The international route to a truly diversified property portfolio

Real estate is often seen as a diversifier for a traditional equity and bond portfolio. Yet, while most investors are aware of the importance of portfolio diversification, many with property investments still exhibit varying degrees of “home bias”, a tendency to favour domestic markets over those in other countries. Investors in direct real estate (“bricks and mortar” as opposed to property securities tradeable in liquid markets) are, if anything, more susceptible to this home bias than others.

In this article, we analyse the prevalence of home bias in direct real estate and suggest why it may make sense to diversify into international property markets. We also show that the reasons to diversify may vary depending on the investor’s starting point in their home market and that there are specific factors to be taken into account when evaluating property investments.

Real estate usually constitutes the largest proportion of alternative assets in institutional investors’ portfolios, representing approximately 10% of total assets in global pension portfolios alone[1]. Endowments, foundations and funds of funds are the only institutional investors that do not have direct real estate as the largest part of their alternative asset allocation. However, the domestic weighting of the asset class can range from a little over 60% in Canada to nearly 80% in the US and 90% or more in the UK and Japan. By comparison, on average only 43% of equities in institutional portfolios are allocated domestically[2].

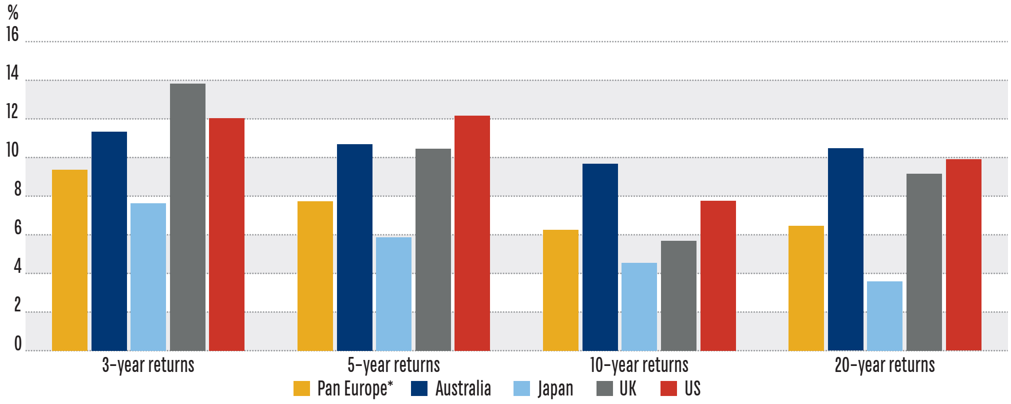
So why is home bias particularly prevalent in direct real estate? It is certainly true that this is an asset that is significantly less liquid than others and requires extensive due diligence and expertise to invest in successfully. Investors may therefore feel more comfortable sticking to property investments close to home, which they may feel they understand better. It could be equally well argued, however, that these same characteristics should make investors more keen to diversify abroad in a search for better – or at least more consistent – returns, while reducing risk.

Returns look winning

It is not hard to see why investors have wanted to make an allocation to direct property. Several property markets have comfortably outperformed returns from developed market equities and bonds over a number of periods (Figure 1).[3] However, it is true that returns have tended to be lower in absolute terms over longer periods. This weakness can be largely explained by the property crash between 2007 and 2009 and its aftermath. Despite these poorer years, longer-term returns have still been respectable.

1 Willis Towers Watson’s Global Alternatives 2016 Survey and Willis Towers Watson’s Global Pension Assets Study 2016.
2 Willis Towers Watson and MSCI, 2014.
3 By way of comparison, the local currency returns for the MSCI World equities index were 13.7%, 10.2%, 5.5% and 6.8%, and for the Citigroup World Government Bond Index 3.3%, 4.0%, 3.7% and 4.7% respectively over the four periods shown in Figure 1.

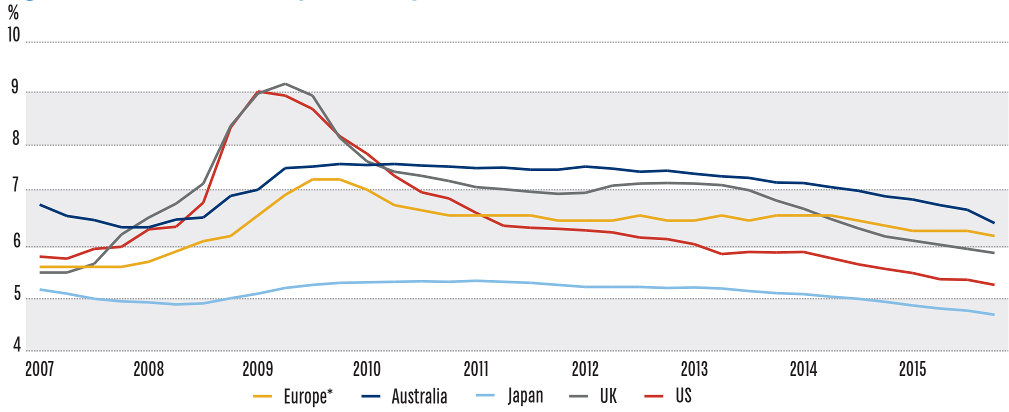
Figure 1: International property has offered healthy returns over most horizons...



*Europe ex-UK, offices only. All returns are annualised and in local currency.
Source: Investment Property Databank (IPD), National Council of Real Estate Investment Fiduciaries (NCREIF) and Schroders, as at 31 December 2015.

While the level of returns clearly matters, their composition is also important. One of the key attractions of real estate for many investors is its high and relatively stable yield. Although yields have fallen, property still provides a superior income return to bonds in most markets. The size of this gap is likely to vary over the property cycle, depending on prospects for rental growth. When the economy is strong and rentals are expected to rise, investors may only require a small premium of 1-2% to compensate for the additional risks of depreciation and illiquidity. Conversely, when the economy is weak and rental income static, or expected to fall, investors may require a premium of 3-5% over bonds. As it happens, the current premium is around this level, which we believe is attractive given the prospects for steady economic and rental growth in most markets.

Figure 2: ...and a wide spread of yields...



*All Europe. Europe, Australia, Japan and US yields based on capitalisation rates. UK yields based on equivalent yields.
Source: Green Street Advisors, IPD and Real Capital Analytics, as at 31 December 2015.

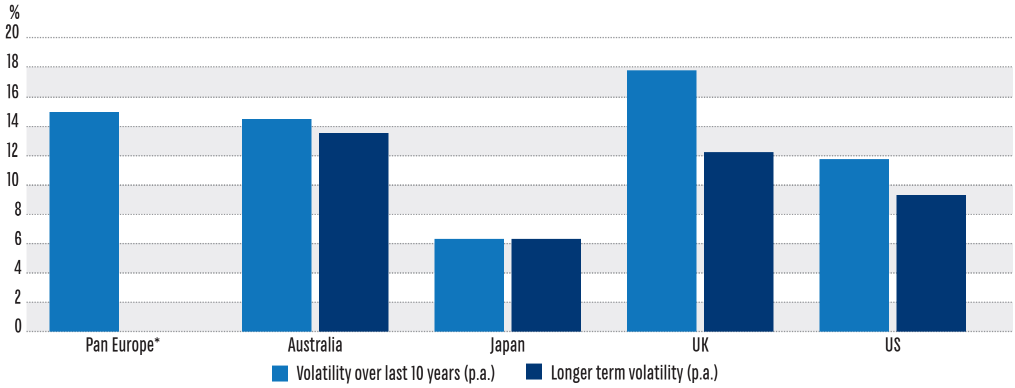
As Figure 2 shows, capturing this premium often requires a willingness to invest abroad. Once that decision has been made, we would argue that differences in lease terms and political risk mean investors should then focus on a limited number of cities with certain key characteristics. These include a diverse economy, skilled labour force, good infrastructure, proactive local government and good retail and leisure facilities. Attractive cities include major ones, such as Amsterdam, Berlin, Boston, Brussels, Hamburg, London, Los Angeles, Munich, New York, Paris, Shenzhen, Stockholm, Sydney and Tokyo, and smaller ones, such as Bordeaux, Cambridge, Mannheim and Malmö.

Risk can be spread more widely

Of course, returns are only half the story. Indeed, one of the major advantages of real estate should be its potential for risk reduction. As we have said, investors often consider their home market to be less risky than unfamiliar foreign markets. This may be true when the investor lacks the necessary expertise, putting them at a disadvantage to local investors. However, this is not an argument against investing overseas, simply that appropriate expertise is required.

In truth there may be lower risks away from home. Take volatility, which is one way to define risk. Volatility varies quite widely from one region to another, when measured using "unsmoothed" returns (Figure 3), calculated using a mathematical approach that attempts to recreate the volatility intrinsic to financial markets[4]. There should therefore be potential for investors to reduce risk by switching assets into foreign markets.

Figure 3: ...as well as a wide spread of risks



*Pan Europe data from 2006 only. Unsmoothing methodology devised by Schroders Research and Analytics team.
Source: IPD and NCREIF, as at 31 March 2016.

However, volatility is only one aspect and there are several other risks, many stemming from the simple fact that real estate is a physical asset, rather than a financial one:

Illiquidity. The extended due diligence required to buy bricks and mortar and relatively high transaction costs mean that investors need to take a long-term view and understand that they cannot sell quickly without compromising on price. Investor sentiment and liquidity also fluctuate significantly over the property market cycle.

Lease terms. Lease terms vary from one country to the next. Standard lease terms in France, Belgium, the Nordics and Japan are short, with either an expiry or break option every two to three years, whereas leases in Germany, the UK and US are typically between five and 10 years. However, there is a certain amount of inertia among commercial occupiers: tenants in France, for example, are more likely to renew their lease than in the UK. Furthermore, many continental European leases include an element of inflation indexation, whereas UK leases have no indexation, but include an upward-only rent review clause which prevents a cut in rent during the lease period.

Covenant strength. As with equities and corporate bonds, investors in real estate are exposed to the risk of default. However, one of property's redeeming features is that, in the event of a tenant insolvency, the landlord should be able to re-let the vacant space, whereas a shareholder or bondholder in an insolvent company could lose everything.

Structural change and obsolescence. The long holding period means investors need to be aware of how structural shifts may change occupier demand, e.g. on-line retail, robotic process automation and driverless cars and trucks. They also need to anticipate how infrastructure and regeneration projects will change the attractiveness of locations. The other side of the coin is that real estate investors can add value in a number of ways, including changing and upgrading properties and extending leases.

Deceptive diversification. Investors need to be careful they don't squander the benefits of geographical diversification by picking cities with the same economic driver. For example, demand for offices in Frankfurt, Hong Kong, the City of London and New York is linked to financial services. Similarly, energy and commodities drive demand in Calgary, Houston, Oslo and Perth. As a result, a portfolio which includes cities whose economies are largely domestically orientated (e.g. Atlanta, Chicago, Cologne and Melbourne), or are seats of government (e.g. Brussels, Berlin and Washington), probably carries less risk than one dominated by cities tied to the global economy.

4 Amongst other things, this takes account of the inevitable lag and infrequency of real estate valuations, as well as valuers' caution and their tendency to understate both peaks and troughs in market prices.

Taking these factors together, we can see from annual returns (Figure 4) that global real estate markets are seldom in synch. Thus, while the UK market was one of the first to be hit by the credit crunch in 2007, it was also the first to recover in 2009. The US was just behind and then experienced a much stronger recovery than virtually any other region. This lack of alignment between property cycles around the world suggests that an international portfolio should not only diversify returns, but also reduce risk.

Figure 4: The best annual returns vary from year to year…

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Europe ex-UK	12.0%	12.9%	0.1%	-4.7%	4.8%	6.0%	4.6%	5.2%	9.6%	13.4%
Australia	19.7%	18.4%	-0.1%	-2.3%	9.4%	10.3%	9.4%	9.3%	10.8%	14.0%
Japan	13.5%	11.3%	-1.1%	-6.3%	0.2%	2.9%	3.7%	6.2%	7.8%	8.9%
UK	18.1%	-3.4%	-22.1%	3.5%	15.1%	7.8%	3.4%	10.7%	17.8%	13.1%
US	16.6%	15.8%	-6.5%	-16.9%	13.1%	14.3%	10.5%	11.0%	11.8%	13.3%

All returns are in local currency. Source: IPD and NCREIF, as at 31 March 2016.

We can further demonstrate direct real estate's diversification potential with cross correlation figures for the five markets. The relatively low correlations displayed in the table (Figure 5) demonstrate the existence of past diversification opportunities. While there are limitations to using historical correlations to determine such opportunities, they are a good starting point. Take the US, for instance. It is relatively uncorrelated with the other markets, suggesting that its returns may be driven by distinctly different factors from other markets.

Figure 5: …while correlations between regions confirm the diversification potential

	Pan Europe	Australia	Japan	UK	US
Pan Europe	1.00	0.44	0.53	0.55	0.64
Australia	0.44	1.00	0.62	0.34	0.20
Japan	0.53	0.62	1.00	0.50	0.16
UK	0.55	0.34	0.50	1.00	0.45
US	0.64	0.20	0.16	0.45	1.00

Unsmoothing methodology devised by Schroders Research and Analytics team. Source: IPD and NCREIF. Base date 31 December 2005, data as at 31 March 2016.

Confirmation of these figures comes from the performance of real estate investment trusts, which are essentially market-traded collections of property. Long-term correlations for trusts operating in our five major markets are similar to those of the unsmoothed returns from direct real estate.

Conclusions

We have shown that diversifying into foreign real estate markets can be beneficial, particularly from a risk reduction perspective. How much to invest internationally and where will ultimately depend on the investor's starting point. Some investors are principally looking for superior total returns, while others are more concerned about achieving a certain level of income. Either way, international real estate should offer more security for investors than concentrating assets in their own property market.

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