Real estate has earned itself a firm place in institutional portfolios, with worldwide investment in property reaching a record $13.6 trillion. However, one key difference remains between investor attitude to real estate and to other asset classes. Pension funds and other institutions tend to see international allocation as an integral element of bond or equity holdings. In real estate, however, many still only invest in the domestic market and are willing to consider global property only in exchange for a premium return (and therefore higher risk).

In this paper we offer the contrarian view – that international real estate allocations should be primarily about long-term diversification of income and maintaining attractive total returns, without the automatic expectation of incremental return. We examine the heuristic hurdles involved, as well as the advantages of core global real estate investment.

Our research shows that a core global real estate portfolio offers:
- Diversification benefits, along with a degree of protection against any downturns in the domestic market;
- Scope for higher risk adjusted returns;
- Exposure to a large and diverse opportunity set.

### How do we define global core?

<table>
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<th>Characteristics of core property</th>
<th>Benefits for investors</th>
<th>Global comparison</th>
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<td>Good location;</td>
<td>High quality occupiers paying market rents without the need for excessive incentives;</td>
<td>International standards of construction;</td>
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<tr>
<td>High quality standards of construction;</td>
<td>High tenant retention;</td>
<td>International standards of lease covenants;</td>
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<td>High quality amenities and fit out;</td>
<td>Active market in which assets can be sold at or above carrying value;</td>
<td>Income that can be repatriated to an investor’s home base;</td>
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<td>Adaptable to different users and to evolving occupier requirements;</td>
<td>Properties can be readily leased in the event that the existing tenant(s) depart.</td>
<td>Returns denominated in a freely tradable, liquid currency.</td>
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<tr>
<td>Future-proofed to expected technological and environmental changes;</td>
<td>Part of a liquid, mature and transparent real estate market.</td>
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### Global opportunity set

Investment grade commercial real estate is split broadly evenly across three global regions – Asia Pacific, Europe and North America. Therefore, by focusing only on their own region, investors effectively turn their back on around two-thirds of the potential global investment universe and on the opportunities within.

The opportunity is reduced even further if investors focus on their own home country. The United States is by far the largest single country real estate market in the world, but even that only accounts for around a quarter of the global invested stock. The share for other countries is much smaller.

By focusing only on their own region, investors effectively turn their back on around two-thirds of the potential global investment universe and on the opportunities within.

1DTZ, ‘Money into property 2015’.
Diversification benefits

Portfolio optimisation illustrates the scope to increase risk-adjusted returns by investing abroad in prime core real estate.

Taking a US investor as an example, our research shows that reducing allocation to the US – while increasing European and Asia Pacific holdings across the three sectors – results in a higher Sharpe ratio and growing portfolio returns.

Over the period analysed (2000 to 2014), reducing the portfolio’s exposure to the US property market improves both the risk-adjusted return and overall portfolio returns. As the global share of the portfolio expands, the risk-adjusted returns continue to noticeably benefit from increased international exposure until the fund holds just 10% of the value of its portfolio in the US. At this point the Sharpe ratio is 0.80, with 50% of the real estate portfolio invested in Asia Pacific and 40% in Europe.

In reality, it is unlikely that investors will want to make such a large allocation overseas, and their ability to do so may indeed be restricted by covenants. But even a more modest – and more realistic – 30% holding of global real estate would have significantly increased the Sharpe ratio to 0.72 from 0.63 for a fully domestic portfolio. At the same time, portfolio returns would have risen to 10.0% from 8.9%.

The same principle holds globally. By investing half of their portfolio across two non-domestic regions, investors – be they European, American or Asian – would have seen improved performance over the past decade than if they had just remained in their home region.

Overcoming heuristic hurdles

The size and quality of the opportunity set, and the prospect for strong risk-adjusted returns are key considerations for investors. However, past experience and perceptions – so called heuristic factors – can also have a strong impact on the eventual investment decision.

A number of such perceptions are often associated with global real estate investment. Here we illustrate how the rationale for the return premium fails when placed under scrutiny.

1. Lack of familiarity

Often a lack of familiarity is cited as a barrier to international real estate investment. The unfamiliar can seem risky, so investors ascribe greater risk to foreign real estate and therefore demand higher return from it, which can only be achieved through more speculative investments.

However, core real estate – well located, well leased properties with low leverage – is much the same in one developed country as in another. High quality, prime offices, for example, tend to have similar characteristics regardless of whether they are in Tokyo, New York, London, Melbourne or another major global city. In addition, foreign markets may have more favourable leasing practices, demand/supply dynamics or prospects for economic and population growth.

Real assets, arguably, require more on-the-ground expertise than equities or fixed income. However, this hurdle can be overcome with the help of an investment manager who specialises in the chosen region or locality. Indeed, such an approach is prudent when taking the first step into global rather than just domestic property investment. This can be achieved through investment in a fund or through creating a segregated account or a joint venture with a local manager. Direct overseas investment is largely the preserve of only the world’s biggest pension funds.

2. Currency risk

Assets – be they bonds, equities or real estate – are generally priced in the currency of their domicile, so any kind of global portfolio would open up investors to foreign exchange fluctuations.

Currency risk, however, can be hedged. This can be done either directly (through FX options and other instruments) or indirectly, by balancing out global exposure across the entirety of an investors’ global, multi-asset portfolio.

By investing half of their portfolio across two non-domestic regions, investors – be they European, American or Asian – would have seen improved performance over the past decade than if they had just remained in their home region.
Furthermore, it is important to consider currency exposure in the context of the total portfolio. For example, with 10% of total funds allocated to real estate, of which 30% is international, an investor would have only 3% currency exposure at the total portfolio level.

Conversely, some investors may actively seek out the currency risk. If a country’s economy is expected to do well then its property market is also likely to perform strongly while its currency appreciates, potentially adding an extra layer of returns for a foreign investor (albeit alongside extra risk).

3. Fees
Fees are an important consideration for investors, and some associate foreign real estate with higher fees than domestic strategies. This may hold true for certain closed-end opportunistic limited partnerships, which are more akin to private equity than to pure real estate. Typically, opportunistic strategies charge a combination of fees on committed equity, drawn equity and on performance above a hurdle – the “two and 20 model”. In aggregate, the fee and expense leakage on such strategies can be 3% per annum or more.

In contrast, investors can select international, regional or country-specific core strategies which charge only a base fee on net asset value, resulting in a much lower gross to net leakage of 1.5% or less.

4. Risk and return trade off versus opportunistic investment
Opportunistic strategies can grab headlines and investors’ attention with the potential to earn a net 15% or even 18% internal rate of return (IRR) from offshore real estate. That is not something that can be matched by a core strategy, either globally or domestically.

However, to achieve such high rates of return, opportunistic strategies often involve relatively high leverage – of up to 70%. Therefore in order to achieve a net IRR of 15%, a project would need gross returns to exceed 20% per annum, equating to two times the equity multiple over a five year hold period.

The success of an opportunistic strategy is strongly linked to its “vintage” – were the assets acquired in a favourable period to buy and disposed of at a favourable time to sell? The total returns from opportunistic strategies are not immune to beta, irrespective of management skill.

For such strategies to achieve success, all the stars need to align. If even one star falls out of alignment, the investment outcome will rapidly erode, accelerated by the high leverage.

By contrast, low leverage, open-ended core strategies are focused more on income generation rather than just capital growth, resulting in a more stable returns profile. Whilst not immune to cycles, they are not faced with the same pressures to release capital, are not constrained by finite fund life horizons, do not rely on leverage and offer far lower fees.

Conclusion

Our research shows that international real estate is a key source of diversification, just as for any other asset class. By building a global core property portfolio, US, European and Asian investors can have the potential to improve risk-adjusted returns compared to what can be achieved by focusing only on their domestic markets.

When considering offshore real estate investment, we advocate security at the asset level with an emphasis on strong tenant covenants and excellent location. Such a strategy reduces risk and comes with lower fees than opportunistic real estate investment, while still reaping the benefits of higher risk-adjusted returns thanks to a wider opportunity set and strong diversification benefits.

By building a global core property portfolio, US, European and Asian investors can have the potential to improve risk-adjusted returns compared to what can be achieved by focusing only on their domestic markets.

The Oval, Frankfurt, Germany

2 The “two and 20” fee structure is commonly used in private equity and hedge fund investments, where funds charge a flat 2% of total asset value in management fees, as well as 20% of any profits earned.

3 PREA, “An overview of fee structures in real estate funds and their implications for investors.”
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