if we hold our mutual fund investments for more than a year our profits are taxed at the capital gains rate, just like actual real estate.

- If we decide we'd like to **invest** in real estate mutual funds, do our research first. Use online stock screener to find funds specializing in real estate. Look at the funds' track records: see how they have performed over short-, mid- and long-term periods of time. Read the fund's prospectus, a report covering all the basics of a fund: who runs it, what the fees are, what the minimum investment amount is and what individual companies the trust owns. The prospectus will also describe the level of risk associated with the fund and define the fund's goals.

- Investing in real estate investment trusts and buying a property ourself are the two obvious alternatives to real estate mutual funds. Real estate investment trusts are a good transition into actually purchasing investment property; we can actually go visit properties the real estate investment trust owns and read expense and income statements for them. One way to begin with our own rental property is to buy a new home and turn our former home into a rental rather than selling it; this way, we're already familiar with the expenses and taxes owed on the property, and can set the rent accordingly.

VIII. CONCLUSION

For investors looking to park their funds in the real estate sector, mutual funds are the most cheapest and convenient method. This category of funds also offers superior protection against inflation. The real estate sector has seen tough times recently but the presence of these investments generally adds stability to a portfolio. This is because the volatility in property prices is far less compared to the kind experienced by stocks. Adding such funds to a widely diversified portfolio would increase returns while reducing the associated risk significantly.

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