The case for real estate

Michael Ness
Head of Separate Accounts UK,
CBRE Global Investors

Real estate plays an important role as an asset class in both domestic and global multi-asset portfolios. The key benefits of global real estate investment include competitive risk-adjusted returns, high income yields and low correlations with stocks and bonds.

Real estate is an attractive yield investment. The majority of total returns for real estate investment come from income, not appreciation. This is not a new concept, although the recent Global Financial Crisis (GFC) highlights the value of having high, stable yielding assets in a portfolio.

The global investable universe for real estate is growing and offers enhanced investment opportunities. CBRE Global Investors estimates that the global institutionally-investable real estate market has a value of £17.2 trillion. This is predominantly made up of assets in developed markets. However, with their economic growth, and demographic and structural trends underway, emerging markets are expected to increase their share sizably over the coming years.

In a world of opportunities, it is important to remember that localised qualities impact real estate performance. A building's location and physical qualities influence the type, structure and length of lease that is achievable. Along with the covenant strength of a tenant these factors dictate a property's income profile and its growth potential.

Global real estate investment is growing and is expected to expand over the coming decades. Cross-border real estate capital now accounts for one-fifth of real estate transactions. The figure is expected to increase, given the considerable benefits of having global real estate in a mixed-asset portfolio.

Key benefits

Real estate is playing a more important role as an asset class in both domestic and global multi-asset portfolios. Several factors have contributed to this, including:

1. Large global investible universe;
2. Competitive risk-adjusted returns;
3. Portfolio diversification;
4. Attractive and stable income returns.

This article will demonstrate how these factors are enhanced by investing abroad, in addition to investing domestically.

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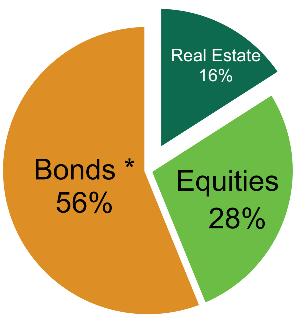
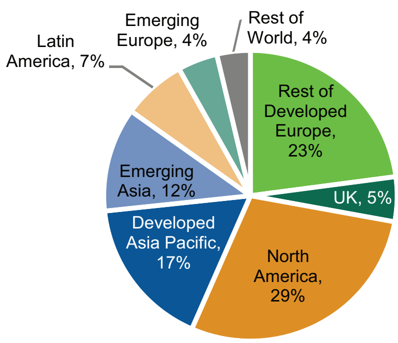
Figure 2: Global asset class capitalisation



Source: CBRE Global Investors, EIU, World Federation of Exchanges, City UK, Stock and bonds investible universe represented by total market capitalisation.

Figure 2: Real estate investable universe



Source: CBRE Global Investors

Large global investable universe (GIU)

CBRE Global Investors estimates that the global institutionally-investable real estate market has a value of £17.2 trillion. This represents roughly 16% of the total global mixed-asset class market capitalisation, which includes stocks and bonds (Figure 1). On an absolute and relative basis, this estimate indicates the market is deep enough to support at least a 10% real estate allocation in a multi-asset portfolio, a typical allocation for pension funds.

The UK real estate investible market is approximately £860 billion. Although large, it only represents 5% of the global investable universe; the majority of real estate lies beyond national borders (Figure 2). An investor can greatly reach expanded investment opportunities by looking abroad, but many UK pension funds tend to invest exclusively within national borders when it comes to real estate. This contrasts with other asset classes such as equities, where most UK pension funds adopt a global investment approach to broaden their opportunities, enhance returns and improve portfolio diversification.

Figure 3: UK total returns annualised (1970-2012)

	Total Returns		Standard Deviation
	Nominal	Real	(Risk)
Retail Price Index	6.3%		
Real Estate	10.7%	4.1%	11.3%
Equities	12.4%	5.8%	29.3%
Gilts	10.1%	3.5%	13.4%

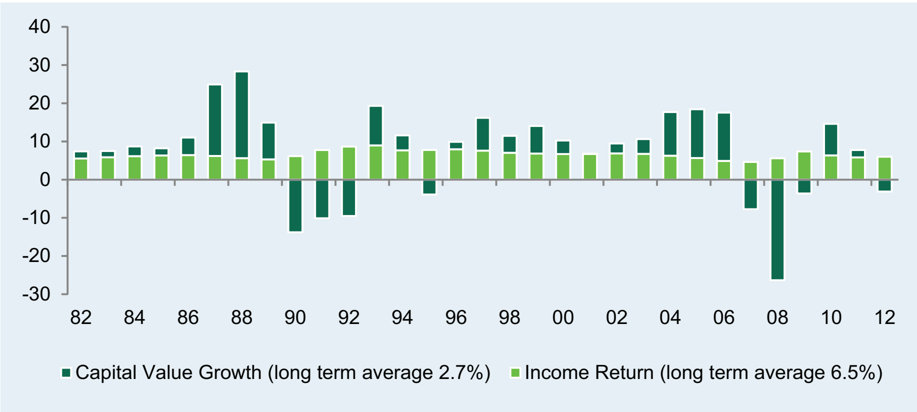
Source: IPD, Reuters

Figure 4: UK correlations in total returns 1970-2012

	Correlations (Total Returns)		
	Real Estate	Equities	Gilts
Real Estate	1.00		
Equities	0.28	1.00	
Gilts	0.04	0.56	1.00

Source: IPD

Figure 5: UK total return contributions, % LATEST=2012



Source: IPD

Competitive risk-adjusted returns

Real estate generates attractive returns. In the UK, unlevered real estate generated an annualised total return of 10.7% over the past 42 years. On an inflation adjusted basis, this translates into a total return of 4.1% per annum. (Figure 3) Although real estate returns were in absolute terms lower than those of equities, when adjusted for risk, real estate generated superior returns over this period compared to both 10-year government Gilts and equities.

Portfolio diversification

Real estate provides portfolio diversification, owing to low correlation of real estate returns to other asset classes. In the UK, the correlation between real estate and Gilts was very low at 0.04 from 1970-2012. The correlation between real estate and equities was also low at 0.28. Both correlations are below 0.50 mark and thus support the argument that real estate is a solid diversifier in a multi-asset portfolio. In contrast, the correlation between equities and Gilts (0.56) was higher than each of these asset classes combined with real estate. (Figure 4)

Attractive and stable income

Real estate generates attractive yields. This has played an important role in investment portfolios for its diversification benefits. Figure 5 illustrates that in the UK, the majority of total returns come from income, not capital value appreciation. This is clearly not a new concept, although the recent GFC highlights the value of having high, stable yielding assets in a portfolio. Since 1981, average annual UK income returns have been 6.5%; furthermore the income return has been consistently above 5% with the exception of 1989/90 and 2006/7, which history shows were periods of over-heated pricing of the property market.

Real estate's yield generating capacity is potentially even more important in an environment where yields from traditional fixed-income instruments have declined significantly due to strong demand from income-oriented and risk-averse investors. This is particularly true in the case of index linked Gilts in the UK. This is presented in Figure 6, and highlights that property in the UK continues to offer attractive value relative to "safe money".

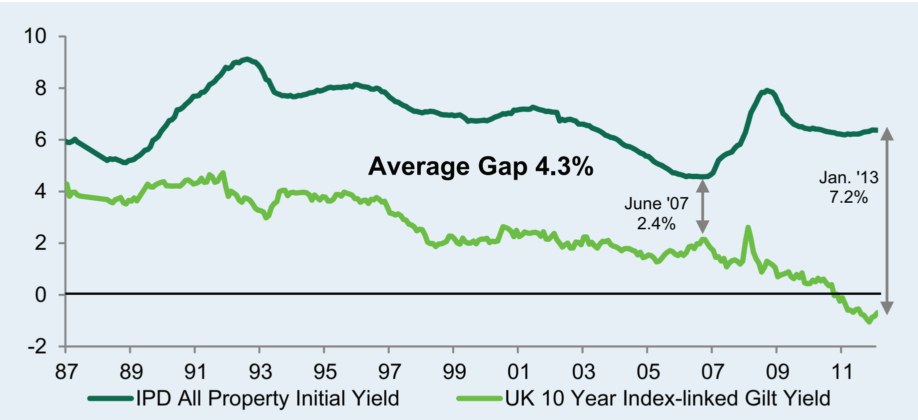
Certainly one reason why spreads in the UK have been exacerbated is that in an environment of risk aversion, yields on safe-haven assets, including sovereign debt, have been driven to precariously low levels. For this reason, a similar trend between initial property yields and nominal bond yields is readily apparent in other mature property markets. Although real estate yields at the UK All Property level have compressed after peaking in 2008/2009, they remain attractive on an absolute and relative basis.

Broadly speaking, global cap rates are much higher than most current 10-year government bonds, which are currently sub-2% in Germany, slightly above 2% in the United States and under 1% in Japan. A global real estate portfolio provides valuable diversification benefits and this also applies to income streams, as global property cash flows have low correlations. Total returns are clearly a strong consideration when investors make an asset allocation, but yield is a critical element for income-oriented investors.

Concluding thoughts

Real estate plays an important role in multi-asset portfolios. This article outlined that global real estate investment offers numerous benefits. Above all these include competitive risk-adjusted returns, attractive and relatively stable income returns, portfolio diversification and a large global investible universe. A skilled fund manager should be able to help a discerning investor capitalise on these benefits, while mitigating risks factors through appropriate sector allocation and portfolio structuring. Indeed, this can be achieved by building a global real estate portfolio, by choosing the right investment vehicles and through a local presence.

Figure 6: UK yield differentials



Source: IPD, Reuters