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Going global

Widening the real estate opportunity set

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Empower Results®

Executive summary

- The global diversification of equity and fixed income allocations is regarded as an integral part of portfolio construction; however is less so for real estate.

- The real estate investible opportunity set is increased substantially by expanding outside of a single domestic market and this warrants increased consideration of the benefits of such an allocation. To put this into context, the UK real estate market is approximately 5% of the overall global investible market in terms of institutional quality stock[1].

- An allocation to global real estate enhances the stability of income in a real estate portfolio and can provide a cushion against country specific risks - given the localised nature of real estate returns, we view this favourably. This risk is aptly illustrated by the lower return expectations of UK real estate in the midst of Brexit uncertainty.

- Here, we specifically consider the core and core plus (we collectively define these as 'core') segments of the real estate opportunity set as key to meeting the objectives for a real estate allocation of diversification and stability of income. Clients with existing UK property exposure will be invested in balanced, diversified funds or have segregated direct portfolios which focus on this combined opportunity set and we are applying the same approach to a global real estate strategy. The outcome is a portfolio where there is a strong income component underpinning returns with potential for additional performance generated through active asset management.

- We would expect a global core portfolio to deliver an annualised return of approximately 6-7% net of all costs and fees over the next real estate cycle whereas for comparison, consensus forecasts are that UK core real estate will return less than 5% per annum[2]. For investors seeking higher returns, higher risk strategies are available outside of the core space which can potentially deliver double digit returns; however this is not the primary focus of this paper.

- Global core real estate allocations should be considered a long term allocation, similar to domestic real estate investments. However, there are additional risks and considerations such as regulatory risks, tax leakage and structural differences which investors should acknowledge prior to investing.

- Global real estate is an established opportunity set and can be accessed through listed or non-listed routes. The best route for investors will depend on individual circumstances, although for the majority of our clients seeking diversification and income, the non-listed route is likely to be most appropriate.

- The approach to gaining exposure to global core real estate depends on the structure and size of an investor's existing portfolio, as well the desired risk, return and liquidity profiles.

- Portfolio construction and manager choice within global real estate is crucial to its efficacy.

[1] *CBRE Global Investors, 2017, Presentation: Global Real Estate Investible Universe*
[2] *Investment Property Forum (IPF), May 2018, UK Consensus Forecasts (Spring 2018) Full Report*

Introduction

The global diversification of equity and fixed income allocations is regarded as an integral part of portfolio construction; however this is rarely reflected in the case of real estate allocations. A 2017 survey of European institutional investors found 49% of investors have an allocation to domestic real estate but only 5% have an allocation to non-domestic real estate[3].

Historically this has been driven by a number of factors, including:

- The complexities and costs of investing in global real estate;
- Local regulatory restrictions;
- The limited numbers of managers with global expertise; and
- Strong performance of domestic property markets.

The majority of our UK domiciled clients have real estate exposure which is predominantly core and domestically focussed. Where global real estate exposure exists this is often via tactical allocations to more levered value-add and opportunistic closed ended funds.

We believe that market developments and diversification benefits warrant revisiting the case for global core and core plus focussed real estate strategies.

We focus on core and core plus real estate as our preferred strategies and the combined strategies are referred to as ‘core’ for simplicity within this paper. Fundamentally this combined approach results in a portfolio where there is a strong income component underpinning returns with potential for additional performance generated through active asset management.

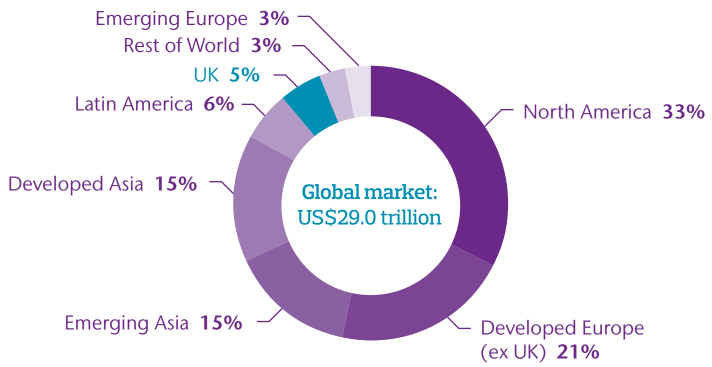
This paper explores the strategic rationale for building a diversified, global core real estate allocation as well as providing consideration points for access and implementation.

Revisiting the strategic case for global real estate

Institutional investors have typically invested in domestic real estate markets and placed a significant risk premium on foreign markets. Imperfect information on foreign real estate markets and a lack of managers with the expertise and skills required to manage global portfolios are part of the rationale for this.

However, we believe the situation has changed markedly, especially with regards to solutions available for investors. Consequently, investors who only invest domestically are limiting their investment opportunities substantially and concentrating their risk to one market, making their portfolio returns susceptible to negative country specific shocks.

Estimated investible global real estate universe[4]



The chart above shows the breakdown of the global, investible commercial real estate universe. It is estimated to be around $29 trillion in size, split roughly equally across the broad North American, European and Asia Pacific markets. Taking a more granular look at each market would reveal that the sector composition of each market also differs.

A global real estate allocation increases the opportunity set and we believe that the size and the distribution of the investible universe warrants focus on the benefits of such an allocation.

[3] *Mercer, 2017, European Asset Allocation Survey*
[4] *CBRE Global Investors, 2017, Presentation: Global Real Estate Investible Universe. Note that figures are subject to rounding.*

Income and total return

Income from global core real estate has been relatively consistent over market cycles and regions, as illustrated by the chart to the right. The diversification across markets improves protection of this income base and reduces the impact of country-specific market cycles on total returns as cycles are typically not synchronised across regions. However, the asset class is inherently cyclical in nature and capital losses can more than offset income return at low or negative points of the cycle.

Global core real estate total annual returns

Source: MSCI

Diversification of return drivers

Differences in the composition of investible real estate across markets creates an opportunity for investors to gain exposure to different sectors and tenants. Sophisticated investors may even be able to take tactical views and allocate new capital to the most attractive subsectors across regions, provided sufficient cash flow and flexibility to do so.

Correlations of returns across national markets are not perfect, as is well documented in other asset classes. Capital deployed towards real estate is less mobile than other liquid assets which compound lower correlations within the asset class.

Correlations of annual returns 2007–2017

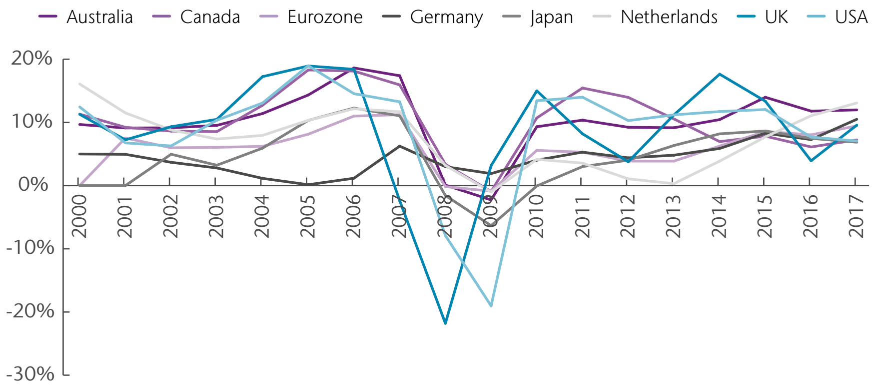
	Australia	Canada	Eurozone	Germany	Japan	Netherlands	UK	USA
Australia	1.00	0.71	0.95	0.74	0.92	0.69	0.45	0.88
Canada		1.00	0.53	0.21	0.54	0.19	0.21	0.82
Eurozone			1.00	0.84	0.87	0.85	0.40	0.74
Germany				1.00	0.76	0.83	0.37	0.53
Japan					1.00	0.65	0.33	0.77
Netherlands						1.00	0.02	0.38
UK							1.00	0.54
USA								1.00

Source: MSCI, showing correlations of IPD Total Return Annual indices in local currency

Protection from idiosyncratic shocks

Real estate returns are highly localised and driven by local economic forces. Relying solely on one national market results in a high exposure to market specific shocks that can have a detrimental effect on returns. When looking at annual returns of the countries in the correlation matrix above, the chart to the right highlights the extent of differentiation in returns in different years:

Annual total returns from 2000 – 2017



Source: MSCI, showing IPD Total Return Annual indices in local currency

There is a significant advantage in a global real estate allocation which can reduce volatility alongside exploiting structural changes in local economies. Localised events, such as the UK's 2016 referendum vote to exit the European Union, exemplify the risk of being highly concentrated to a single market.

Despite strong returns from UK commercial real estate since 2009, the outlook for the UK economy and real estate market is uncertain ahead of the March 2019 EU departure date. Consensus forecasts are that UK commercial real estate will return 4.8% per annum for the five years to 2022[5].

Capital values are expected to decline over this period which increases the attractiveness of global diversification.

Core versus higher risk strategies

Investors with size and scope have tended to access global real estate via closed ended value add and opportunistic strategies, usually as part of a wider private markets portfolio. Whilst these funds play a role within a high return seeking real estate portfolio, they take on considerable property risk and higher leverage. These strategies target low to high teen net returns and would not be suitable the purpose of broad, core real estate exposure and diversification from other growth assets.

For global core real estate, we would expect a return around 6–7% net per annum over the long term and therefore these strategies are suitable for investors seeking attractive risk adjusted returns with diversification from equities.

[5] *Investment Property Forum (IPF), May 2017, UK Consensus Forecasts (Spring 2018) Full Report*

Consideration points

Global, core real estate allocations should be considered a long term allocation, in a similar light to domestic real estate. However, there are additional risks and points of difference which investors should acknowledge prior to investing.

Regulatory risks

Legal structures of markets may vary across regions. As such, investors should consider country specific structures. UK property rights legislation, for example, is particularly well developed and favourable for institutional investors. The UK market was ranked as the most transparent real estate market by JLL in 2018. According to JLL, almost 75% of the direct real estate investment into the 100 markets covered by their transparency index is invested in the 11 most transparent markets[5].

Top 10 Most Transparent Real Estate Markets

1	United Kingdom
2	Australia
3	United States
4	France
5	Canada
6	Netherlands
7	New Zealand
8	Germany
9	Ireland
10	Sweden

Transparency and investor security are crucial within real estate and we therefore have a preference for investing in regions with strong property law and a stable regulatory regime.

Tax leakage

Tax treaties currently in place will benefit UK approved pension schemes to mitigate tax leakage but care still needs to be taken in the selection of suitably structured funds.

Fund initial entry costs

In contrast to UK core funds, core funds in most markets do not charge an upfront cost to reflect the costs of acquiring property when an investor subscribes for units. Instead, this is priced into the net asset value with acquisition costs typically amortised for a fixed period of time. This approach dampens the impact of upfront acquisition costs when investing in an established fund although there will still be a fixed exit cost similar to that of UK funds when divesting.

Liquidity

Global core real estate has similar redemption terms to UK funds and is supported by a robust secondary market which provides additional liquidity. Typically funds are dominated by institutional investors and are well established, meaning that they have long track records in managing investors' liquidity needs.

Currency

Real estate cash flows are inherently difficult to hedge and therefore currency risk is difficult to avoid in global real estate investments. Institutional investors may or may not hedge; some may take the view that real exchange rates are stable over the longer term, whilst others may wish to implement a hedging strategy either on specific investments or at an overall portfolio level.

Structural differences

Leverage, fees and valuation methodologies are all factors to consider when looking at global core real estate. The role of leverage is particularly notable and increases volatility of returns over the market cycle. UK core funds typically use very little or no leverage whereas in other markets, a core strategy will utilise moderate leverage which will typically be up to 40%.

[5] *JLL, 2018, In pursuit of hyper-transparency, http://www.jll.com/greti/most-transparent-real-estate-markets*

Accessing global real estate

Global real estate is an established asset class and can be accessed through listed or non-listed routes.

The choice of route to access global real estate has important implications for investors. For example, the listed route has a lower governance burden, greater speed of access and greater liquidity, but is associated with a higher degree of leverage and equity-like volatility of returns.

The non-listed route encompasses direct investments in assets or pooled vehicles that may gain exposure to real estate either directly or indirectly through investments in other funds. Non-listed investments are typically our preferred approach but require a longer investment horizon and have greater time and management costs for investors. They do, however, offer greater diversification from public equities and control over more granular exposures.

Institutional investors have an increasing amount of choice when accessing global markets. Smaller investors typically invest via a globally focussed pooled vehicle, while larger investors can have more control by building a bespoke segregated portfolio. Only the very largest institutional investors are able to build up global real estate exposure through direct investments in real estate assets.

The best route for investors will depend on individual circumstances but institutional investors in global real estate have a variety of investment options.

Improved access for core exposure

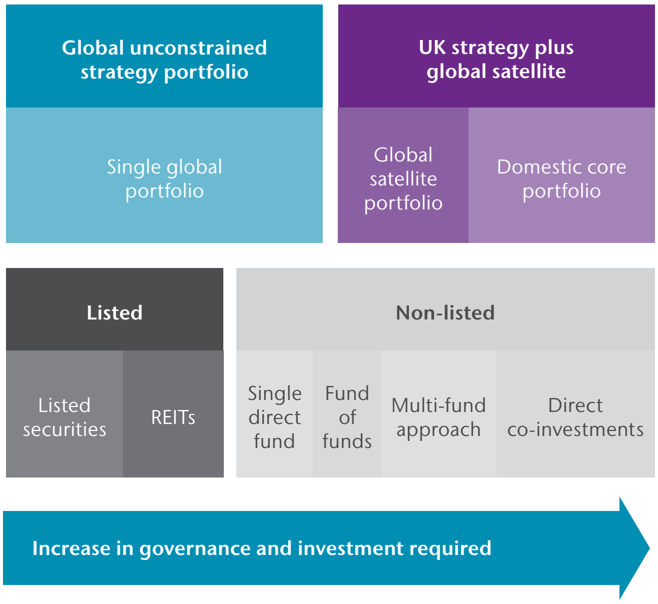
For institutional investors looking to access the global core market, there has been a historic lack of suitable funds or managers with sufficient global coverage and expertise.

There are still a limited number of strategies relative to pan regional strategies and in 2017 the INREV Global Real Estate Fund Index identified only 4% of the capital covered by the index to be attributable to global strategies[6]. However, prior to the Global Financial Crisis, there was no index covering such strategies and we anticipate more suitable funds will be launched as more investors are looking to access the asset class.

Although the number of funds with a global strategy is still low, there are significantly more regional funds or global fund of funds platforms available to investors. As a result, it is more feasible to build global exposure through an allocation to multiple funds which focus on different pan-regional or national markets. Larger investors also have the option to build exposure through a segregated approach with more bespoke exposures (country and sector/segment specific funds) and potentially direct investments to high conviction assets.

[6] *INREV*

Implementation



Source: Aon. For illustrative purposes only.

Target allocation	Global unconstrained strategy	UK strategy plus global satellite *(assume 60:40 split)*
£10 million	Global fund / fund of funds	**UK strategy:** 1–2 core funds **Global strategy:** Global fund / fund of funds
£50 million	**Low governance solution:** Global fund / fund of funds **Alternatively:** multi-funds approach (with potential cap on number of funds)	**UK strategy:** 1–2 core funds **Global strategy:** Global fund / fund of funds or possible multi-funds approach (as per global unconstrained strategy)
£150 million	Bespoke segregated indirect portfolio	Bespoke segregated indirect portfolio(s) of UK and non-UK funds

Source: Aon. For illustrative purposes only.

Exactly how to approach building an allocation to global core real estate depends on the structure and size of an investor's existing portfolio, as well as the desired risk, return and liquidity profiles. An investor's governance framework and any associated constraints will also determine the optimal route for investors.

The chart and table above summarise the different ways that investors can access the global core real estate market. Each route has different characteristics with respect to investment risk, return, cost and governance required. Significant trade-offs exist between investment characteristics and the governance burden on investors. For example, investors wishing to gain exposure to global real estate through a large number of individual strategies would need to consider the governance burden associated with implementing, monitoring their investments and the feasibility of rebalancing. In this scenario, it is typically more appropriate to outsource the construction process to a portfolio manager who has the resources needed to develop a comprehensive solution, manage cash flows and can allocate to the best opportunities over time.

If an investor wanted to maintain their current allocation to real estate then an allocation to global real estate can be funded solely through a reduction in domestic property. Alternatively as investors tend to have modest allocations to real estate we believe there is merit in considering increasing the allocation to real estate through the addition of a global real estate mandate.

Under either approach investors would need to be mindful of transaction costs. However, we believe the better risk adjusted returns from a global mandate, increased overall diversification and crystallising strong UK property returns over the past few years offsets any potential transaction costs.

Regardless of how an investor chooses to implement an allocation to global real estate, manager selection is crucial to the efficacy of a global real estate allocation. This is a particularly important consideration when going down the unlisted route.

Beyond core

If investors are looking to enhance returns through their real estate allocation then higher return seeking global value-add and opportunistic real estate strategies may be worth considering. These strategies, which typically target net returns of 10%+ p.a. are more focussed on capital appreciation than income. They can be positioned as a satellite to a core real estate allocation and may be appropriate to include depending on client specific circumstances. However, investments in these strategies play a different role in a real estate portfolio to core real estate.

Finally, clients can also add more specialist real estate strategies such as explicit inflation-linked property or real estate debt to their wider portfolios.

Summary

- The majority of UK investors have real estate exposure through core domestically focussed strategies. While UK core property has performed well over the past few years the outlook is less compelling which is illustrated by the lower return expectations of UK real estate in the midst of Brexit uncertainty.
- The real estate investible opportunity set is substantial and there are benefits to adopting a global approach to real estate investing. While this can be accomplished through a reduction in domestic real estate we also believe there is merit in considering increasing ones overall allocation to real estate.
- Global real estate offers the potential for enhanced returns, as well as strengthening the stable income profile of the asset class and providing a cushion against country specific risks.
- The core segment of the real estate spectrum is most appropriate for investors seeking diversification and stability of income. Portfolios focussed on this segment offer a strong income component underpinning returns with potential for additional performance generated through active asset management.
- For investors looking to enhance returns they may want to consider going beyond core and considering global value add or opportunistic strategies.
- Global real estate should be considered a long term allocation and investors should acknowledge the additional risks associated with global investing. Portfolio construction and manager choice are critical to mitigating some of the risks and to delivering the potential returns on offer.
- The best route for investors will depend on individual circumstances, although for the majority of our clients seeking diversification and income, the non-listed route is likely to be most appropriate.
- We recommend that investors revisit the case for global real estate in light of changes in market conditions and wider developments discussed in this paper.

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